decision technology

Damage by Default:
The Flaw in Pensions Auto Enrolment

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Executive Summary

Workplace pension auto enrolment means more people are saving for their retirement, and upcoming increases to minimum contributions will dramatically boost the amount being saved.

Since most employees do not actively engage with their pension savings, around £43bn will be invested each year in default funds from 2019.

But default funds cannot meet the varying needs of millions of savers, meaning £9bn (or £700 per employee) will be wasted through contribution misallocation each year.

New behavioural science research can help overcome the engagement barrier and provide recommendations for Government, pension providers and employers to reduce the waste of savings.

A flawed policy

"Automatic enrolment is a policy that works"[1]. So said the UK Government when asking employers, employee groups, pension industry professionals, financial advisers and the public to provide views and evidence on the success of the scheme to date. The Department for Work and Pensions estimates that by 2018, around 10 million out of an eligible population of 11 million people will be newly saving or saving more as a result of auto enrolment[2].

But while auto enrolment may have increased the number of people with a workplace pension and the amount they are saving, it risks failing to provide the best outcomes for savers because it places them in default funds. Default funds vary substantially between pension providers, so are unlikely to be appropriate for all individual employees. The value of pension savings is being destroyed as a result, and the amount of money mismanaged in this way is about to increase dramatically as auto enrolment is rolled out to all employers, and minimum contributions rise.

> *"Auto enrolment risks failing to provide the best outcomes for savers by placing them in default funds."*

The science of saving

Auto enrolment was introduced in 2012 in a bid to counter falling pension scheme participation. The policy requires employers to enrol employees into a workplace pension scheme and make a minimum saving each month unless they choose to opt out.

In many ways, the policy has been highly successful. From 2012 to 2016, the percentage of employees in workplace pensions increased from 47% to 68%[3], and by 2015 the total amount saved each year rose from £75bn to £82bn[4]. This increase was driven by auto enrolment.

However, auto enrolment does not solve the problem of employee disengagement. Instead, it amplifies it by enrolling the most disengaged people. More people may be saving for retirement, but they do not care any more about having a pension than they did about not having one. And they are unlikely to be getting the rate of return from their investment they could be. This is because the vast majority of savers remain in the default fund.

Wasted investment

Our research indicates that around £43bn will be invested in default funds every year from 2019 as more employers adopt auto enrolment and minimum contribution rates increase. But these default funds cannot adequately meet the varying needs of so many people.

Based on a study of employees' preferences for alternative funds, we estimate that around £9bn of value will be wasted each year from 2019 by the misallocation of savings. If people were to engage with their pension and choose a better fund to invest their money in, each employee could increase the value of their pension pot by an average of around £180,000.

"Government, pension providers and employers all have a role to play in improving engagement with pensions."

A new kind of success

As part of its review of auto enrolment, the Government is rightly considering how to improve engagement to enable people to maximise their savings. This must include measures to encourage people to change the funds their pension is invested in. And the Government, pension providers and employers all have a role to play.

The Government should:

1. Communicate how much money employees are throwing away each day by remaining disengaged with their auto enrolment pension.
2. Emphasise that default funds are not recommendations, and better options may be available.
3. Invest in financial education so employees are more familiar with financial concepts and terminology and better equipped to make investment decisions.

Pension providers should:

1. Identify employees who have not accessed their pension accounts or made an active choice about where to invest and send tailored communications to help them understand how much they stand to lose by remaining in the default fund.
2. Improve their website design to make it easy for employees to compare between funds and make the best choice available to them.
3. Ensure information on their websites is simple and understandable, without jargon, so it is as easy as possible for employees to make investment decisions.

Employers should:

1. Select pension providers whose default fund best suits the needs of their employees, in case they do not engage, and adapts to employees' lifestage.
2. Provide clear guidance for employees about how to log in and access accounts with pension providers, and ensure information on the issues to consider when deciding how to invest their pension savings is readily available.
3. Prompt employees to review their pension on an annual basis and to consider whether their investment funds are meeting their needs.

An Epidemic of Apathy:
Why auto enrolment is not enough to solve the savings crisis

Pensions is not a sexy subject. Most people find the concept of saving for retirement boring and the financial jargon used to describe the different ways they could do it confusing.

Behavioural science shows that, as human beings, we are hard-wired to prefer things that give us instant reward; since pensions epitomise delayed gratification, it's perhaps not surprising we don't pay more attention to them.

In 2012 less than half of UK employees had a workplace pension[5]. This prompted the Government to significantly reform the pension system, introducing auto enrolment as a behavioural 'nudge' to encourage greater participation, in a manner similar to the famous 'Save More Tomorrow' scheme used to increase 401(k) savings in the US. The theory behind the policy was that since people were apathetic about joining pension schemes, they would be similarly apathetic about leaving them once enrolled.

In many ways, the nudge has been highly successful. From 2012 to 2016, total workplace pension enrolment increased from 47% to 68%[6], driven by a surge of auto enrolment in defined contribution (DC) pension schemes. The simultaneous introduction of minimum contribution rates (see Table 1) increased the total amount saved by all employees from £75bn to £82bn from 2012 to 2015[7]. These figures will continue to increase as auto enrolment is rolled out across the wider workforce (see Table 2).

However, as the Pensions Minister has acknowledged[8], while auto enrolment has been a success, there is much more work to be done if it is to succeed in providing people with a financially secure retirement.

This is not least because auto enrolment, while increasing the number of savers and level of savings, does not solve the problem of low levels of engagement with pensions. Similarly, employees may interpret minimum contribution levels as a recommended rate of saving, therefore dissuading them from saving more.

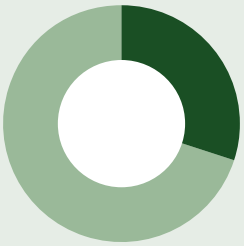
Table 1: Workplace pension minimum contributions[9]

Date	Employee Contribution	Employer Contribution	Total Contribution
2015	1%	1%	2%
2018	3%	2%	5%
2019	5%	3%	8%

Table 2: Automatic enrolment rollout deadlines[10]

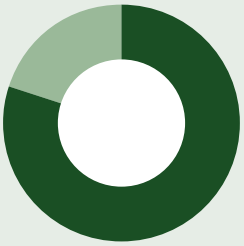
Employer Size	Rollout Deadline
250 or more employees	February 2014
50 to 249 employees	April 2015
30 to 49 employees	October 2015
Less than 30 employees	April 2017

Those who are automatically enrolled in a scheme are unsurprisingly less engaged than those who actively choose to have a pension. This was demonstrated in our recent pension engagement audit of over 900 employees, as shown in the graphic below.



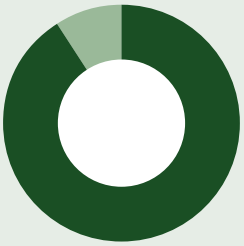
33%

of those who have a pension don't know who their pension provider is



80%

don't know how much is in their pension pot



91%

don't know what funds their pension is invested in

Historically, employers provided defined benefit (DB) pension schemes, where employees received a fixed amount of money based on their earnings history, length of service and age. The employer was responsible for investment decisions, but the pension payments were not directly dependent on investment returns.

However, auto enrolment disproportionately places employees in DC pension schemes. This means employees are responsible for investment decisions and have to face the consequences of poor fund choice, as the level of income in retirement is dependent on investment performance rather than being guaranteed. If employees do not choose the best fund to invest in, they are at risk of losing out on thousands of pounds in retirement.

This comes at a time when millions more employees will be auto enrolled and minimum contributions are set to rise, massively increasing the amount of money at stake. So engagement with pensions is more important than ever.

Damage by Default:
Why savers should be changing which fund they invest in

Our estimation of default fund growth

	2016	Our Prediction 2019
Employees with DC pensions (% of workforce)	38%[11]	48%
Estimate of amount saved in DC pensions	£26.2bn	£53.5bn
Estimate of amount saved in DC pension default funds	£21.1bn	£43.0bn

The Department for Work and Pensions reported that employees saved just under £82bn in 2015[12]. From this figure, we estimate that the 38% of employees with DC pension schemes contributed around £26bn under auto enrolment in 2016.

This figure is set to rise. Given the trends in DB and DC pension scheme membership and the continuing rollout of auto enrolment we expect 48% of employees to have a DC pension by 2019. Additionally, minimum contributions will increase substantially, from 2% to 8%. This means that over £53bn will be saved in DC pensions each year from 2019, when enrolment and contributions have reached their peak[13].

Our research suggests that 8.5 million of the 11 million people enrolled in these schemes are not managing their pension, so it's likely that around £43bn will be thoughtlessly invested in 'one-size-fits-all' default funds each year from 2019 onwards.

This is a huge problem. All pension professionals would agree that no single fund can meet the needs of over 8 million people. Funds take on different levels of risk, vary in asset allocations and geographies, and can be either actively or passively managed – all of which affects the return on investment. No fund can be all things to all people. But just how much damage is being done to employees who leave their pension savings in default funds?

The cost of apathy

To answer that question, we provided employees with the opportunity to choose their own fund from various risk levels. As they explored their options, we showed them the distribution of annual retirement incomes they could expect to receive if they used their pension pot to purchase an annuity upon retirement.

If a typical employee, earning around £22,000 annually and contributing 8% to their pension for 40 years, chose an amount of risk similar to that of an average default fund, they could expect an annual income of around £11,700 when they retire[14]. In a sustained bull market their income could be as much as £29,320, but if conditions are poor it could be as little as £3,900 (see Table 3). In general, taking more risk results in higher returns, but it can result in lower returns in bear markets; lower risk shields investors from economic downturns.

Table 3: Expected return from various funds in different market conditions

	Market Conditions		
Fund	Bear	Average	Bull
Average Default Fund	£3,900	£11,704	£29,321
20% Less Risk	£3,865	£9,081	£18,854
20% More Risk	£3,775	£15,107	£45,429

Overall, we found that employees preferred funds with a higher level of risk than is achieved by the average default fund (see Graph 1). This means pension providers should increase the risk profile of their default fund in order to meet the risk appetite of the greatest number of employees.

However, it is still crucial that employees are engaged with their workplace pensions. Although employees prefer riskier funds in general, we observe a considerable amount of variation in fund preference. This means it is highly unlikely that employees are investing in the right fund, unless they have actively engaged with their pension.

Furthermore, default funds are far from standardised, but vary substantially across the nine major UK pension providers. Their default funds vary in terms of number of asset classes (ranging from five to twenty), the percentage held in equities (as low as 35% to as much as 85%), and management style (active versus passive)[15]. Employees do not have control over the pension provider their employer chooses, so cannot be sure if the default fund is suitable until they have personally engaged.

This matters, because a relatively small change in risk can result in a dramatic change in pension returns over the long term. Comparing the average self-chosen fund against the average default fund, we found that the self-chosen funds increase expected retirement income by +£4,544 (see Table 4). That's an improvement of 39%.

Graph 1: Riskiness of Self-Made Funds

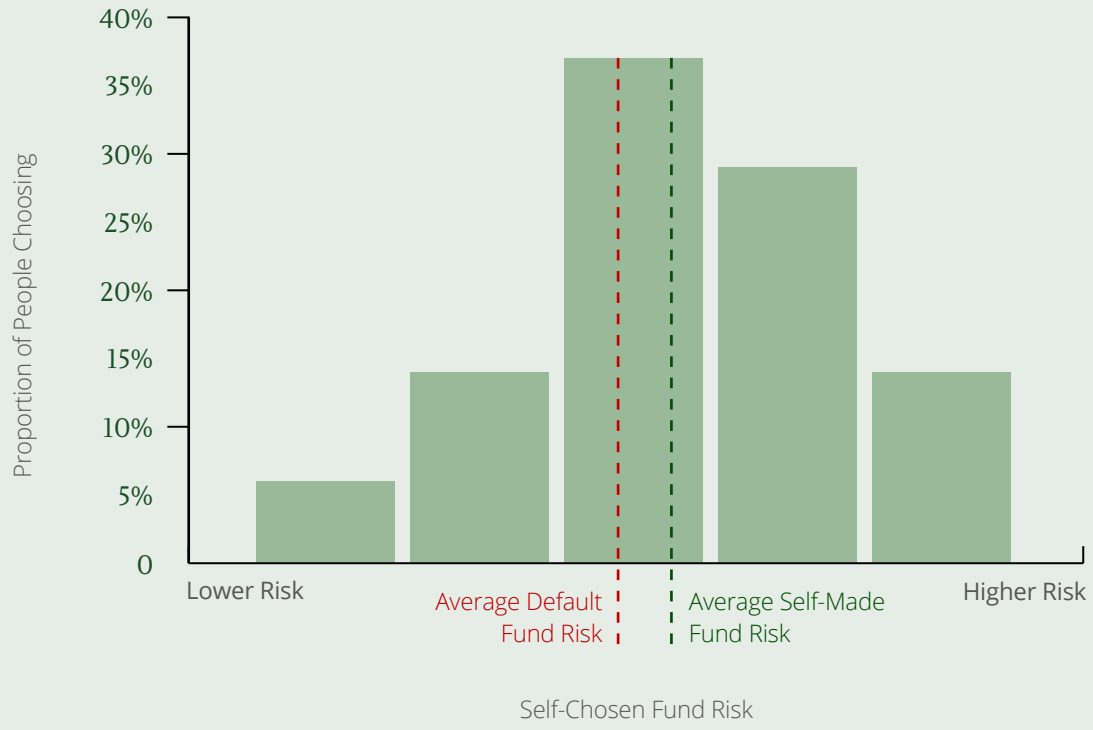


Table 4: Expected return from various funds in different market conditions

	Market Conditions		
Fund	Bear	Average	Bull
Average Default Fund	£3,900	£11,704	£29,321
Self-Chosen Fund	£3,710	£16,248	£59,649
Difference	-£190	+£4,544	+£30,328

This additional income has been generated by taking more risk, but even after converting the default fund and self-chosen fund performance into risk equivalent outcomes, the self-chosen fund is still 29% more valuable than the default fund[16].

Almost a third of the money that's being paid into default funds by young, early career employees is being wasted. The amount of value destruction decreases as people get older and closer to retirement, because there is less time for mismanagement to erode the pension pot's value. Overall, for an average employee the value destruction is around 20%. This suggests that of the £43bn that will be invested in default funds each year from 2019 onwards around £9bn, or £700 per employee, will be wasted[17].

Put another way, by failing to properly engage with their pension employees are likely to retire with a much smaller pension pot than they could have. For example, an employee auto enrolled into a default fund aged 21 in 2020 and saving 8% of their salary could end up with about £180,000 less in their pension pot upon retirement than someone in a similar position who engaged with their pension and chose an appropriate fund[18].

Urgent action is needed. While many people will spend hours on price comparison websites looking for the best energy supplier to save £240 a year, few spend time reviewing their investments – and yet they could save around £700 a year that is currently being wasted in their workplace pension. This discrepancy needs to be addressed.

From 2019, around

£9bn

of the money invested in auto enrolment default funds each year will be wasted

Smarter Savings:
How to get more out of auto enrolment

Despite the success of auto enrolment in increasing the number of people contributing to a workplace pension, as it stands it will not be enough to give most people sufficient savings to effectively replace income upon retirement. So, it is critical that employees engage with their pension and select a more appropriate fund than the default to invest their money in.

But fewer than 10% of the people we contacted knew what their pension pot was invested in. Of the 80% whose money was in default funds, only 4% had tried to change the fund they invest in. Clearly, the lack of engagement that prompted the Government to introduce auto enrolment five years ago remains the biggest barrier to overcome if we are to encourage adequate pension saving.

"Lack of engagement is the biggest barrier to adequate pension saving."

Behavioural science provides a number of reasons for low levels of engagement with pensions:

- The benefits of pensions are only realised in the distant future at the point of retirement, which undermines the relevancy of any action individuals take and helps them justify procrastination.
- Psychological inertia leads people to avoid decisions they expect to be difficult, causing employees to ignore or postpone any choices related to pensions again and again.
- Employees may perceive default funds to be a recommendation from their employer, pension provider and/or the Government, and therefore believe the default fund is the best place for their savings so there is no need for further engagement with their pension.

Behavioural science can also help overcome these barriers. As part of our pension engagement audit we found that employees are significantly more likely to engage with their pension and switch out of the default fund if they can clearly see the value of doing so. Similarly, making the switching process as easy as possible increases the likelihood of employee engagement. These results, and our expertise in behavioural science, form our recommendations to the Government, pension providers, and employers.

The Government should:

1. Communicate how much money employees are throwing away each day by remaining disengaged with their auto enrolment pension. This will appeal to people's aversion to loss and give the issue a sense of immediacy and relevance.
2. Emphasise that default funds are not recommendations and better options may be available, to reduce people's complacency.
3. Invest in financial education to undermine psychological inertia, so employees are more familiar with financial concepts and terminology and therefore better equipped to make investment decisions.

Pension providers should:

1. Identify employees who have not accessed their pension accounts or made an active choice about where to invest and send tailored communications to help them understand how much they stand to lose by remaining in the default fund.
2. Improve their website design to make it easy for employees to compare between the fund they are currently investing in and the other options available, with information on rates of return, management fees and risk level etc. But avoid presenting too many funds, to prevent choice overload.
3. Ensure information on their websites is simple and understandable, without jargon, so it is as easy as possible for employees to make investment decisions. Even minor inconveniences can quickly derail decision making

Employers should:

1. Select pension providers whose default fund best suits the needs of their employees, in case they do not engage, and adapts to employees' lifestage.
2. Provide clear guidance for employees about how to create accounts with pension providers, and ensure information on the issues to consider when deciding how to invest their pension savings is readily available.
3. Prompt employees to review their pension on an annual basis and to consider whether their investment funds are meeting their needs.

The Government, pension providers and employers all have a moral responsibility to ensure employees get a good deal from workplace pensions. Clearly there will be a cost associated with improving customer engagement, but it is a cost that is well worth paying. However, some costs can also be offset.

For Government, given increased engagement will reduce the £9bn we predict will be wasted each year from 2019 and increase the average pension pot by £180,000, there will be future savings in social care and other public services as people will have higher incomes in retirement. Pension providers will have the opportunity to promote specialist funds with higher fees as engagement increases, as well as improving their brand reputation through increased customer communication and a smoother online pension management process. And employers can reduce staff turnover and save on recruitment costs by demonstrating they care about the future welfare of their staff and will help them make the most of their pension savings.

Increasing the number of people with a workplace pension and the amount they are saving is a significant success story. But unless engagement is improved and people maximise their savings by investing in the best funds available, auto enrolment will prove little more than a footnote in the story of the UK's retirement finance crisis.

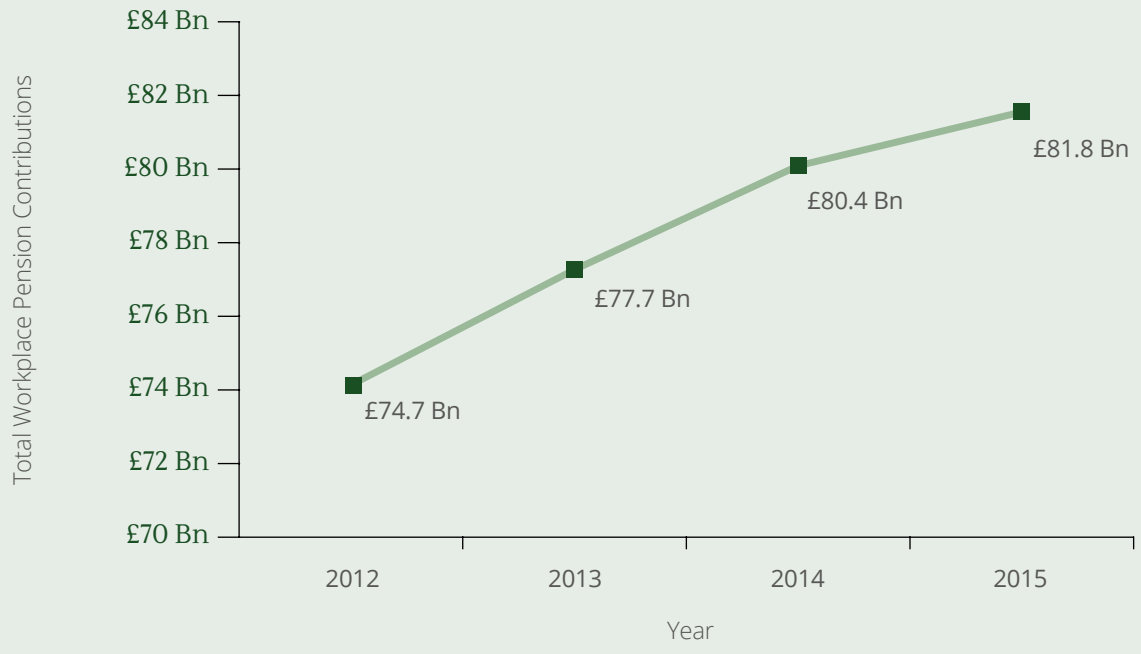
Technical Appendix

Pension Enrolment & Contributions

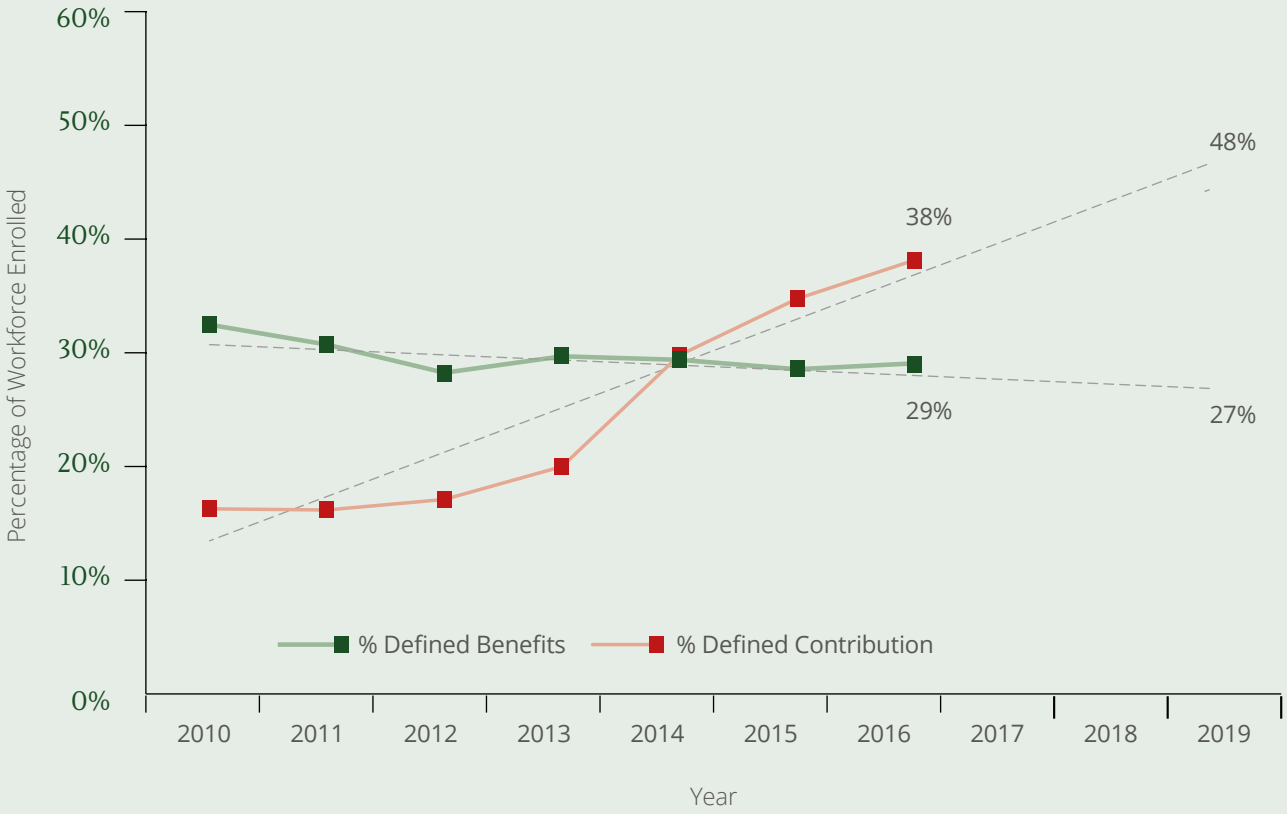
Driven by auto enrolment, total workplace pension contributions have increased by £7.1bn from £74.7bn in 2012 to £81.8bn in 2015 (see Graph 2)[19].

Workplace pension contributions are a function of two things: workplace pension enrolment, and contribution rates. In order to predict annual contributions, and therefore the amount of money squandered in default funds, we predict enrolment and contribution rates.

Graph 2: Total annual contributions to workplace pensions



Graph 3: Modelling enrolment in DB and DC pension schemes



To determine enrolment in DB and DC pension schemes, we modelled the historic trend of enrolment from 2010 to 2016[20] (see Graph 3), and thereby predicted enrolment in these schemes each year up to 2020. From this model we predict enrolment in DC schemes will increase from 38% in 2016 to 48% in 2019.

Table 5: Number of employees by banded rate of employee contribution and sector

Employee Contribution (2016)		Number of Employees	
	Public Sector	Private Sector	Total
Zero	73,549	1,441,178	1,514,727
Greater than 0 to under 2%	40,452	7,490,567	7,531,019
2% to under 3%	11,032	1,619,101	1,630,133
3% to under 4%	33,097	1,761,440	1,794,537
4% to under 5%	139,743	1,619,101	1,758,844
5% to under 6%	1,176,781	1,423,386	2,600,166
6% to under 7%	426,583	765,070	1,191,653
7% and over	1,772,526	1,654,686	3,427,212
Sum	**3,677,440**	**17,792,320**	**21,469,760**

Pension contributions were predicted by taking the distribution of employer and employee contributions for 2016[21] and allowing for the statutory changes in contribution levels over the next three years. As minimum contributions increase in 2019, those people contributing less than the minimum (i.e. those 14 million people in the shaded cells in Table 5) will increase to 5%.

Combining this information with predicted enrolment gives us the number of employees at different levels of contribution in 2019. Assuming median income levels, we predict total contributions in 2019 to be £110.3bn.

Accounting for the proportion of employees in DB versus DC pension schemes, and their respective average contribution levels, we predict 49% of the £110.3bn is contributed by employees in DC schemes, of which 80%, or £43bn, is saved in default funds.

Employee preference for riskier funds

Employee fund preference is calculated using data from our pension engagement audit – an online survey of 938 employees conducted from 15th – 19th December 2016 using Pureprofile, a large UK based research panel. Employees were incentivised to respond to our survey and to provide high quality data. Respondents' data was checked for consistencies, and any data that failed to meet our quality standards were removed from our analyses.

Employees were presented with a scenario where they imagined they were 25 years old, working full time, earning £21,000 per year before tax, and making 8% contributions to their workplace pension. Upon retirement at age 65 their pension pot would be converted into a regular annual income by buying an annuity.

We then allowed the employees to choose the level of risk they wanted to take with their workplace pension, and explained that higher risk results in a higher chance of achieving a higher income upon retirement, but with less certainty about how much income they would achieve. We also explained that with risky investments, the value of the investment can go down as well as up, so employees may get back less than they invested.

Employees were presented with Table 6 and Graph 4, and we explained that the table and chart show an estimate of the likely fixed annual income that employees would receive when they are retired, for the level of risk they have chosen. We also explained that the dashed line on the chart shows what employees would get if they had kept their contributions as cash rather than investing.

The employees then explored their expected incomes by manipulating the level of risk on a scale ranging from 0 (i.e. no risk, beta = 0) to 20 (i.e. high risk, beta = 2). A default risk level of 10 (i.e. average risk, beta = 1) was pre-selected.

Table 6: Scenario expected retirement income with risk level of 10

Level of Risk: 10

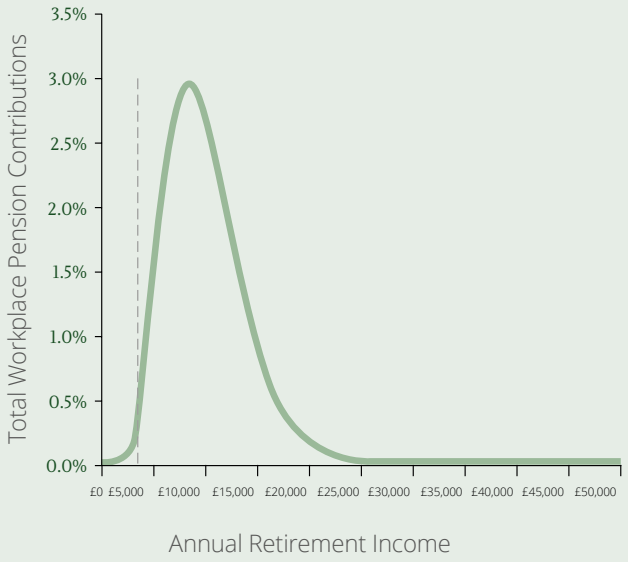
Average expected retirement income:	£11,704

Range of possible incomes

Annual retirement income	Chance of receiving this income
£0 - £3,500	0.5%
£3,500 - £7,000	16.3%
£7,000 - £10,000	27.5%
£10,000 - £25,000	53.2%
£25,000 - £50,000	2.5%
More than £50,000	0.0%

The forecasted expected retirement income was given in present pounds sterling. The risk free rate was assumed to be equal to inflation, i.e. 2.5%, and the risk premium was assumed at 5%. The standard deviation of fund returns with beta 1 was taken to be 10%, and fund management fees were set at 0.75%. The annuity rate was 6%. The retirement income achieved assumed no payment holidays, and returns in any given year were independent of those of other years.

Graph 4: Scenario expected retirement income with risk level of 10



Based on the level of risk chosen in our pension engagement audit, we found that employees prefer funds that are around 11% riskier than the average default fund. As shown in Table 4 in the report, this difference in risk would, on average, result in an extra £4,544 of annual retirement income (i.e. £16,248 versus £11,704). That's an improvement of 39%.

Figure 1: Pairwise comparison of chosen fund versus a certainty equivalent

Pension Fund A

Average expected retirement income:	£11,704

Range of possible incomes

Annual retirement income	Chance of receiving this income
£0 - £3,500	0.5%
£3,500 - £7,000	16.3%
£7,000 - £10,000	27.5%
£10,000 - £25,000	53.2%
£25,000 - £50,000	2.5%
More than £50,000	0.0%

Pension Fund B

Guaranteed income after retirement:	£8,181

Range of possible incomes

Annual retirement income	Chance of receiving this income
£8,181	100%

However, this additional income is a consequence of increased investment risk, so we need to account for the increased downside should the value of the investment go down. To do this we went on to present each employee with a choice between two options. The first option was the annual retirement income they could expect to receive from their self-chosen fund, which could be higher or lower based on market conditions. The second option was a definite amount of annual retirement income, i.e. a certainty equivalent (see Figure 1).

We used a binary logit model to calculate employees' preferences for the uncertain retirement income yielded by their self-chosen fund versus the certainty equivalent, after accounting for heterogeneity of preferences. The weighted average of employees' certainty equivalents was £13,686.

This process was then repeated, but comparing the average default fund, rather than the self-chosen fund, against the certainty equivalent. After modelling, the weighted average certainty equivalent was £9,732.

The difference in certainty equivalents for the self-chosen and default funds indicate that employees perceive the self-chosen funds to be 29% more valuable than the default fund.

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13. See the Technical Appendix for details of prediction calculations.
14. Our typical employee is 25 years old, earning £21,000 before tax, with an 8% pension contribution, retiring at 65, and expecting to receive an annuity for 20 years.
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16. See the Technical Appendix for further details.
17. See the Technical Appendix for further details.
18. Calculation is based on a 21 year old working for 47 years with a starting salary of £20,044, with 8% contribution, 1% salary growth, fund return of 7.5% and fund management charge of 0.15%. Self-chosen fund assumed to provide returns of 8.33% (i.e. 11% better than market rate of 7.5%)..
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