Spotlight on Pensions
PRESENTS
Le Grand View

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Keeping focus despite adversity

Private (non-state) pension arrangements are a vital part of the retirement welfare system for UK citizens. This is particularly so as the state's appetite for financial support for the elderly looks to be dwindling, notwithstanding the current persistence with the anomalous state pension triple lock promise.

Private provision will continue to grow in importance as most workers build up their pots through the automatic enrolment system. As its importance grows, so does the need to address shortcomings that threaten its success.

So far, feared widespread member opt-outs in response to increases in the minimum member contributions have not materialised (although the economic impact of COVID-19 has yet to work through). The negative explanation for this is that people cannot be bothered to take the action to opt out. The positive interpretation is that most appreciate their membership and its growing value to their future financial security. The reality is likely to involve a combination of both.

Members helped with difficult decisions...

It seems clear nevertheless that a significant factor in the breadth of membership coverage achieved by automatic enrolment is the use of soft compulsion. Given the generally low levels of pensions and other financial knowledge, automatic enrolment helps address the public's need for help with a complex subject by taking away one difficult decision – whether to join a scheme in the first place. Further help follows through minimum contribution levels and default investment strategies. Whether or not these provide optimal solutions for all members, they certainly do help to redress the loss of paternalism through defined benefit (DB) being replaced by defined contribution (DC) as the main basis of provision.

...but more help needed

If the system is well-configured to help members join and contribute to schemes, the opposite is true when it comes to taking benefits. Members face a bewildering array of options, including whether to access their funds at a point (and by implication for a purpose) unconnected with retirement. With default solutions lacking, they are forced to make their own decisions but with insufficient support. This is recognised by the FCA with its immediate-past Chief Executive stating that the general view at the FCA is that the pension freedoms were introduced too soon, given the absence of suitable support for members.

The FCA and TPR are working with industry on solutions such as default retirement pathways to address some of the challenges facing members, but this is taking time, and is one of the workstreams deferred by responses to COVID-19 issues seen as more pressing. Meanwhile, regulators and industry alike rightly continue to be concerned over the vulnerability of members not only to innocently taking poor decisions themselves, but also to the growing menace of scammers.

Poor decisions persist

A further demonstration of the problem of poor decision-making by individual members of DC arrangements is evidence that not insignificant numbers have been withdrawing monies from the tax-efficient pension environment of their schemes, only to pay it into ISAs or in many cases hold it as cash in ordinary deposit accounts. That either implies a serious misunderstanding of the tax system, or an unwarranted distrust of their particular pension scheme or schemes in general. For the latter, persistent publicity around actual and predicted reductions in pension tax reliefs is likely to be a factor, driving a "buy while stocks last" mentality.

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Tax review opportunity?

The Government is looking at changes to the pensions tax system. If the review results in a clearer, more equitable system, change will be welcome. However, past experience does not encourage optimism. Furthermore, there are fears that the new system will be less generous than the current one, undermining retirement-focused savings. Heavy hints from Number 11 that the inevitable economic pain from the Government's coronavirus-driven spending spree will have to be shared widely and involve a re-balancing of liabilities across the taxpaying universe add fuel to this concern. Pensions once again look vulnerable to attack.

Enter COVID-19

The impact of the COVID-19 pandemic looks set to exacerbate these existing problems. Particularly at risk are members aged 55 or more who have either not yet accessed their pension accounts, or whose DC plans are in drawdown mode, since they have greater opportunity to take major decisions now. However, there are issues across all cohorts, and include:

- It is widely expected that the number of unemployed will increase significantly, despite Government financial assistance programmes for employers. Employees unexpectedly losing what might have previously appeared to be a secure job, possibly following a period of furlough on reduced income, and facing a long wait to secure other employment, will naturally be tempted to access their retirement pots early. In many cases this will leave them without funds for old age, and with limited opportunity for replacement through future employment.

- With the economic upheaval already experienced and likely to continue, investment values will be volatile and unpredictable for a long time to come. In most cases asset values in pension pots will be below pre-pandemic levels. History suggests that there will be an increase in the number of concerned members accessing their funds early through panic over reduced fund values, thereby unnecessarily crystallising losses. Fear might also affect the under 55s looking at their reduced fund values, but the negative effects should be less pronounced with this group as investment changes should nevertheless leave the funds within the pensions system, and experience suggests that most are likely to succumb to inertia and take no action.

- Those who access their pension pots in an unplanned way during this time will be at increased risk of realising smaller than expected amounts. Furthermore, many pension pot sizes were already very small before the current crisis, and figures have highlighted concerns that a significant number of people were already withdrawing unsustainably large sums from their pots, leaving them likely to run out of money during retirement.

- Horror stories about corporate failures and underfunded pension schemes are likely to provoke an increase in the numbers of people seeking to transfer out of their DB schemes for the more exposed world of DC, notwithstanding widespread information on the protection provided by the PPF.

Short-term response – tread carefully

The COVID-19 pandemic therefore seems likely to expose and exacerbate pre-existing weaknesses in the pensions system. In the short term, trustees and managers of schemes, together with relevant official bodies must continue working hard to help members make "sensible" and considered decisions (including doing nothing). There is a temptation to take a paternalistic stance placing a temporary moratorium on the most drastic actions, such as emptying pots completely, or cashing out investments that have suffered more than a given percentage of their former value. Such unprecedented interference would be fraught with difficulties and should only be considered after careful assessment of all the possible implications, including possibly undermining confidence in pensions saving.

Longer-term – redouble efforts

We have been given a wakeup call. We need to speed up existing programmes to address systemic weaknesses, whether by way of education, improved information (such as through the pensions dashboard), guidance, advice or paternalistic controls. In the unpredictable world emerging hesitantly from global lockdowns, with plummeting GDPs, high unemployment levels and bloated national debts, there will be much to manage. Issues that seem less pressing will be put to one side.

Some may feel that pension reform is one such. However, the exposure of the pension system's shortcomings (even if they do not result in the feared dire outcomes) indicate the opposite. We need to press on with necessary reforms at speed, to reduce member exposure.

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