Side by side

Rather than competing as rival savings products, DC pensions and ISAs – whatever their stripe – are set to sit alongside each other in tomorrow's workplace benefit packages, which emphasise financial well-being above all else

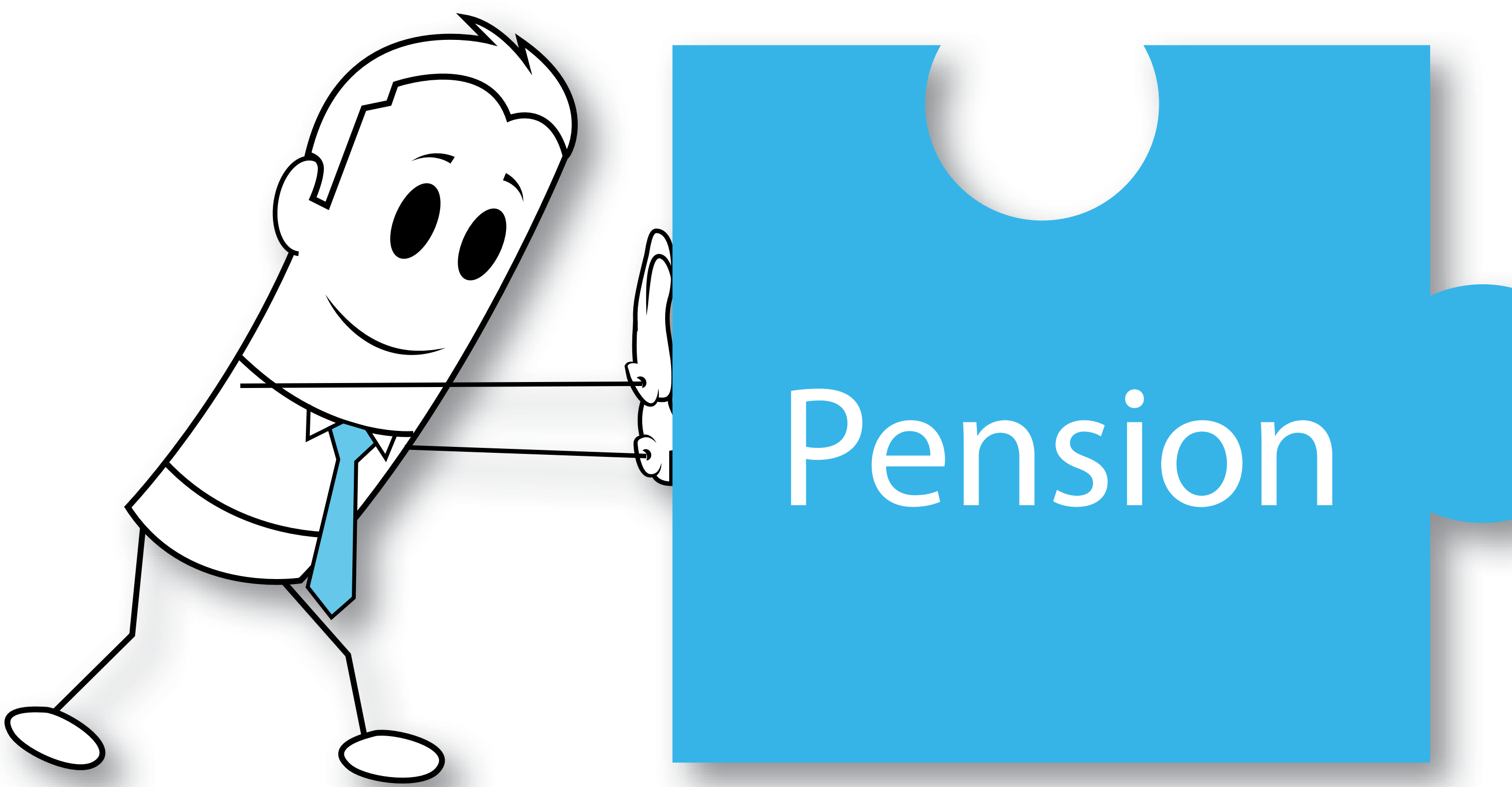
Summary

- DC pensions have clear advantages over other savings products, such as ISAs, but auto-escalation may dampen their appeal to cash-strapped employees.
- More than ever, education is needed to counteract any backlash against higher contributions – it could also lead to a more mature savings culture in the UK.
- In the future, DC pensions and other savings vehicles will sit alongside each other in many employee benefit packages, giving workers a range of options that suit their particular financial needs.

An ISA or a defined contribution pension scheme? When it comes to picking which of the two is the best retirement savings product for a typical workforce, then it's a no-contest.

Take each vehicle's annual allowance limit as an opening gambit. For a DC pension, this currently sits at £40,000; for ISAs, the most generous limit is £20,000. This is accentuated by the two wrappers' polar tax rules: the taxman gets his share of pensions on withdrawal and most ISA savings still enjoy a virtually tax-free status, notwithstanding the fact that the money in ISAs is diverted from already taxed income. However, the former can benefit from a lower or even tax-free rate, depending on what the personal income tax thresholds are at any particular time.

Their accumulation phases can differ widely as well. In the past five years cash ISA pots, as Barnett Waddingham head of DC Mark Futcher points out, have suffered from negative real returns, resulting in up to a 15 per cent erosion of value in some cases. In a stocks and shares ISA, capital can be better protected depending on a saver's risk appetite. But in a sophisticated target date default fund, pension scheme



members can build up high returns safe in the knowledge that the fund will lock in some of those gains as they get closer to retirement.

The cards are stacked even higher with other forms of the ISA, such as the lifetime version. Saving for retirement is restricted to £4,000 per year, contributions must cease at age 50 and benefits cannot be drawn in a tax efficient way before someone turns 60.

And to top it all off, although one disadvantage of saving into a pension is that the monies cannot be accessed until age 55, as Crowe Clark Whitehill Financial Planning's managing director Phil Smithyes points out, it could be argued that this is one of its key attractions as it protects individuals' long-term savings.

ISAs' shine has also faded somewhat. Coinciding with auto-enrolment, its numbers have dropped significantly. Government statistics show that ISA subscriptions peaked in 2011 at 14 million. In 2017 they were down to 11 million. Total capital, meanwhile, reached a high of £80 billion in 2015. This now sits at £60 billion.

Testing times

Nonetheless, the DC pension's position as the preeminent retirement saving product is not assured, as MNOPF and Ensign pension policy director Ivan Laws warns.

"The changing savings landscape will provide individuals with even more options on where to place their money," says Laws.

"And unless employers spend time educating employees on the impact of saving (or not) into a DC pension arrangement, we could be looking at a pensions black hole arriving in the non-too-distant future."

Scottish Widows' head of policy, Peter Glancy says that research has consistently shown that people do not understand the value of pension features such as employer contributions, compound interest and pound-cost averaging.

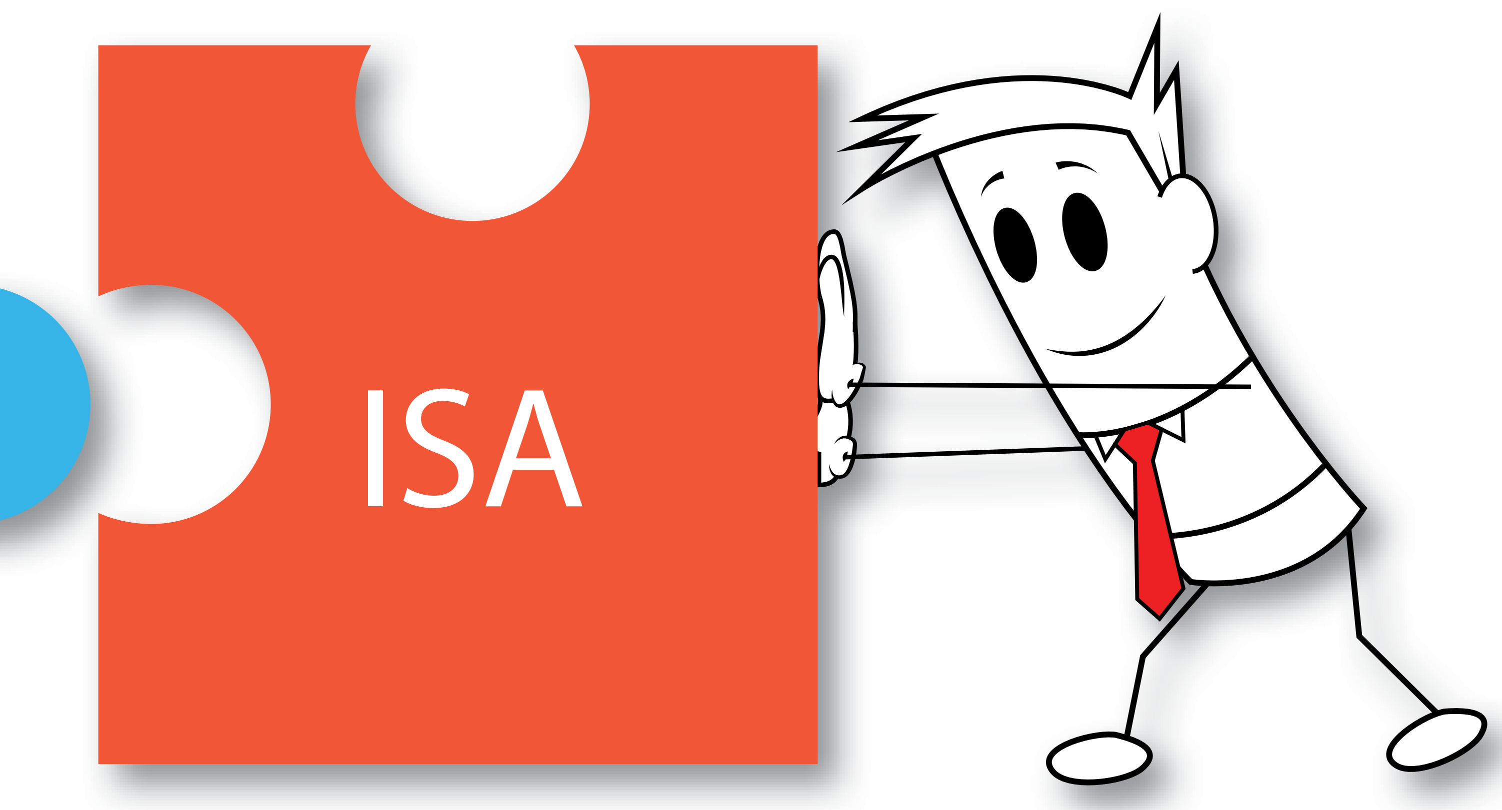
This lack of understanding may lead to some members baulking at the idea of higher contributions – and opting to choose a different savings vehicle as a result.

The crunch test will come over the next two years when the current minimum contribution rate will rise from 2 per cent, to 5 per cent, and then 8 per cent by the end of 2019.

"The problem *[with this]*, as research from Lloyds Banking Group has shown, is that at the moment, for a typical salary in the UK of £27,000, the 1 per cent contribution represents 5 per cent of disposable income," explains Futcher.

"It's the rise of the percentage of disposable income by 2019 to 25 per cent that's really going to encourage the opt-out rate."

Glancy says that the danger of high opt-out rates means that some conversations will have to take place between the three people who put money into pensions: the employees, the employer and the Chancellor. And if



incentives can't be found to make auto-escalation more palatable, then it may be time for some tough decision-making. "We're all waiting to see what happens when contributions go from 5-8 per cent," he says.

"Then we'll have to ask to what extent do we continue to make use of inertia in auto-enrolment and to what extent do we make higher contributions mandatory?"

Reasons for optimism

Thankfully, the new flexibility around accessing money has made pensions more attractive, and may yet mitigate some of the negativity that could come with auto-escalation.

State Street Global Advisers' head of European DC investment strategy, Alastair Byrne, explains: "Compelling people to buy an annuity at retirement increasingly looked to be at odds with more gradual and phased retirements, but with that requirement removed DC schemes are well placed to meet member needs for income in later life. The main challenge for the market is developing better products to support that income phase."

Another reason for optimism is the creation of a new public financial guidance body, which will be created in October of this year by merging Pension Wise, the Money Advice Service, and the Pensions Advisory Service. In addition to helping savers who contact it, the new body will have a remit to raise financial awareness across the UK. This education push could also dampen any backlash against rising contributions.

Complementary vehicles

Raising the country's collective understanding of pensions, and financial products in general, however, is not designed to engineer pensions' dominance over ISAs. Instead, it is to help people make the right use of a suite of savings products that will sit alongside each other in a mutually beneficial employee benefit arrangement.

"We see bringing the products together in the workplace as the way forward," says Glancy.

"Employers will provide short-term savings products for those saving for a rainy day and then long-term, for retirement.

"We have the right products that we need, the trick is to surround the products with a suite of education guidance – and advice if the employer wants to facilitate that – so that people aren't missing out on employer contributions. It's not just a question of sticking the right products in front of people in the workplace, because they will make all sorts of bad decisions if they do that."

Willis Towers Watson senior consultant Richard Sweetman believes improving people's financial capability can also give them more scope to safely personalise their savings journey.

"I'm in the camp of allowing people to make the savings they want to make, rather than forcing them to pay everything into pensions," he says.

In Sweetman's view, allowing employees to shift money into products that suit their needs at various times in their lifecycle whether that be to save for a house deposit or pay for a daughter's wedding, is a sign of a mature savings culture.

It should, however, he says, be done on the proviso that pension savings are built up to a reasonable level at the same time.

This fluid savings environment also fits into the wider areas of debt management and general financial well-being.

"Rather than saving, an IFA would tell someone with debts to pay them off or at least get them under control," says Sweetman.

"So we're beginning to see employers look at that broader financial position. And one or two employers are putting interventions in place to help employees with their financial planning, such as education sessions, broader financial planning plans, and workplace loan facilities."

Such paternalistic moves by companies can not only help their workforces to save more for their later years, but it can also result in them doing a better job.

"We've found in some recent research that if people have financial worries then they tend have higher levels of absenteeism, and are less productive in the workplace. So, potentially, there's some commercial advantage in getting your employees to take control of their finances."

Written by Marek Handzel, a freelance journalist