Written evidence from the Scottish Widows (PSL0023)

Thank you for the opportunity to contribute to this inquiry. Scottish Widows provides pension products to millions of customers to help them save for later life and then make the most of their savings through retirement.

There will be a wide range of eventual retirement outcomes for today's pension savers, both between and within generations. The further we look to the future, the more retirees will be reliant on defined contribution (DC) pensions, rather than defined benefit (DB) entitlements. Saving rates in DC pensions are too low to deliver adequate outcomes for the majority of households and most people don't know they have a problem.

It's widely recognised that the contributions required under automatic enrolment are not yet sufficiently high. We believe that the minimum rate should increase to 12% but workers should be pointed towards a savings rate of 15% to target a moderate standard of living in retirement.

Concerns expressed by some that higher savings rates could lead to lower paid workers being over-provisioned often assume that someone who is currently in low paid work will remain in low paid work throughout their working lives. It is typical for younger people to begin their careers on lower wages and then increase their earnings over time. A pound paid into your pension in your 20s will buy you around 4x as much retirement income as a pound paid in during your 50s, and so those early contributions are critical, even when they come from a lower salary.

There is also concern that those on lower earnings could face additional hardship in the short term if they lock away scarce financial resource for the future, whilst struggling to make ends meet today. We believe that introducing more flexibility to the auto enrolment framework could be a win-win, giving people the confidence to save for later life, whilst knowing they can access some money if they face an expenditure shock in the short term.

At present, employers are only obliged to contribute to a worker's pension, where the worker is also able to contribute (i.e. if they don't opt out). This can cause a problem when a household falls upon hard times and a worker has to opt out for a period of time. As employer pension contributions are effectively 'deferred pay,' we effectively have a system that docks people some of their pay when they are struggling to make ends meet. To avoid this counter intuitive scenario, we believe that where workers on very low earnings have to opt out of their own employee contributions, they should continue to benefit from a contribution from their employer towards their retirement.

It is increasingly common for people to have more than one job. A worker's total earnings could exceed £10,000 (the auto enrolment trigger) but if they earn less than that from each employment, it's possible that nothing is being put aside for retirement.

Some part-time workers earn less than £10,000 but are part of a household where total earnings are quite high. This can be the case when someone is looking after young children or elderly parents. Our research shows that women are disproportionately in that position and this contributes to the gender pensions gap.

By removing the earnings trigger of £10,000, multi-jobbers would accumulate pension pots akin to those on the same earnings from a single employment, and those working part time whilst undertaking caring duties would benefit from contributions, helping to address the gender pensions gap. Removing the earnings trigger in isolation, however, could exacerbate the financial position of very low income households, making it harder to make ends meet today and we believe that this change would need to be accompanied by the proposal to allow those on very low salaries to opt-out of employee contributions whilst continuing to benefit from the 'deferred pay' from their employer.

The self-employed are particularly under-prepared for retirement. There is a role for product innovation, better education, well-placed nudges and carefully crafted communications. But that won't be enough. AE has seen millions of employed workers saving for retirement, many for the first time, by making saving the statutory default. Whilst a quite different ecosystem will be needed to be effective amongst self-employed workers, a statutory default introduced by Government will be a necessary component if a similar level of change in savings behaviours is to be achieved.

1. Do households in the UK have adequate pension savings for retirement?

1.1. Adequate will mean different things in different households and there is wide divergence in pension outcomes with some doing much better than others. The savings landscape is also changing for future generations of retirees, particularly as fewer people accrue defined benefit pensions (DB) and will instead be reliant on defined contribution (DC) pensions, typically funded at much lower levels. Overall though, the UK is not on track for adequate retirement incomes.

1.2. We can use different definitions of adequate retirement income, for example the Retirement Living Standards (RLS) developed by the Pensions and Lifetime Savings Association (PLSA) and Loughborough University or the replacement ratios used by the 2004 Pension Commission and the DWP. Under either measure, the minimum saving rate under automatic enrolment (AE) of 8% of salary is not enough to deliver adequate retirement incomes for the majority of households.

Retirement Living Standards

1.3. The RLS describe three types of retirement: minimum, moderate and comfortable and illustrates that these cost £10,900, £20,800, and £33,600 a year for single people outside of London, and £16,700, £30,600 and £49,700 for couples[1].

1.4. As a full state pension covers much of the income required for a **minimum** standard, most households are on track for achieving this. While it is useful to have a range of targets, we don't believe that the minimum standard should be the benchmark we aim for when talking

[1] Note these are expressed as costs, not incomes. Therefore taxable incomes, such as pensions, need to be higher.

about adequate retirement incomes in the UK. It would mean a significant drop in living standards for many.

1.5. The moderate standard is a more appropriate target for most households. While projections will vary depending on earnings, inflation, investment growth and time out of work, we expect a typical earner, working full-time all their adult lives until State Pension Age (SPA) and saving the 8% minimum, will fall short of this standard as a single person. They may achieve it as part of a couple, provided a 25% lump sum isn't used for purposes other than generating a retirement income. A single person would need to be saving in the range of 12-15% of their income, rising to 18-20% if they retire in London.

1.6. It is important to note that the RLS make no provision for rent or mortgage payments – it is assumed households own their homes without mortgages, or rent is otherwise covered by benefit entitlements. This assumption may hold largely true for today's retired households but it is expected that many more will be in the private rented sector in future. The Resolution Foundation has estimated that up to a third of under 35s will never own their own home. Therefore, more income will be required in retirement.

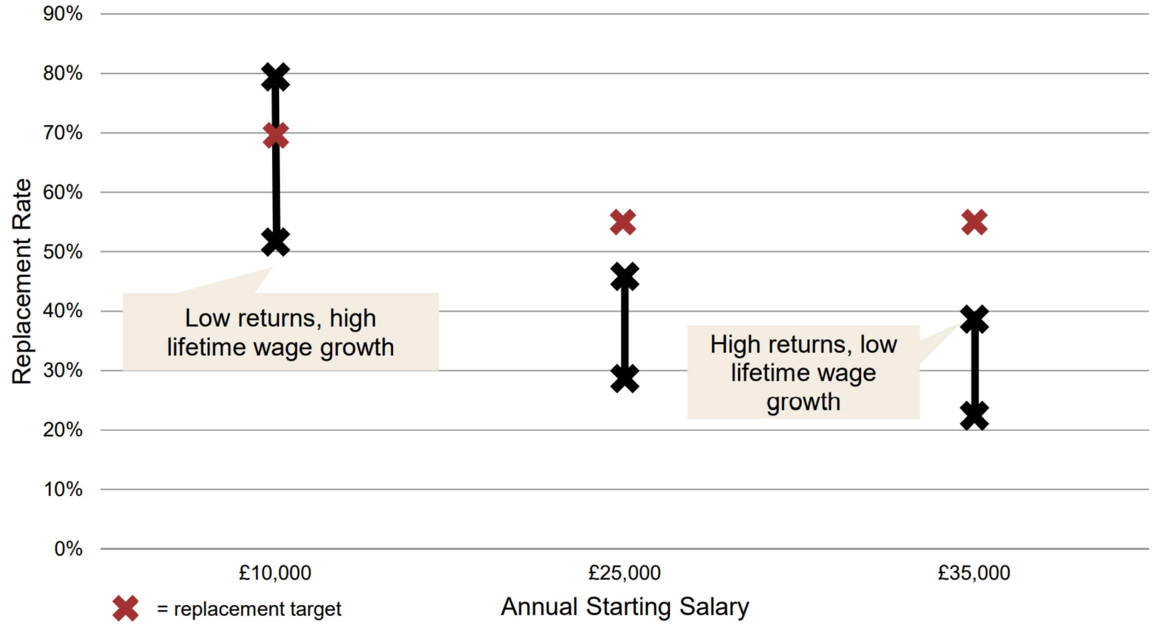
Replacement ratios

1.7. The replacement ratios set a target retirement income as a % of pre-retirement income, with different targets for high and low earners as low earners cannot afford as big a drop in incomes. Five bands are used, with replacement rates ranging from 80% to 50% and median earners targeting 67%. This measure of two thirds of pre-retirement income is often used as a general rule of thumb. Again, these targets make an assumption that retirees will not be paying mortgages or rent.

1.8. By these measures, the lowest earners have a good chance of hitting their target of 80% of pre-retirement earnings, as the flat-rate State Pension makes up a significant proportion of their pre-retirement income and even low rates of saving through AE provide a sufficient top-up.

1.9. Average and higher earners are much less likely meet their targets and a savings rate of 8% is insufficient.

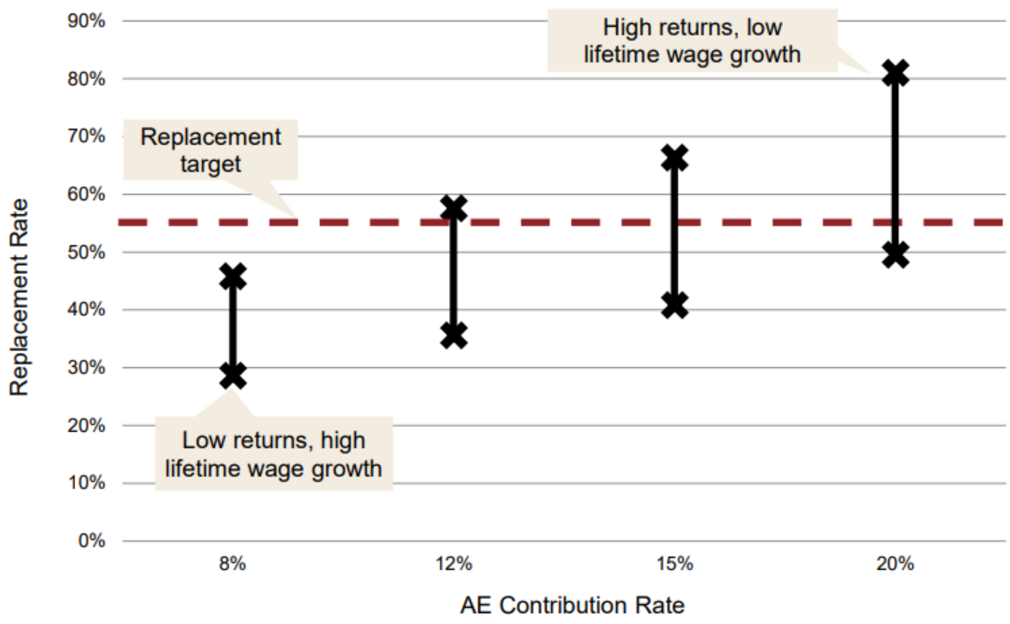
Figure 1: retirement income for middle-income individuals is likely to fall well below target replacement rates under automatic enrolment minimum contributions



Source: LBG analysis, replacement rate targets from the DWP Automatic Enrolment Review 2017
Assumptions: working full-time from age 21 to 68. Low real wage growth is 1%, high is 2%. Low real investment returns are 2% a year, high is 3%. Contributions are made on full salary, not qualifying earnings. For the replacement target, as a simplification we have taken an average between high and low wage growth assumptions.

1.10. Our analysis is that middle or higher earners need to be saving in the region of 12% to 15% to have a decent change of hitting their targets.

Figure 2: an individual who starts their career earning £25,000 needs to be saving around 12-15% to have a realistic chance of meeting their replacement target by State Pension Age



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1.11. This is reflected in the DWP's previous analysis of under-saving (Automatic Enrolment Review 2017: Analytical Report), which found that 12 million people in the UK were under-saving for retirement, the bulk of whom were on middle incomes. This is unlikely to change under the current AE rates.

Retirement ages

1.12. A further important point is that in these exercises we typically assess projected retirement incomes with an assumption that people don't take any benefits until they reach State Pension Age (SPA). This may not reflect future working lives, with many people considering phased retirement or early retirement desirable or even necessary. We're yet to see the full impacts of a higher SPA coupled with a reduction in DB provision and what these mean for workers in their 60s. Earlier retirements require more savings.

2. Are changes needed to auto-enrolment to provide an adequate level of pension savings for retirement?

2.1. Yes. There is an underlying debate as to whether we should close the gap in adequate savings by increasing the AE minimums or by encouraging people to actively save more. We think it is clear that, in order to address the majority of under-saving, AE rates will have to increase.

2.2. Much like the wider pensions industry we are committed to improving engagement with pensions. It's a key area for development and innovation for us and we have supported Government projects such as the pensions dashboard from the early stages. But it would be naïve to think that better engagement will make major inroads on the UK's under-saving and more directive measures are needed.

2.3. Firstly, the DWP needs to follow through on its commitment to reduce the age for AE to 18 and to change how qualifying earnings work so contributions are calculated from the first pound earned, not from the current figure of £6,240. **Currently, for an average earner, 8% of qualifying earnings is really only around 6% of their total earnings**. If the DWP is to deliver this for the mid-2020s, now is the time to be designing the change, giving employers time to prepare, and if any legislation is necessary it should be introduced in this Parliament.

2.4. Then, longer-term, there is a need to increase the rate of AE, at least to 12%. This increase could fall on either employer or employee contributions or a combination of both. It is worth noting that the UK is something of an outlier in relying more heavily on employee contributions.

2.5. Some stakeholders may express concern that such an increase will lead to low earners being overprovisioned at retirement. We recognise these concerns - not so much that the risk is their pensions will be *too good* - but that they may benefit more from the money being available for more immediate needs. In response to Q5, we make a some suggestions for how automatic enrolment could be deployed more flexibly to accommodate other savings needs and to provide better financial resilience. But beyond this, we believe there is a solution whereby low earners can opt-down in AE and retain the full employer contribution, even without making the employee contribution. We don't believe this option should apply to everyone, just people earning under a set threshold.

3. What advice and guidance do people need when saving for retirement?

3.1. There's a wide range of help people need when saving for retirement. Some is general information and some is more personalised. General information that should be more widely known includes:

- The benefits of starting saving early (compounding effects)
- That pension saving is rewarded with tax relief and employer contributions (though this should be balanced with an understanding that pension income is taxed)
- That some employers might pay more when their employees pay more, by matching increases
- That savers can consolidate pensions and this can get them better value
- That pension pots consist of savers' own money, held in their own name, not their employers', and they have control over things like investment choices.

The recent budget made some provision for improving financial education – ‘pension basics’ could be a key part of that. Some of this could also be introduced much earlier, in schools.

3.2. More personalised help would come in answering:

- How much income do I need?
- (For defined contribution savers) How big a pot do I need for that income?
- How much have I got now and what is that projected to be at retirement (including the State Pension)?
- What do I need to do to make up any shortfall?
- How should I invest?

3.3. It is already somewhat possible for engaged savers to answer these questions, though it is not joined-up neatly and requires some effort and understanding. Three key building blocks are required to make it easier for customers:

- Retirement income targets, which are already in place but perhaps not widely used or known about
- The pensions dashboard, which needs to be fully populated to give a complete picture of all pension entitlements, including the state pension, and which must be able to express those entitlements in a common currency (i.e. how much will I get?)
- Help to identify what steps should be taken to get retirement plans on track

3.4. The latter point could be delivered by people (e.g. working for the Money and Pensions Service or a pension provider) or through online tools helping people self-serve. It would be a mistake to believe that all savers will be happy to work it out for themselves even with the help of online tools. Many will want the help of an expert telling them what to do. That brings us back to the debate on advice and guidance and where the boundaries should sit.

3.5. A regulatory regime that supports more personalised guidance and simplified advice would help more consumers receive the support they need. Personalised guidance would, for example, allow providers to do more to alert customers who appear to be making sub-optimal decisions and also to encourage them to increase their pension contributions. Simplified advice would allow advisers to provide advice on a narrower basis. This would mean an expert answering a single question or providing a solution to a single problem, as opposed to a holistic approach, which would require a fact find and broad understanding of the savers’ whole financial circumstances. This would provide customers with a level of financial support that is specific and more affordable for the mass market.

4. **Could retirement income targets help savers plan for retirement?**

4.1. Yes and we promote the RLS with our customers. Ideally they would be a starting point for customers developing their own more personalised retirement targets but even in the absence of that, they are useful rules of thumb.

5. Apart from increasing contributions, how can the Government improve outcomes for savers?

5.1. Government policy on saving for retirement is too often siloed, taking saving for retirement in isolation. This does not reflect how financial needs compete with each other and how limited savings might be allocated to short-, medium- and long-term goals. In particular, the Government should aim for a more joined-up approach between saving for retirement, saving for a home and saving for a rainy day.

5.2. For clarity, we do not believe that existing pension pots, already too small for many people, should be available to help people buy their first home or to cover unexpected bills.

5.3. But we do believe that if AE rates are to increase, we will need to consider how this impacts other savings needs. Some flexibility in how additional AE savings can be accessed may be the trade-off required for higher rates of saving.

5.4. It may also help increase voluntary saving. We tested the concept of having some limited access to pensions to provide a savings safety net and 35% of savers said they would save more in a pension if this was an option (we downweighed this to 16% to account for likely action). We would be happy to share more detail on this with the Committee.

6. Can pension providers change the design of pension products to improve outcomes for savers?

6.1. The core design of pensions has been the preserve of Government, not pension providers. The aspects that make them so favourable for savers are the tax treatment and the requirement for employers to contribute. To this extent, the design of pensions is for Government.

6.2. Providers can maximise the benefits – with well-performing investments as well as tools and guidance to help people plan, but there is little flexibility to significantly change the design of pension products.

6.3. Providers' integration of ESG (environmental, social and governance factors) investing in their pension products serves two key purposes regarding saver outcomes:

- Providing more sustainable returns on risk over the longer term, especially when combined with investment in illiquid assets
- Using ESG as an engagement hook can encourage savers to become more involved with their pensions and increase their contribution levels. This has been shown in theory for some time and the technology is now there to allow pension providers to

put it into practice, including the Find Your Impact feature within our own app. This will provide members of workplace pension schemes with their own personalised sustainability impact ratings, based on the companies and funds they are invested in.

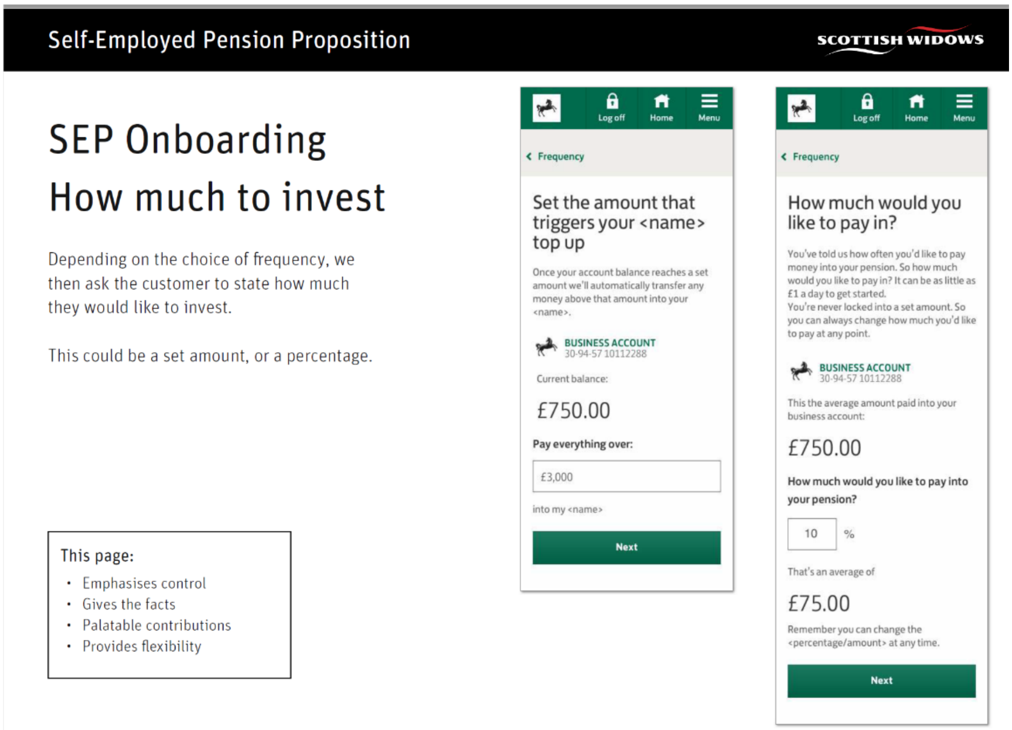
7. What should the Government be doing to support self-employed people to save for retirement?

7.1. The self-employed are a diverse group with different needs and attitudes towards saving but one thing many of them have in common is that they are not saving enough for retirement. From our research we have seen that many love what they do and don't engage with the concept of retirement at all, instead they intend to keep on working. The idea that "my property is my pension" also comes up a lot (as it does with the employed but at least they are mostly auto enrolled). And many want more flexibility than pensions can offer - this applies to how they save and also to how and when they want to access savings.

7.2. We don't believe that any measures the Government could take will be more effective than extending AE or something similar to cover the self-employed. There is no easy mechanism for delivering this as we need something that will work in the absence of the payroll ecosystem. One solution could be through the tax system, which we understand would be a huge undertaking for the Government. Another solution could be through banking – with a % of income automatically moved to a long-term savings plan.

7.3. We have done some exploratory work on propositions that could appeal to the self-employed and would be happy to share that with the Committee. We recognise that some might have 'lumpy' incomes with good and bad months, so it's hard to commit to a regular amount of savings (and no payroll to process a % of their income). Figure 3 shows a wireframe we developed as we explored a concept where 'extra' funds in a business bank account could be automatically moved to a pension. This could also be used to offer the additional benefit of ensuring a buffer remained for a rainy day. However, while financial services providers could design products for the self-employed, they're unlikely to see high take-up. The success of AE comes from the legislation that makes saving the default, circumventing inertia.

Figure 3: wireframe customer journey for the self-employed.



8. Are different or additional measures required to help gig economy workers save for retirement?

8.1. The recent Supreme Court judgement should reduce the grey area between self-employed and employed. Therefore, gig workers are less likely to be excluded from pensions.

8.2. Reducing or removing the £10,000 earnings trigger for AE would see more part-timers and multi-jobbers saving and benefitting from employer contributions. It's also important for such workers that the Government goes ahead with its plan to change qualifying earnings, as discussed in Q2.

9. Are there measures which the Government should consider to close the gender pension gap?

9.1. Broadly speaking, the best pension outcomes are linked to having well paid and secure employment. Structural inequalities have led and continue to lead to women and other minority groups being under-represented in that sort of employment, with worse pension outcomes as a result. While these inequalities need to be addressed to drive the most significant change, there are a number of pension-specific things we can do.

9.2. Automatic enrolment could be reformed. Improvements already announced (but not introduced) include scrapping band earnings and bringing the age down to 18. We would like the Government to go further and stop employer contributions being contingent on employee contributions for low earners.

9.3. Employers could provide more information to employees, particularly for parents returning to work part-time after maternity leave.

9.4. Couples should be encouraged to discuss retirement together and to understand where they may rely on each other's pensions.

9.5. The Government could make it compulsory to include pensions in divorce proceedings.

9.6. People choosing annuities at retirement should be more aware of joint annuities and the role these can play in supporting a partner with less pension provision. Only 30% of annuities purchased between October 2019 and March 2020 were joint life annuities, and only 24% of respondents to a Scottish Widows survey, who said they plan to purchase an annuity in future, said they would buy a joint-life annuity (with only 22% of men saying so).

February 2022