

Improving effectiveness in social security

UK Report

14 April 2015

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Introduction

This report presents a high level picture of the UK pension system. It is intended to support the wider analysis of the *Improving Effectiveness in Social Security* project by highlighting the challenges that UK pension reform has sought to address and those that remain. The scope of the report is broad as it includes both state and private pensions. It also seeks to address themes of financial sustainability, adequacy and equality.

Given the breadth, this report is organised into two parts.

1. **Part One** describes the UK Pension system as it currently is and highlights key reforms that have occurred in the last ten years and those for which legislation has been passed though the change is pending.
2. **Part Two** discusses the issues that reform has sought to address, those that remain and some of the unintended or unforeseen consequences of reform.

This reports draws entirely on the secondary evidence base, including official data sets and literature. At the end of this report there is a guide to further reading and analysis for those who may wish to delve deeper into the topics that have been summarised.

Part 1: The UK pension system and reform story

This first part of the report comprises the following sections:

- The UK system in overview
- State Support for pensioners: The state pension and pensioner benefits
- Accumulating for retirement: Private pensions
- Decumulating for retirement: Turning pensions into income
- Pensions and the tax system: Tax implications during pension saving and during retirement
- The reform story: A 'potted history' of UK pension system reform over the last decade

1.1 Description of the UK system

An overview

State support in retirement is intended to provide a basic underpinning income and to prevent pensioner poverty. It is supported by general taxation.

The primary purpose of both occupational and personal pensions is to redistribute income across a person's lifetime, not to redistribute income from higher-income to lower-income people.

The UK system of support for pensioners that exists today is a complicated one. In overview, it comprises three strands: state support; workplace pensions; and personal pensions. Each of these is discussed in detail in the following chapters.

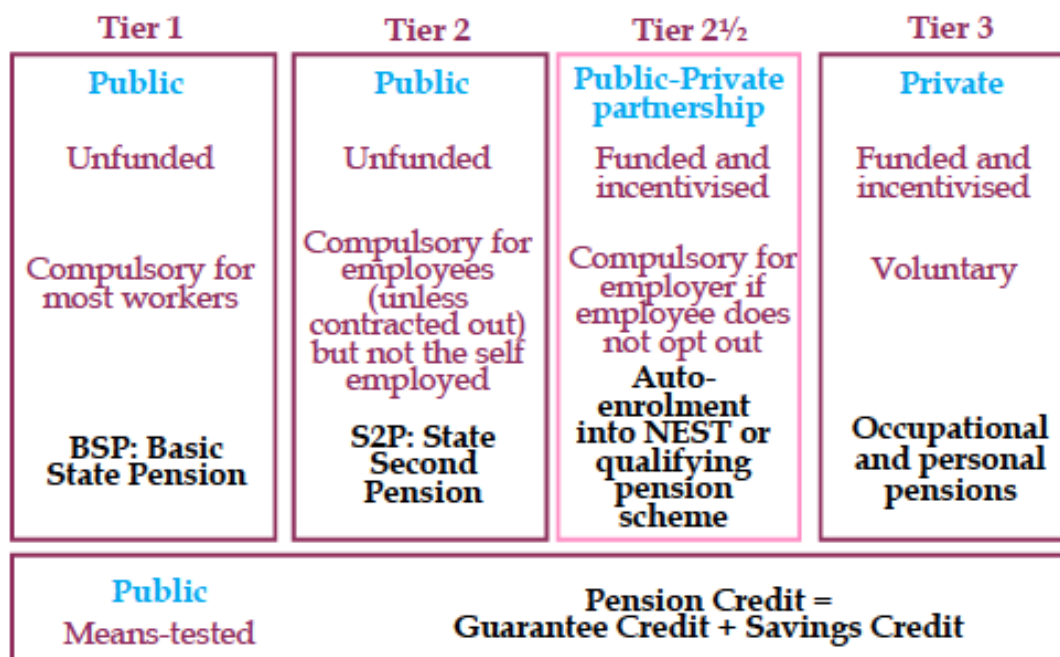
State support is primarily designed around protection against poverty and provides little more than a basic underpinning income. It is paid for through National Insurance (which funds the Basic State Pension, or BSP) and general taxation (which funds means-tested and universal benefits). It also includes a mechanism for employees to accrue further pension income, which is related to earnings. There is a maximum level of support that is provided through the state, combining all of these elements.

Workplace pensions play a key role in bolstering that basic underpinning and are intended to replace pre-retirement income, albeit to greater and lesser extents between individuals and throughout history (see Part 1.3). The workplace pension landscape is diverse and features both defined benefit schemes (largely legacy schemes which are now closed to new members) and defined contribution schemes – the latter now supported effectively by a contract between employers, employees and the state.

Personal pensions are available on an entirely voluntary basis and are used in addition to or instead of an employer-based scheme.

In addition, people may draw on non-pension related assets to fund their retirement. These are potentially as wide-ranging as savings accounts and investments to housing.

Figure 1.1: Current UK pension system in overview



Source: Pensions Policy Institute¹

The design of the current UK pension system is based on the following precepts:

- State support should provide a basic underpinning income, intended as a protection against poverty rather than replacing pre-retirement income
- State support should not act as a disincentive to save
- State support should not allow pensioners to get poorer faster than the rest of society when prices and wages rise
- Employers play an important role in bolstering the retirement savings of working people, both in terms of offering an occupational scheme and making contributions to it
- Individuals do not always make rational decisions – even with incentives and information, they may fail to plan adequately for their retirement
- The state should support individuals to realise adequate retirement incomes through policy legislation and taxation that supports saving for retirement

¹ The Pensions Primer: A guide to the UK pensions system. June 2014. Available at: <http://www.pensionspolicyinstitute.org.uk/pension-facts/pensions-primer-a-guide-to-the-uk-pensions-system>

1.2 State support in retirement

State support comprises four main components: the basic state pension (BSP); earnings-related benefits or Additional State Pension (ASP); flat-rate non-contributory benefits; and means-tested benefits.

Basic state pension

People can claim the BSP by reaching state pension age and having made enough National Insurance² contributions in their working life³. The BSP is not means-tested so it does not matter what a person's previous salary was or how much a person holds in savings.

The amount of BSP income received each week depends on how many years during an individual's working life they have paid or been credited with National Insurance contributions. People currently need 30 qualifying years of contributions or credits to get the full BSP, £113.10 a week for a single person (or £5,881 a year)⁴, in 2014/15. This means for 30 years at least one of the following applied:

- Person was working and paid National Insurance
- Person was receiving National Insurance Credits, e.g. for unemployment, sickness or as a parent or carer
- Person was paying voluntary National Insurance contributions

Number of qualifying years

Prior to 2007 this was 44 for a man and 39 for a woman to achieve the full BSP. The Pensions Act 2007 changed this to 30 for both men and women. Under the new single tier state pension, this will be 35 years for both men and women.

If the individual has fewer than 30 years of NI contributions, their BSP is payable at a pro-rata rate. The pro-rata rate is calculated by multiplying the full BSP rate by the proportion of the number of years for which an individual had a qualifying contribution record. For married people, if one partner has not built up their own state pension they are able to claim a state pension based on their spouse's record.

The current **state pension age** (SPA) is 65 for men and 62 for women. Prior to April 2010, the SPA was 60 for women but since 6 April 2010 the women's state

² National Insurance is the system of compulsory payments by employees and employers to provide state assistance for people who are sick, unemployed, or retired.

³ Note that people do not receive their state pension automatically when they reach state pension age – they receive a letter four months before they retire, which will detail how they can claim.

⁴ Married people, where both have built up state pension, get double this amount – so £226.20 a week.

pension age has gradually been increasing (for those born on or after 6 April 1950). By April 2015, SPA will rise to 63 for women and will match the SPA for men by November 2018.

There is also a political consensus to increase the SPA generally – for men and women. From December 2018, the state pension age for both men and women will rise to reach 66 by October 2020 and 67 between 2026 and 2028⁵. The government will review the SPA every five years, with the principle that SPA will change in line with life expectancies.

Under previous legislation, SPA was going to increase to 67 between 2034 and 2036, and to 68 between 2044 and 2046. However, it was announced in 2013 that this would be brought forward to increase to 67 between 2026 and 2028. This change was covered in the Pensions Act 2014, which received Royal Assent on 14th May 2014. The Pensions Act includes legislation for a review of the SPA every 5 years. The review is to be based around the principle that people should expect to spend a third of their adult life (beginning at 20) in retirement.

Claiming the BSP can be **deferred** until after SPA in return for an increase in the level of state pension payments. Those who defer claiming their state pension for less than twelve months receive an enhanced state pension. Those who defer claiming their state pension for at least twelve months can choose to receive an enhanced state pension or a taxable lump sum and non-enhanced state pension.

Since April 2011, the BSP increases every year by whichever is the highest of the rise in prices⁶ or the rise in earnings⁷ over the previous year. There is a guarantee that in any event the rise will not be less than 2.5%. The Government has named this the '**triple lock**' and have publicly pledged to keep it in place until 2020 if the Conservatives win at the May 2015 general election. This measure was introduced to protect pensioners from nugatory increases in pensions, such as the 75p a week increase given in 2000 at a time of very low inflation, and to make sure their income was not eroded by the gradual increase in the cost of living. Not everyone agrees that the 'triple lock' achieves these objectives (see below).

⁵ Announced in the Chancellor's Autumn Statement: <https://www.gov.uk/government/topical-events/autumn-statement-2013>

⁶ The percentage growth in prices in the UK as measured by the Consumer Prices Index (CPI).

⁷ The average percentage growth in wages (in Great Britain)

The ups and downs of BSP uprating

The formula for calculating increases in the BSP has been an area of contention and frequent change over the decades.

Until 1980, the BSP was increased by average earnings, and was worth 24% of average pay. In 1980 this link was broken and the BSP instead uprated in line with annual changes in prices. This stayed in place until 2003, when the Labour Government decided to increase the state pension by at least 2.5%, regardless of the level of inflation. However up until 2009, based on RPI as an inflation measure, inflation was higher than 2.5%. By that point, the BSP had reduced in value to 16% of average earnings.

In response to the declining value of the BSP relative to average earnings and as part of the larger package of pension reforms, the Pensions Act 2007 made provision for the state pension to return to average earnings indexation. The legislation to restore the earnings link was taken through Parliament by the Labour Government. At the time the Pensions Act was passed, the intention was that this would be implemented by 2015 at the latest, and earlier if the government deemed it to be affordable. In 2010, there was a change of government. The current Government commenced the legislation and committed to the 'triple lock' in April 2011.

The triple lock policy has proved to be controversial, as it has been introduced during a period when annual increases in the majority of working-age benefits been capped at *below* the rate of inflation (meaning their value has effectively been cut each year up 2014). Earnings growth throughout the economy has also generally been low, so the triple lock has enabled pensioners to do better than the vast majority of working people. This raises questions of intergenerational fairness, as today's taxpayers meet the costs of the guarantee at a time when the majority of employees are impacted by austerity measures. Some commentators argue that the triple lock is unsustainable and highlight that the pensioners of the future may not experience the same benefit as pensioners today.

The triple lock meant the basic state pension rose by 5.2% in 2012, in line with prices – an increase of £5.30 a week and the largest cash rise ever seen (earnings, by contrast, rose by just 1.4%). In April 2013, the BSP rose by £2.70 to £110.15 a week - a rise of 2.5%, which was higher than either earnings or inflation.

In April 2014, the BSP rose by 2.7%, an increase of £2.95 a week in line with prices (earnings rose by less than 1%). From April 2015, the BSP will increase by 2.5%, making it £115.95, an increase of £2.85 per week – substantially more than either prices (1.2%) or the average pay rise for workers (1.3%).

Additional state pension

The current UK system supports an additional state pension scheme for employees. The additional state pension is an extra amount of money that individuals may qualify for alongside the BSP (or even if they do not get any BSP). The aim of the additional state pension is to provide further pension income to employees related to their earnings. Note that the self-employed are excluded from the additional state pension.

The system has undergone various amendments since it was introduced in 1961. The current additional state pension system is called **State Second Pension**, or S2P. It was brought in to weight existing additional pension benefits in favour of low and moderate earners at the expense of higher earners, and to extend access to include certain carers and people with long-term illness or disability for the first time.

The pattern of accruing benefits under S2P is currently based on two earnings bands and two accrual rates:

- For low earners, a flat rate of S2P pension is guaranteed.
- Higher earners accrue an additional earnings-related benefit.

Disabled people, and people with caring responsibilities (who meet certain criteria), are credited into the flat-rate part of S2P and are effectively treated as low earners.

It is currently possible for members of Defined Benefit schemes to replace some additional state pension with private pension. That is, some of the money that they would have accrued under additional state pension can count towards their Defined Benefit pension instead. This is known as '**contracting out**'. This option was available to members of Defined Contribution pensions too up until April 2012 (as will be explained in Part 1.3, automatic enrolment into Defined Contribution schemes also began in the same year).

Those who contract out effectively pay lower NI contributions, as do their employers, since they are considered to be saving the equivalent amount in their Defined Benefit scheme.

The size of the rebate is set every five years, with advice from the Government Actuary Department, and can act as an incentive or disincentive to contract-out depending on whether the invested rebate is perceived to give more or less than the benefit payable under S2P.

The additional state pension is paid automatically with the basic state pension unless the individual has contracted out of it. The maximum amount of S2P it is possible to

get in 2014/15 is £163 a week. This is in addition to the maximum basic state pension of £113.10. This potentially takes the total state pension to £273.10 a week. Most people receive less than this and women receive less than men. Part 2.4 provides more detail on the equality challenge.

The State Second Pension is set to be abolished in 2016, when a **new flat-rate pension** will replace both the basic state pension and S2P. However, those who built up S2P contributions will still be entitled to some of the benefit.

Topping up the state pension

It is possible to top up the state pension by paying **voluntary National Insurance contributions**. In April 2014, a new class of Voluntary National Insurance contribution – Class 3A – was introduced to allow existing pensioners and those reaching State Pension age before 6 April 2016 the opportunity to gain additional State Pension. (After April 2016, the new single tier pension will be in place.)

The cost of topping up falls as age increases. The contribution required for an extra £1 pension per week for a person aged 65 is £890. This means that for £4,450, the individual could receive an additional £260 per year for life, increased in line with prices and inheritable on death in the same way as existing additional State Pension⁸. For a 70 year old the rate reduces to £779 and at age 75 the rate is £674.

Means-tested support

If an individual's income is below a certain level, it is possible to boost it by claiming **Pension Credit**. Pension Credit was introduced in the UK in 2003 by the Labour Government and replaced the Minimum Income Guarantee (introduced in 1997 and by the same Government). It has been subject to a number of changes over its existence, but has the core aim of lifting a large number of the poorest retired people out of poverty whilst at the same time not acting as a disincentive to make private provision for retirement (however, the extent to which this has been achieved is disputed – see Part 2.2 below).

Pension Credit has two components: the **Guarantee Credit** (GC) and the **Savings Credit** (SG).

GC is paid where other sources of income do not meet a minimum level. It is effectively an income safety net for the poorest pensioners and is the key redistributive measure with the package of state support. It is paid for from current

⁸ With a minimum of 50% for the surviving spouse or civil partner.

taxes (unlike the basic state pension, which is paid to those who accrued NI contributions) and is only paid to those on low incomes.

Currently, GC provides up to £148.35 a week for a single person and £226.50 a week for a couple (in 2014/15). It is uprated annually by a percentage at least equal to the increase in average earnings.

Savings Credit aims to ensure that those who have made some private provision for retirement in excess of the BSP and S2P will be better off than those who made no provision. The maximum amount payable under SC is £16.80 extra per week for a single person and £20.70 for a couple. For every £1 of income received above the level of the SC threshold (£120.35 for Single pensioners and £192 for couples in 2014/15), but below the level of the GC, SC pays an additional benefit of 60p. The credit is then 'tapered down' for additional income above the GC level.

'Passported' benefits

Being in receipt of the GC provides a 'passport' to other entitlements, namely Housing Benefit and Council Tax Support, aimed at supporting the poorest pensioners.

Housing Benefit is a means-tested benefit available to people who live in rented accommodation. How much people get depends on income and savings, who else lives in the household and their circumstances, how much rent is paid and the number of rooms in the household. Housing Benefit is available to those in receipt of GC, regardless of how much they have in savings. Pensioners in receipt of GC would usually have their rent paid in full.

Pensioners who own their own home and who are in receipt of GC may be eligible for **Support with Mortgage Interest**. This is normally paid directly to the mortgage lender rather than the individual. People cannot get help towards the capital amount that they borrowed – only the interest.

Anyone who was in receipt of the GC part of Pension Credit is also entitled to **support with paying Council Tax**. Council Tax is the local property tax and applies to all residential properties. The average annual levy on a property in England in 2011 was £1,196. Prior to 2013, those in receipt of GC were also eligible for full 'Council Tax Benefit', which was a national benefit that covered the entire cost of their Council Tax bill. This benefit is now set locally, and known as Council Tax Support. Councils are required to cover the full cost of Council Tax for those pensioners in receipt of GC.

Those who do not get Guarantee Credit but have a low income and less than £16,000 in savings, may still get some help with Housing Benefit and Council Tax Benefit.

Universal benefits for pensioners

Pensioners receive other benefits as part of the package of state support. These include: free bus passes, TV license (for those aged over 75), prescriptions and eye tests; and a winter fuel allowance (for those aged over 75) and a 'Christmas bonus' of £10.

These benefits are available to pensioners regardless of their income or the amount that they hold in savings. They have been under scrutiny given the austerity measures taken in the UK but in the run up to the May general election, all the main political parties have vowed to continue these benefits in the next Parliament, should they be elected.

Coverage of state support in retirement

Everyone either contributes or has access to state support. However, this does not mean that state support provides full coverage. Around 95% of employees qualify for BSP (making NI contributions) and around 70% qualify for S2P.

Not everyone receives the full amount of basic state pension. In 2012, just under 60% of those of state pension age were in receipt of a full BSP.

Take up of means-tested support, such as Pension Credit and the passported benefits that come with it, is much lower than it ought to be and non-take-up has risen substantially over the last decade. There are various reasons for this including: lack of awareness, pride and a lack of support to make the claim.

Around two-fifths of pensioner households entitled to Council Tax Benefit (now Council Tax Support) and a third of those entitled to Pension Credit are not claiming them⁹.

State pension reforms – the single tier pension

From 6 April 2016, **the Basic State Pension, State Second Pension and Pension Credit will effectively be replaced by a single tier state pension.**¹⁰

⁹ DWP (2012) Income related benefits estimates of take-up in 2009-10. Available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/222915/tkup_full_report_0910.pdf

The single tier state pension is intended to simplify state pension arrangements; to improve state support to women (who tend to have greater gaps in their NI record) and the self-employed (who have been excluded from S2P); and to provide a firm foundation for private pension saving.

The main part of the legislation (Pensions Act 2014) is to combine the basic state pension (BSP) with the state second pension (S2P) to create a new 'single-tier' pension which would be set at a level high enough to ensure that anyone with full entitlement would not qualify for the means-tested Guarantee Credit within Pension Credit.

The rate of single tier state pensions will not be decided until shortly before it is introduced. It will be set above the basic level of means-tested support (£148.35 per week). People must have 35 years of NI contributions, rather than 30, to receive the full single tier state pension. They must also have contributed for a minimum of 10 years. Those who have fewer than 35 years when they reach State Pension age will get a pro-rata amount.

For those who have made contributions under both the new single tier pension and the current/ previous system, special arrangements will apply. These are complex, but overall those who made National Insurance contributions or received credits under the current system will have these converted into a single-tier 'foundation amount'. This will be no less than the amount calculated using the present rules¹¹. New contributions will then build on this foundation.

Currently, it is possible to inherit or derive rights to the state pension of a spouse or civil partner. This will no longer be possible under the new single tier pension. However, those who have National Insurance contributions or credits under the current scheme will receive transitional protection.

Spending on state support and the fiscal impacts of reform

Welfare spending on pensioners, including the state pension and other benefits, accounted for roughly 55% of welfare spending, and almost **7% of Gross**

¹⁰ Pensions Act 2014, which received Royal Assent in May 2014. Available at:

<http://www.legislation.gov.uk/ukpga/2014/19/contents/enacted>

¹¹ Full details available at:

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/181237/single-tier-pension-fact-sheet.pdf

Domestic Product, in 2013-14¹². The state pension is the largest component of welfare spending on pensioners and accounted for 5.5% of GDP in 2013/14.

Despite the ageing of the population, spending on pensioners was fairly stable as a share of GDP until 2007-08, when the effect of the recession on GDP and relatively high inflation on uprating helped to push expenditure higher.

The state pension has historically been the largest component of welfare spending, averaging 37% of total welfare spending over the past 30 years. This is expected to rise to 44% by 2018-19. Without the increases in state pension age, spending on state pension would have been **0.5% higher** as a proportion of GDP by 2018/19.

Spending on state pensions was estimated at **£83 billion in 2013-14**, around 40% of total welfare spending. It is the second highest item of public expenditure. Across all public spending, only NHS expenditure (£109.7 billion in 2013-14) was larger than spending on state pensions¹³.

Based on currently enacted policy and the proposal to introduce a single tier state pension system, total public expenditure on state pensions is projected to increase from almost 7% of GDP in 2013/14 to 8.4% (or £438 billion) of GDP in 2062/3. Without the single tier pension, the long-term costs would have been even higher as a proportion of GDP¹⁴. The new single-tier pension specifically will reduce spending on state pensions by 0.4% of national income by 2060.

¹² Office for Budget Responsibility. October 2014. Welfare trends report

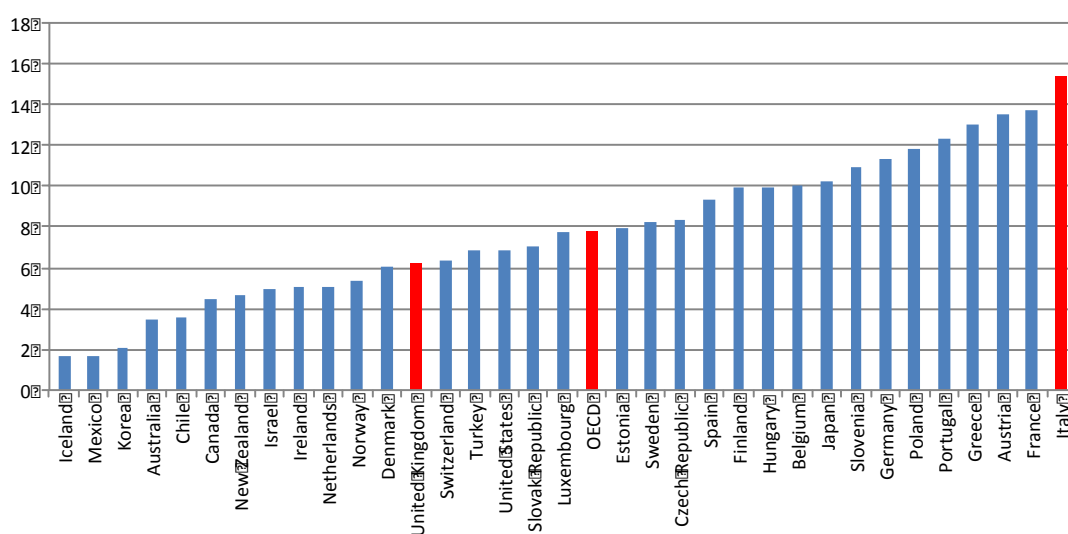
¹³ Office for Budget Responsibility. October 2014. Welfare trends report

¹⁴ See ONS Pension Trends, Chapter 5: State Pensions, 2013 edition. See also Office of Budget Responsibility, Fiscal Sustainability report, 2013. For more on pensions and public spending see <http://www.ifs.org.uk/publications/7461>

How this compares across the OECD

Public spending on old-age pensions and survivors' benefits in the OECD increased 15% faster than the growth in national income between 1990 and 2007, from an average of 6.1% of gross domestic product (GDP) to 7.0%. Public pensions are often the largest single item of government expenditure, accounting for 17% of total government spending on average. The UK ranked 13th in OECD and G20 countries in terms of spending on pensioner benefits, based on the system as it was in 2011. It is not known whether this position has changed following the latest UK reforms.

Spending on pensioner benefits as % of GDP



Source: OECD (2011), "Public Expenditure on Pensions", in Pensions at a Glance 2011: Retirement-income Systems in OECD and G20 Countries, OECD Publishing.
http://dx.doi.org/10.1787/pension_glance-2011-30-en

1.3 Accumulating for retirement: Private pensions

Private pension provision is a key pillar of the UK pension system. Like the system of state support, private pensions are complicated. There are a variety of different types of pension and, given related reforms and changes to the pensions industry, individuals' experiences of private pensions will be very varied for some decades yet.

Private pensions broadly consist of **employer sponsored pension schemes** and individual arrangements or so-called '**personal pensions**'. The former involve employers, to a greater or lesser degree, and consist of Defined Benefit and Defined Contribution schemes (see below). The employer either operates the pension scheme or chooses a pension provider to deliver a scheme. Employees do not choose the workplace pension for themselves. In contrast, individual arrangements are taken out between an individual and a pension provider.

Until recently, employers did not have to contribute to a workplace pension scheme. All employers with five or more employees who did not already have comprehensive pension provision were required to designate a 'stakeholder pension' provider (a type of personal pension, see below) but they were not required to contribute to it. Now all employers, even those who only employ one member of staff, must provide a scheme and make a contributions to it (explained further below).

Workplace pensions

Defined benefit schemes

A **defined benefit** scheme, sometimes called a final salary pension scheme, is one where the final benefit is known to the member and is usually calculated through a formula incorporating wages and length of service.

For those who have saved into a defined benefit pension scheme, their savings – along with the contributions of their employer and the tax relief they receive from the government – have been invested in the stock market over their working years. However the income that they ultimately receive is a guaranteed, pre-agreed amount. This is the 'defined benefit'.

Contributions of employers and employees are varied to ensure that this agreed pension is reached. This works on a pooled fund basis – all contributions are paid into a common fund, which is invested to provide all retirement benefits. Therefore in the normal course of events, the investment performance of the scheme assets has no or minimal impact on the benefits an individual receives. However investment

performance does affect the contributions needed: the better the investment performance, the lower the required contributions.

There are two main types of defined benefit pension:

- **Final salary** schemes are based on how much an individual was paid at the point that they retired.
- **Career average** schemes are based on an average of the salary paid to an individual across their career.

Both types of pension provide valuable benefits, the biggest of which is 'index-linking.' This means that pension income is guaranteed to rise each year, so that it can keep up with rising prices in the future. This protection is usually capped at 2.5% a year, although in some cases it is linked to inflation measured by the Retail Prices Index.

Other benefits of these schemes include:

- Death in service payments to spouses, partners or dependants if the policyholder dies before reaching pensionable age
- Full pension if the individual has to retire early through ill health
- Reduced pension for early retirement, although this cannot be done before age 55

Defined benefit schemes usually have a normal pension age of 60 or 65, but a member can usually retire early with a reduction in the amount paid out. People leaving the scheme as a result of changing their employer can also preserve their rights in the scheme until pension age, or transfer the accrued rights to another arrangement.

To increase the security of Defined Benefit schemes, the government established the 'Pension Protection Fund' in April 2005. This pays a minimum level of pension even if an employer becomes insolvent and the pension fund is underfunded.

Final salary pension schemes are advantageous for members because the scheme takes all the investment risk and is obliged to meet the 'pension promise' of a pre-defined amount of income made to each member, regardless of how underlying investments have performed. This means final salary pension schemes are riskier for employers.

Final salary pension schemes are also becoming more expensive as people live longer, because they have to pay out for longer. For these reasons, most private

sector schemes have now been closed to new members and replaced by defined contribution schemes.

Defined contribution schemes

A **defined contribution**, or money purchase, pension scheme is a type of workplace pension. It is built up through your own contributions, those of your employer and tax relief from the government. Contributions are usually expressed as a percentage of salary or total earnings. The rate of contribution could be flat-rate or could be tiered by age and/ or length of service and /or seniority and/ or level of earnings. Employers make a base level of contribution for all employees and may also match any employees' additional contribution.

In a Defined Contribution scheme, the member will not know for certain how much their pension will be worth to them in retirement. They will be given a projection, which is subject to change, and which is not a guarantee. The value of their pension will depend on the success of investment returns. What this will mean to them in terms of a retirement income will depend on the financial product(s) they decide to take out at retirement using the money they build up (see Part 1.4).

Most company pension schemes are now defined contribution. Prior to automatic enrolment (see below), it was possible for employers to offer a defined contribution pension scheme under any contribution terms they wished. That is, there was no minimum that the employer must contribute so a wide variety of employer/ employee arrangements existed. There are now minimum requirements on employers but they may contribute more than this if they wish.

Defined contribution pension scheme charges

Pension charging has come under recent scrutiny because of the significant impact they have on an individual's pension fund value, and therefore the contribution their private pension makes to their overall retirement income. However, charges on pensions are often lower than on other savings products. Furthermore, they offer the most tax efficient way to save for retirement (see Part 1.4 on pensions tax).

Workplace pension schemes tend to have lower charges than personal schemes. The amount and type of charges can vary from provider to provider and from scheme to scheme.

Most defined contribution schemes have an **annual management charge** (AMC). This is an amount the member is charged each year, either as a set monetary amount or, more commonly, as a percentage of the value of the pension fund. The

AMC covers the cost of running and administering the pension scheme, as well as investing contributions.

Over the last 10 years, charges on pension schemes and plans have been reducing. Employers, especially large employers who represent good business to pension providers, may negotiate lower annual management charges with the provider. As such, employer sponsored pension schemes and group personal plans tend to have lower AMCs than a pension an individual has taken out himself or herself.

Additional fees may be incurred for transferring the pension from one provider to another and making fund switches. Consultancy fees may have been charged and taken out of the pension fund for advice given in establishing the pension for the individual. This was particularly the case for group personal plans and other personal pensions. Consultancy charges were banned in April 2015¹⁵.

In March 2014 the Government announced a **0.75% cap** on charges for the default funds of all qualifying schemes for automatic enrolment (see section on Automatic enrolment below). Over the next 10 years, the government estimates that an extra £195 million of pension contributions will turn into pension savings, rather than being lost through costs and charges¹⁶.

Personal pensions

People can make their own private arrangements by taking out personal pensions. A personal pension is a type of defined-contribution pension. Personal pensions are characterised by individual arrangement, to varying degrees depending on the product, between the pension provider and the member. They have typically been used in addition to occupational provision and by the self-employed.

Prior to automatic enrolment (see below), some employers offered employees access to a personal pension via the workplace – for example they offered a **Group Personal Plan** or had designated a **Stakeholder Pension scheme** provider. In these cases, the pension is still deemed to be 'personal' because the individual employee must arrange their contributions with the pension provider and make an active fund choice (even if that is to choose a standardised fund). Though this sort of pension is generally thought of as a personal pension, it is likely that many employees who have experienced these schemes via their employer would struggle to differentiate them from occupational pensions.

¹⁵ Other charge structures deemed incompatible with auto enrolment will be banned from April 2016 which includes both Active Member Discounts ('AMDs') and adviser commissions.

¹⁶ DWP (2014) Better workplace pensions: Further measures for savers.

One form of personal pension is a **Self-Invested Personal Pension** or SIPP. A SIPP is essentially a 'do it yourself' pension. Other personal pensions limit investment choice to a shorter list of funds normally run by the pension company's own fund managers. With a SIPP, members can invest almost anywhere they like and choose their own investments.

Another form of personal pension is a **stakeholder pension**. Stakeholder pensions are a form of defined contribution pension. They have low and flexible minimum contributions, capped charges and a default investment strategy. People can start making payments into a stakeholder pension from £20 per month. They can pay weekly or monthly. They may also make lump sum payments at any time if they don't wish to make regular payments. Stakeholder pensions have to meet some minimum standards set by the government. These include:

- management charges can't be more than 1.5% of the fund's value for the first 10 years and 1% after that
- Members must be able to start and stop payments when they want or switch providers without being charged
- They have to meet certain security standards, e.g. have independent trustees and auditors
- They must offer a default investment approach for those who might be deterred by a requirement to make a fund choice

Automatic enrolment

The previous government acted on the recommendations of the Pensions Commission (see Part 1.5) and legislated in the Pensions Act 2008 for the introduction of automatic enrolment. It requires all employers to provide a pension that meets certain criteria¹⁷ and to make contributions. It also requires that employees who met eligibility criteria must be enrolled automatically. As such, employees will need to actively opt-out if they do not wish to be in the scheme. Prior to automatic enrolment, employees had to actively opt-in.

Employees are eligible for automatic enrolment if they are aged between 22 and state pension age and earn £10,000 from a single job¹⁸. Contributions become

¹⁷ The scheme must be tax registered and meet certain quality standards.

The scheme must not require any action on the part of the employee in order for them to benefit. For example, the scheme must not require employees to choose funds themselves. Though fund choice may be given as an option, a default fund must be in place. In theory, this could be a defined benefit scheme but defined contribution schemes are expected to dominate.

¹⁸ Note that the earnings eligibility threshold has increased a number of times.

payable on earnings over £5,772 and up to a limit of £41,865. If employees do not meet the eligibility criteria, they can request to join the scheme¹⁹.

After a phasing in process of 6 years (ending in 2017), minimum total contributions of 8% of earnings within designated bands will be paid to a qualifying pension scheme, with a minimum of 3% from the employer. If the employer decides to contribute the legal minimum 3%, then the employee will have to contribute 4% and the government will contribute 1% through tax relief.

Automatic enrolment is being rolled out gradually, with the largest employers affected by the new duties first. By February 2018, all employers will be required to automatically enrol their eligible employees.

Employers who already provide a pension scheme (or schemes) for some or all of their workers may use this scheme for automatic enrolment provided it meets the criteria. In reality, some employers have chosen to replace their existing scheme, some have worked with their existing pension scheme provider to ensure that it meets the necessary criteria and others operate several schemes together – maintaining an existing scheme for those employees who were already members and operating a new scheme for automatically enrolled employees.

NEST

Among the choices of new schemes for employers is NEST, the **National Employment Savings Trust**. The Pensions Act 2008 legislated for the introduction of a new low cost scheme that has a public service obligation, meaning it must accept all employers who apply to join. It has been established by Government to ensure that employers, including those that employ low to moderate earners, can access pension saving and comply with their automatic enrolment duties. Whilst the industry has now responded to automatic enrolment and adapted products to help employers meet their new duties, there was some initial concern about whether market failure might prevent automatic enrolment from operating in practice, given the likely smaller pension fund values of automatically enrolled customers (and the profitability of this new business to pension providers).

The charges for NEST are:

- A contribution charge set at 1.8% of whatever is paid in. So, if £10 is contributed, £9.82 goes into the pension fund after the charge.

¹⁹ For more detail on automatic enrolment rules and employer duties, see <http://www.thepensionsregulator.gov.uk/docs/detailed-guidance-4.pdf>

- An AMC of 0.3% of the pension. For example, if the pension is worth £1,000 in a year, the AMC will take away £3, leaving £997 invested in the pension for the next year.

These charges are lower than most personal pensions and much lower than the maximum charges allowed for stakeholder pensions (1.5% annual charge for the first ten years and 1% a year after that).

In its last annual report NEST reported having over a million members and assets under management at £104 million²⁰. It is estimated that NEST now has well over 2 million members.

Pensions and the tax system: tax implications during pension saving and during retirement

The UK tax system is structured to incentivise pensions saving. Pension savers get tax back on the money they put into a pension. This comes in two forms depending on whether the individual is a basic rate or higher rate taxpayer. In addition, gains made in the pension as a result of investment are largely tax free. However, income from pension is subject to tax, if this takes the individual's income over their tax free allowance.

Tax on contributions

The Finance Act 2004, which took effect from 6 April 2006, included a number of amendments designed to simplify the taxation of the UK private pension regime, effectively capturing all pensions under a single set of rules. The amount by which an individual can benefit from tax advantages is controlled by two 'allowances': annual and lifetime. These allowances apply to each individual, and across all registered pension schemes that the individual uses for providing benefits, regardless of the time of joining.

Private pension contributions are tax-free up to certain limits.

People can get tax relief on private pension contributions worth up to 100% of their annual earnings. This means either they don't pay Income Tax on contributions to their private pension or they get tax back. Generally, people don't have to claim tax relief on pension contributions. They get so called 'relief at source' in all personal and stakeholder pensions, and some workplace pensions.

²⁰ <http://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/nest-scheme-annual-report-and-accounts-2013-2014.PDF.pdf>

An individual can make contributions to any number of private pension schemes and receive tax relief on the amount saved in that year up to the annual allowance. This is £40,000 for 2014/15. Contributions above this level are taxed at an individual's tax rate.

Tax must be paid on any private pension savings above the lifetime allowance. This is £1.25 million for 2014/15.

Tax on accumulated gains

No tax is payable on accumulated gains – either through interest or as capital gains – on pension funds. However, the lifetime allowance rule applies to pension funds valued over £1.25 million.

Tax on pension proceeds

People are able to take a 25% tax free lump sum from their pension²¹. Larger lump sums are taxed at 55%, much higher than the usual rate of income tax. Any income people take beyond the lump sum, or that they receive via their pension (for example through an annuity or a drawdown product) is taxed at the usual rate. Note that income for tax would include private pensions, state pension and any other sources of income. The amount of tax people need to pay is based on their total income²².

²¹ Note that it is possible to take a lump sum from a defined benefit scheme as well as a defined contribution scheme. The way this is calculated is complicated. It's based on the schemes 'commutation factor', which represents how much of a lump sum the member gets for every £1 they give up in income. So if they have a commutation factor of 12, you get £12 lump sum for every £1 you give up.

²² For more detail go to: <https://www.gov.uk/tax-on-pension>

1.4 Decumulating for retirement: How and when consumers can access their pension

People are allowed to withdraw pension savings after the age of 55. However, in the Budget 2014 it was announced that this will rise to 57 in 2028. Before age 55 they can only withdraw pension savings if they pay a tax penalty of 55%. At 55, people can choose one or a combination of the following options:

- Taking a cash lump sum. Up to 25% of a pension fund can be taken as a tax free lump sum. If an individual's entire pension fund is less than the trivial commutation limit (set at £30,000 from 27th March 2014), it is possible to 'trivially commute' and take the whole fund as a lump sum, with 25% being tax free.
- Investing some or all of their fund for some part or all of their retirement in an income drawdown account (while taking an income from it capped at 150% of an equivalent annuity)
- Withdrawing their fund in unlimited amounts provided that individuals can demonstrate a secured guaranteed lifetime pension income of at least £20,000 per year.
- Purchasing an annuity. This is an insurance product that pays an income from the date of purchase until the date of death. Note that given the stipulations around drawdown, taking lump sums and withdrawal, the vast majority of people take lump sums up to 25% and buy an annuity.

Rates of income tax

Everybody has a tax free Personal Allowance of £10,000

Basic rate 20% - £0 to £31,865. People with the standard Personal Allowance start paying this rate on income over £10,000

Higher rate 40 - £31,866 to £150,000
People with the standard Personal Allowance start paying this rate on income over £41,866

Additional rate 45% - over £150,000

Freedoms announced at Budget 2014

In the Budget 2014, the government announced significant new freedoms for pension savers.

From April 2015, individuals will be able to withdraw the whole of their pension pot. The tax free lump sum will remain in place but any withdrawals over this amount will just be taxed at the individual's marginal rate.

The government has set up a new free guidance service to ensure that everyone who wants guidance on their new options for accessing their pension can access it.

A further liberalisation for those who have saved in defined contribution pensions was announced in the last budget (March 2015). From April 2016, those who have purchased annuities will be able to sell them without facing the tax charges that currently apply.

The option(s) people take have significant implications for income and level of wealth in retirement. The new consumer freedoms now open to pension savers have come under some fierce opposition as well as support. The potential challenges of this reform are discussed in Part Two of this report.

1.5 The reform story: a 'potted history' of UK pension system reform

UK pensions in recent history

Fifteen years ago, the UK system comprised state support that was never intended to provide fully for retirement and a generous system of defined benefit workplace pension schemes. Not everyone had access to the latter but overall the UK was seen to have a similar level of pension provision to other developed countries, with 56% of the number of eligible workers participating in a workplace pension scheme²³.

The UK system was not without issues, but it wasn't until the turn of the century that these began to be fully recognised. The costs of both public and private pensions were rising as life expectancy increased and the system which had been reformed incrementally had become, in the words extremely complicated. The focus of the government up to that point had been to improve the lot of the poorest pensioners through increasing the means tested pensions credit, as the relative value of the state pension, which had been linked to prices not earnings (by the previous Conservative Government), continued to decline.

The Pensions Commission

The Pensions Commission was appointed in December 2002 with the remit of keeping under review the adequacy of private pension saving in the UK, and advising on appropriate policy changes, including on whether there is a need to move beyond a voluntary approach to private pension saving. They published two reports.

First report: Challenges and choices

The first, in 2004, presented findings of comprehensive analysis of the UK pensions and retirement savings system²⁴. It described in detail the challenges that needed to be met at the time and set out three 'killer facts' that have guided reform through to the present day.

1. Private pensions have been breaking down making more people entirely reliant on the state, even though it was never intended to provide fully for retirement. **The proportion of UK private sector workers relying**

²³ Pension Commission, Pensions: Challenges and Choices

²⁴ Pension Commission, Pensions: Challenges and Choices

entirely on the state sector pension was 46% in 1995 and had risen to 54% by 2004. This powerfully illustrated the failure of private sector pensions and the weight of responsibility under which the state pension was labouring. Increasing longevity, tighter regulation and lower equity returns put pressure on defined benefit schemes and so they were rapidly closing to new members. In some instances, provision has been replaced with defined contribution arrangements. In others, workplace provision has been eroded entirely. In some, usually smaller workplaces, provision never existed at all.

2. Attempts to reverse the decline by encouraging saving on a voluntary basis had not been successful. The Welfare Reform and Pensions Act 1999 introduced legislation that required employers with more than five employees to set up a 'stakeholder' pension scheme that would be open to all workers. These were intended to encourage pension saving among workers but take up was limited, particularly among lower earners. **Only about 0.5% of people make pension saving decisions on a rational basis of the type economists use to model and predict behaviour, taking into account interest rates, discount rates and the net present value of their assets.** Rather, they enter into pension arrangements if they are compulsorily enrolled by the state, if they are automatically entered into a scheme as a by-product of employment or if a pension provider goes to them direct to sell them a pension.
3. The third fact was that it was impossible for small and medium sized enterprises to offer occupational pensions without administrative fees so high that they ended up consuming a punitive proportion of the employee's contributions. **The cost of a pension scheme for a small employer was 1.5-2.0% a year – compared to 0.1% for a Unilever – that ate up 30% of the potential pensions entitlement for an employee.**

Due to increasing life expectancy and a low predicted birth rate, the Commission predicted that the percentage of the population aged over 65 would double by 2050, putting further strain on the pension system. However, perhaps the most shocking finding was that 60%, a clear majority, of employees over 35 were on course to have inadequate pensions (see Part 2.3 on the adequacy challenge). Private savings were not responding on anything near the scale required to offset these developments and were, in any case, highly unequally distributed. The combined result of all this was that, on a business as usual path, pension accrual was "both deficient in total and increasingly unequal."

It rather starkly concluded that, given the increase in the proportion of the population over 65, there were four options to choose from:

1. pensioners will become poorer relative to the rest of society; or
2. taxes/ NI contributions devoted to pensions must rise; or
3. savings must rise; or
4. average retirement ages must rise.

The report argued that the first option seemed unattractive and, given that the proportion of GDP transferred to pensioners would have to rise from 10% to 15% to maintain pensioners' living standards, none of the other options would be able to shoulder the load on their own. This analysis helped define the problem in a very different way to the government's initial intent – from being an issue of the divide between those with defined benefit versus defined contribution, the Commission's analysis showed that the real cliff edge was between those in the private sector enrolled in an occupational scheme of any sort and those with no provision at all.

Second report: Proposals for reform

The Commission's second report, published in November 2005, made recommendations for reform that went well beyond its initial limited remit²⁵. The first recommendation was the creation of a low cost, nationally funded pensions saving scheme which individuals would all automatically be enrolled onto, with the option of opting out. This would help overcome the problem of inertia and the inefficiency of small and medium enterprises provided occupational pensions. The second was to make the system less means tested, in order to minimise disincentives to saving, financed partly by an increase in taxes devoted to pensions. Lastly, the Commission recommended re-linking the basic state pension to average earnings growth financed in part by a steady increase in the state pension age designed to keep the proportion of life spent in retirement constant.

Implementation of Pensions Commission's proposals

In May 2006, the government published *Security in Retirement: Towards a New Pensions System*. The report signalled the government's commitment to the Commission's proposals and set the stage for two pieces of legislation to make them law.

²⁵ Pensions Commission, *A New Pensions Settlement for the 21st Century* (2005)

Issue	Turner Report	White Paper
State Pension Age	Rising to 67-69 by 2050	Rising from 68 from 2044
State Pension	Linked to earnings by 2010	Linked to earnings, probably by 2012
National Pension Savings Scheme	Automatic enrolment if no work scheme	Automatic enrolment from 2012, but workers can opt out
Default Contributions	3% employers, 4% workers, 1% government	3% employers, 4% workers, 1% government
Help for Women	Full state pension to all over 75 based on residency not NI contributions	NI contributions reduced to 30 years
System of Regular Review	Successor body presenting a report every 3-4 years	No system of regular review

The 2007 Pensions Act was the first stage of the changes and included restoring the earnings link, raising the pensions age, reducing contributions requirements and ending the opportunity to opt out of the additional state pension. A second Act in 2008 put in place measures to address the lack of pension provision in the private sector including the creation of new low cost savings vehicles and an obligation on employers to enrol all employees.

Both the 2007 and 2008 Pension Acts enjoyed broad cross-party support though there was some criticism of the means-tested elements in the 2008 Act. The coalition Government has continued with the reforms, but has accelerated the raising of the state retirement age taking account of the increase in life expectancy from the projections on which the Commission's recommendations were based. It has also: introduced the 'triple lock' (April 2011) for uprating the basic state pension; committed to a single tier state pension beginning in 2016 and given consumers new freedoms with respect to how they take their money out of a DC pension (Pensions Act 2014).

Part Two: Implications of reform and current challenges

This second part of the report explores the issues that reform has sought to address in more detail and those that remain despite reform. It comprises the following sections:

- The demographic challenge
- The private pension participation challenge
- The adequacy challenge
- The equality challenge

In each of these sections, the issue is outlined first, followed by a brief summary of the key policy response to the issue and then an appraisal of the current position on the issue. Note that these issues overlap and the policy responses aren't always mutually exclusive.

This section covers issues across the whole system, taking in state support and private pensions. It also takes in all phases of the retirement planning journey from accumulation, be that through NI contributions or contributions to a private scheme, through to decumulation and wealth in retirement. Given the breadth of the scope, it should be noted that whilst there is an attempt here to be comprehensive, this chapter is not exhaustive.

2.1 The demographic challenge

Overview of the demographic challenge

The fundamental challenge of any pensions system, be that in the UK or elsewhere, can be summarised as making a finite amount of money fit into a variable amount of time. Between policy makers and individuals, labour market withdrawal and longevity need to converge at just the right point to ensure the optimum use of available retirement resources to cover the period. This inherent pensions challenge has notably become more problematic in the UK and indeed across the developed world as a result of increased longevity and the resultant shifts in the dependency ratio. In short, more people are spending longer in retirement. At the same time, there are proportionately fewer people of working age.

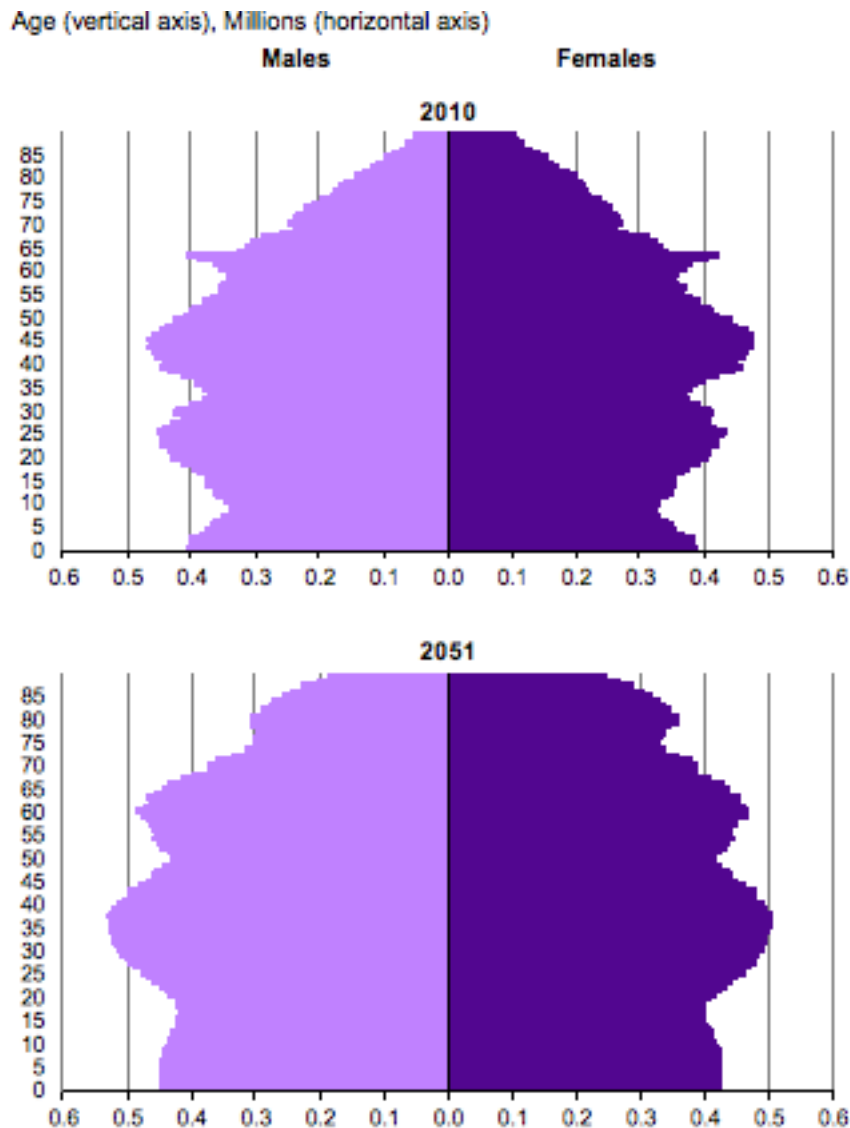
The working population in 2004 supported a historically very low burden of non-working pensioners and children. The size of that burden, if average retirement ages remained unchanged, would have risen significantly given the changing demographic picture.

Life expectancy has increased substantially in the UK over the last three decades and continues to increase.²⁶ Between 2010 and 2051, the proportion of people aged 65 and over is projected to increase from 17 to 24%, while the proportion aged 85 and over is projected to increase from 2 to 7%. In 1981, men aged 65 could expect on average to live a further 14.0 years and women aged 65 a further 18.0 years. By 2051, life expectancy for men aged 65 is projected to be 25.9 years; for women aged 65 it is projected to be 28.3 years. Males born in 2014 could expect to live 90.9 years on average and females 94.2 years. 1 in 3 can expect to celebrate their 100th birthday²⁷.

²⁶ ONS 2013. See Statistical bulletin: Available at: <http://www.ons.gov.uk/ons/rel/lifetables/interim-life-tables/2009-2011/stb-2009-2011.html?format=print>

²⁷ ONS 2013. See Statistical bulletin: Historic and Projected Mortality Data from the Period and Cohort Life Tables, 2012-based, UK, 1981-2062. Available at <http://www.ons.gov.uk/ons/rel/lifetables/historic-and-projected-data-from-the-period-and-cohort-life-tables/2012-based/stb-2012-based.html>.

Figure 2.1: Actual and projected UK population: by sex and age, 2010 and 2051



Source: Population estimates and 2010-based principal population projections, Office for National Statistics

In 2010, there were 3.2 people of working age for each person of State Pension Age (SPA) and over in the UK. The 'old age dependency ratio' measures the number of people of SPA and over for every 1,000 people of working age. It was steady at around 300 from the mid-1970s to 2006 but rose in 2007-09 as women born in the post-World War II baby boom reached SPA²⁸.

Whilst people are living much longer, many people underestimate their life expectancy with significant implications for retirement planning. Comparing perceived life expectancies with official cohort life expectancies, that is, life

²⁸ ONS Pension Trends Chapter 2: Population change 2012 edition

expectancy projections that incorporate some improvements in life expectancy in the future, people appear to be somewhat pessimistic on average. Men aged 50–60 underestimate their life expectancy on average by around 2 years, and for women 4 years. In particular, too few people expect to live until very old age: only 9 per cent of men and 10 per cent of women aged 30–60 expect to live until at least age 90, when in fact the official estimates are that 18 per cent of men and 29 per cent of women in this age group will do so²⁹.

Key policy responses to the demographic challenge

The previous and current government have taken various steps to encourage people to work for longer, thereby reducing the amount of time they spend in retirement (and therefore having a shorter retirement to be funded by the state and privately). They have also been vocal in their expression of support for older workers and for the principle goal of extending working lives.

Increasing the state pension age

The Pension Commission's recommendation to increase state pension age alongside other reform measures has been supported across the political spectrum with both the Labour government and latterly the Liberal Democrat/ Conservative coalition government producing legislation to increase the state pension age.

The state pension has been increasing gradually. It will be 65 for both men and women by the end of 2018. Between 2026 and 2028 it will have increased to 67, under current plans.

Abolishing the Default Retirement Age

In 2011, the Default Retirement Age was abolished. Implemented in 2006, the Default Retirement Age meant that employers could force their employees to retire at the age of 65. Employees could request to stay on after this age but employers could refuse these requests if they wished to.

Extending the right to request flexible working

From 30th June 2014, the right to request flexible working was extended to all employees. Previously, the right had only been available for carers, or people who look after children. Flexible working is intended to help people balance their work with other responsibilities, keep more people in long-term employment and enable companies to keep hold of top talent. Older workers in particular were expected to benefit from this new right, as many may wish to work differently as they approach

²⁹ Ibid

retirement. As part of the right, employees can expect their request to be considered in a reasonable manner by employers and employers can only refuse requests for flexible working on certain grounds.

Other steps to encourage people to work for longer

There have been a variety of initiatives to encourage people to work for longer and to help those over 50 find or stay in work. These are too numerous to cover here. Current key initiatives principally include:

- The government is rolling out an 'older workers' champion scheme across every part of the UK to tackle age discrimination, from April 2015. The scheme is intended to help jobless over 50s into work. Intensive work support will be offered through the scheme with a 'career review', digital support for older jobseekers to get online and link-ups with local small and medium sized businesses with vacancies to fill.
- This year, the government published "A New Vision for Older Workers: Retain, Retrain, Recruit", a report commissioned by the Government by a leading and respected pensions expert and campaigner whom the government appointed as their 'Business Champion for Older Workers'³⁰. This makes a number of policy recommendations that centre around, keeping older workers and their skills in the workplace, on-going workplace training irrespective of age and measures to eradicate age discrimination from the recruitment process.

Impact of policy response to demographic challenge and related issues

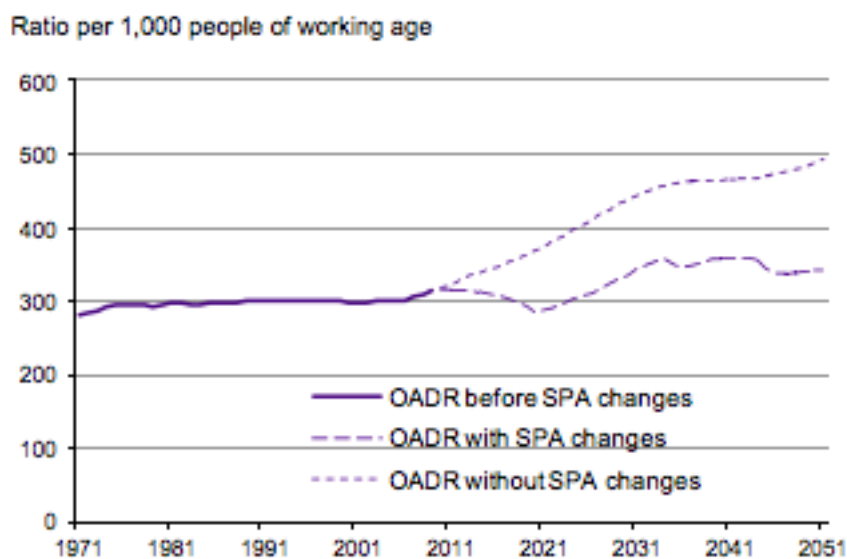
Impact of the SPA increase on the dependency ratio

In the absence of any increases to SPA, the old age dependency ratio would reach 492 by 2051; but, as a result of the SPA increases taking place between 2010 and 2046 under current legislation, it is expected to be 342 in 2051³¹.

³⁰ DWP (2015) "A New Vision for Older Workers: Retain, Retrain, Recruit". A Report by Dr Ros Altman CBE, Business Champion for Older Workers

³¹ ONS Pension Trends Chapter 2: Population change 2012 edition

Figure 2.2: Old age dependency ratio



OADR = old age dependency ratio.

SPA = State Pension Age.

Working age population is defined as individuals aged 16 to SPA.

SPA changes are those contained in the Pensions Acts 1995, 2007 and 2011.

Source: Population estimates and 2010-based principal population projections, Office for National Statistics

It should be noted that life expectancy projections are not static. ONS produce life expectancy projections on a biennial basis taking into account new mortality data between releases. Successive releases have shown a general upward trend in the revision of life expectancy. Whilst it would appear that latest changes will have the impact of improving the dependency ratio, this remains to be seen for certain. Also, potentially further changes to state pension age will be required in order to maintain the desired dependency ratio (see section X for more on reviewing the SPA).

The main fiscal benefit of the most recently legislated increase in the SPA (increasing to 67 between 2026 and 2028, bringing it forward 8 years based on what had been set out in the Pensions Act 2011) is net benefits related savings of £73.5 billion in real terms, with a further £11 billion gain from increased tax receipts and NI contributions resulting from longer working lives³².

Impact of extending working lives measures

Policy interventions in this area have been numerous and many have been smaller initiative based. The government is tracking changes in the average age of withdrawal from the labour market as an indicator of the impact of these

³² See DWP (2014) Pensions Act 2014 Impact Assessment

interventions. Based on their latest reports, no statistically significant increase has been observed in the measurement period, although over longer time horizons, the general trend is towards a later labour market exit (see below). There are clearly problems with attribution as a wide variety of factors will play a role in shaping decisions about when to stop working.

Trend in later labour market exits

People are stopping work later in life. The number of people of state pension age and above in employment has nearly doubled over the past two decades, from 753,000 in 1993 to 1.4 million in 2011³³. Between 2004 and 2010, the average age at which people left work increased to 64.6 years for men from 63.8 years, and to 62.3 years for women from 61.2 years³⁴.

Whilst this trend hasn't been entirely determined by the state pension age (during this period state pension age was 65 for men and 60 for women), there are numerous factors which, taken together, mean this trend is likely to continue. For example, improved performance of the economy, increased longevity, supportive legislation, a growing expectation amongst employees that they will work to an older age, welfare reforms, increases to the State Pension age, the decline of defined benefit pension schemes in the private sector, and plans to increase the normal pension age for public sector schemes.

Public attitudes to working longer are changing too. Messages about longevity appear to be beginning to be heard³⁵ ³⁶ with most individuals in recent surveys stating they expect to live until they're 83.

Those currently in work and not retired are planning later retirements than current retirees. Most recent survey research shows the average age at which people not currently retired said they thought they would stop working and retire was 65.2. This was similar for both men (65.5) and women (65.0)³⁷.

The evidence also indicates that people are prepared to work in some capacity after reaching retirement age. 39% expect to retire after reaching age 65³⁸. The exact numbers differ depending on the survey but all of the evidence points to the same

³³ ONS Older Workers in the Labour Market, 2012

³⁴ ONS 2012 Pension Trends. Available at <http://www.ons.gov.uk/ons/guide-method/method-quality/guide-to-pension-statistics/pension-trends-publications/index.html>

³⁵ Unpublished research for Just Retirement, 2014

³⁶ Crawford, R and Tetlow, G (2012) Expectations and experiences of retirement in Defined Contribution pensions: A study of older people in England

³⁷ DWP (2015) Attitudes of the over 50s to Fuller Working Lives

³⁸ DWP (2015) Attitudes of the over 50s to Fuller Working Lives

trend³⁹. Pre-retirement income appears to shape attitudes, though only to a degree. The readiness to work in some capacity beyond retirement age is observed across income bands. 45 per cent of those earning more than £40,000 plan to retire before 65 compared to 28 per cent of those earning less than £40,000⁴⁰. Research that compares attitudes to flexible retirement of higher and basic rate taxpayers over 50 similarly suggests a relationship between income and plans for a phased retirement. It also reveals that those with no plans to retire at all are more likely to be lower earners or basic rate taxpayers⁴¹.

There are a number of reasons for the apparent shift in attitudes towards working for longer. Some people simply want to keep working and dislike the idea of retirement. This is more the case amongst higher earners⁴². However the readiness to work for longer is also a response to retirement income shortfalls or a bid to improve retirement outcome⁴³. In the hypothetical scenario of pension income only paying 30 per cent of their salary, more than two thirds expect they would continue working.

Shifting trend in working pattern and status

As well as working longer, older workers are also working differently⁴⁴. The traditional assumption is that people work until they retire, at which point they'll leave work altogether and start drawing a pension. The evidence shows that this assumption is becoming increasingly out of step with what people actually do.

The propensity to continue in work after starting to draw a private pension has increased over time. In 2010–11, 47 per cent of men and 31 per cent of women aged 60–64 who were in receipt of an income from a private pension were still in work. This picture isn't unique to the year this data was gathered. Longitudinal evidence shows that there is a clear trend towards working whilst drawing a pension⁴⁵.

Average hours of work are lower among those who are receiving a private pension income than among those who have accrued rights to a private pension but have not yet started drawing it, suggesting retirement is increasingly becoming a journey

³⁹ Aegon Retirement Survey 2014 UK

⁴⁰ Movement Research. Pension Options research for DCIF. April 2014

⁴¹ NEST 2014 Unpublished research

⁴² Ibid

⁴³ DCIF 2014 A New Age of Retirement: The end to traditional retirement and the need for new investment solutions to cater for pension accumulation and decumulation. Available at <http://www.dcif.co.uk/publications>

⁴⁴ ONS Self-employed workers in the UK, 2014

⁴⁵ Banks, J, Nazroo, J and Steptoe, A (eds) October 2012 The Dynamics of Ageing: Evidence from the English Longitudinal Study of Ageing 2002-10 (Wave 5). Available at <http://www.elsa-project.ac.uk/publicationDetails/id/6367>

rather than event. Those drawing a private pension are also more likely to be self-employed than those who have not accessed their pension yet, reflecting the rise of self-employment among the over 65s age group (the number of over 65s who are self-employed has more than doubled in the past 5 years to reach nearly half a million⁴⁶). Recent survey research found that 9% of those not currently retired said that working part time or flexible hours before stopping work altogether would be the best way to retire⁴⁷.

Combined with the picture on fewer working hours this points towards different work patterns, as well as a trend towards working later in life.

Substitution

A key concern about older people remaining in work for longer is the potential impact this has on the availability of jobs for younger people. This view would support that the idea that a high level of employment of one group of individuals can only be at the expense of another group, the so-called 'lump of labour' theory.

Compared to many continental European countries, the UK has not developed extensive policies to encourage older workers to leave jobs for the young. The UK pension debate has largely been focused on the trade-off between social assistance, rather than freeing up jobs for the young. However the example of the Job Release Scheme (1977-1988) shows that a desire to increase youth employment opportunities was also present in the UK at some stage.

A study looking at the impact of this scheme, found that, whilst the theory can feel true in individual cases, doesn't hold up as a general rule. It found some evidence that the Job Release Scheme reduced employment of the old but no positive effect was found on youth employment⁴⁸. When looking at the entire 1968-2005 period, labour force participation of the old is positively associated with employment of the young. Controlling for the business cycle reduces the magnitude of the correlation but does not alter this positive association. Overall no evidence of long-term crowding-out of younger individuals from the labour market by older workers was found. The evidence, according to a variety of methods, points always in the direction of an absence of such a relationship.

⁴⁶ ONS Self-employed workers in the UK, 2014

⁴⁷ DWP (2015) Attitudes of the over 50s to Fuller Working Lives

⁴⁸ Institute for Fiscal Studies (2008) Releasing Jobs for the Young? Early Retirement and Youth Unemployment in the United Kingdom. Available at: <http://www.ifs.org.uk/wps/wp1002.pdf>

Productivity

Another concern about older workers is productivity – that is, whether older workers are less productive than their younger counterparts and are therefore undesirable to employers, and potentially, the economy.

Overall, the evidence comes down heavily against the argument that older workers are less productive than younger workers. The majority of research finds either a lack of relationship between productivity and age, or that older workers are at least as productive as their younger colleagues. The interaction between skills, knowledge and experience means that many tasks can in fact be performed better as people age. Even in physically demanding situations, for example on a factory production line, older workers are often found to be just as productive⁴⁹.

As people age some cognitive and physical abilities do change – however, this does not make older workers better or worse than younger colleagues. There is no evidence of a substantive decline in ability in most people until well past the end of a typical working life.

Research hasn't yet adequately taken account of working lives that extend beyond their current typical length. However, the available evidence reveals that ageing affects everyone differently, and it is not therefore possible to make predictions about any one individual's capability entirely on their age.

Employer attitudes

There is clear acknowledgement from government that in order for people to work for longer, employers need to be receptive to recruiting and retaining older workers. Though there isn't any research that confirms employer attitudes to older people are a significant issue, there has nevertheless been a drive to make the business case for older workers.

Most recent research uses survey methodology to present the attitudes of employers to older workers. Overall, it presents a generally positive picture. Between two thirds and three quarters believe that older workers are no less productive, have specific skills and experience to offer and are reliable employees⁵⁰. However, as is often the case with such survey approaches, some respondents may have answered the questions as they believe they ought to. As such, it is possible that this presents a more positive picture than older people in workplaces and looking for work

⁴⁹ Based on a review of the literature on perceptions of older workers undertaken by the University of Essex for Age UK in 2013. Available at: <http://www.ageuk.org.uk/PageFiles/12808/Age%20and%20productivity%20briefing%20%28March%202014%29.pdf?dtrk=true>

⁵⁰ DWP (2015) Employer attitudes to fuller working lives

experience (separate research reports that the most significant obstacle that those over 50 face when looking for work is age discrimination⁵¹). The research does highlight that employers are concerned about older workers having health problems (30%), about their skill set being out of date (21%) and about their potentially imminent retirement (28%).

The ability of different groups to work for longer

First of all, the overall picture on life expectancy conceals the reality for many individuals. Whilst the most common age at death in England and Wales in 2010 was 85 for men and 89 for women⁵², many people live longer than this or die earlier.

There are differences in life expectancy at the population level and these differences have been linked to social deprivation particularly. Men and women from the richest social class can on average expect to live more than seven years longer than those in the poorest social class⁵³. However, population differences can't determine how long individuals will live. Genetic differences and random events mean that the average can only be a guide. This has significant implications for managing longevity risk at the level of the individual.

In addition, living for longer does not necessarily mean more healthy years in retirement. Being more positive about working for longer doesn't necessarily mean it will be possible and health clearly affects how long people can work. In 2008, the latest year for which figures are available, UK men at age 65 had 9.9 years of healthy life expectancy, while women had 11.5 years. Looking forward, both the number of people with at least one and the number of people with multiple long-term conditions are rising.⁵⁴ For some people, increased longevity will not translate to increased ability to work for longer. In some cases, living longer could mean longer periods of retirement in poor health⁵⁵.

⁵¹ See https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/319872/fuller-working-lives.pdf

⁵² ONS 2012 Mortality in England and Wales, Average life span 2010. Available at: <http://www.ons.gov.uk/ons/rel/mortality-ageing/mortality-in-england-and-wales/average-life-span/index.html>

⁵³ Department of Health. 2011. Mortality Monitoring Bulletin. Available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/215417/dh_130738.pdf

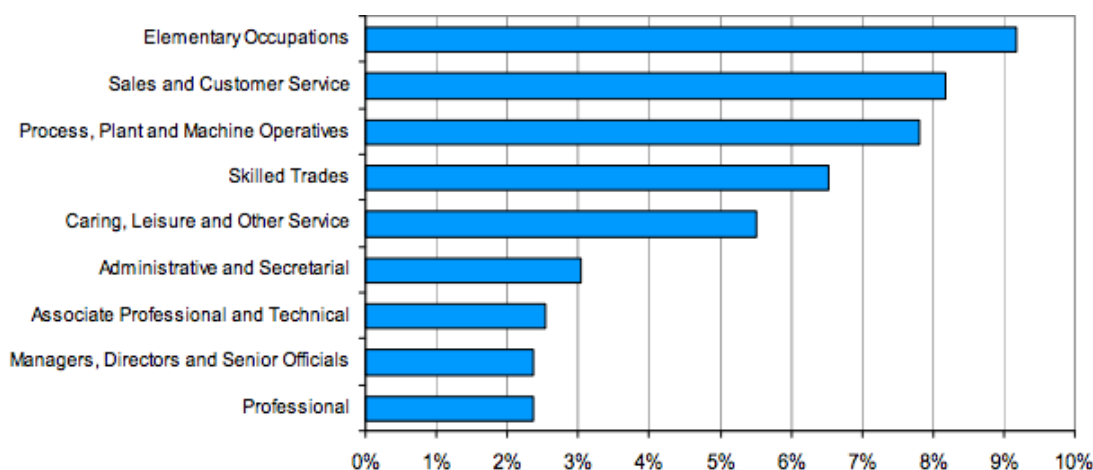
⁵⁴ Buck, D, Frosini, F (2012) Clustering of unhealthy behaviours over time Implications for policy and practice. The Kings Fund. See also <http://www.kingsfund.org.uk/time-to-think-differently>

⁵⁵ Banks, J, Nazroo, J and Steptoe, A (eds) October 2012 The Dynamics of Ageing: Evidence from the English Longitudinal Study of Ageing 2002-10 (Wave 5). Available at <http://www.elsa-project.ac.uk/publicationDetails/id/6367>

There are strong socio-economic factors and occupational factors at work⁵⁶. Unhealthy behaviours – like smoking, lack of exercise, unhealthy diet and high alcohol consumption - are declining in higher socio-economic groups but not amongst the lowest socio-economic groups. Consequently, while the ability to work in later life is generally improving, individuals with lower levels of education lower levels of wealth are more likely to be excluded from working due to poor health.

Over 1 million people aged 50-SPA are not working primarily because of a health condition or disability – this is 42% of economically inactive people in this age group⁵⁷. Those in lower paid and physical jobs are at a higher risk of health-related work exit, as chart X shows.

Figure 2.3: Economically inactive former workers aged 50-SPA who left through ill health in the last eight years as a proportion of current workers in that age group



Source: Labour Force Survey 4 Quarter Average 2013 Q1-Q4

50 to 64 is the peak age for caring, and 17% of men and 24% of women in this group have an informal caring responsibility for a sick, disabled or elderly person. Increased longevity also means that demand for carers is likely to increase in future. Difficulties managing these responsibilities alongside work can lead to premature labour market exit – more commonly for women, though it is still a significant issue amongst older men. Most people with informal caring responsibilities do balance work and care, but the more intense the caring, the more difficult this becomes.

⁵⁶ Buck, D, Frosini, F (2012) Clustering of unhealthy behaviours over time Implications for policy and practice. The Kings Fund.

⁵⁷ DWP (2014) Fuller Working Lives – Background Evidence

Only 3% of older people who are in work care for someone for more than 20 hours per week – this compares to 12% of those who are economically inactive⁵⁸.

⁵⁸ DWP (2014) Fuller Working Lives – Background Evidence

2.2 The private pension participation challenge

Overview of the under-saving challenge

The Pensions Commission first set out the challenge of chronic under-saving into private pensions in 2004 and made the case for how this would heavily impact the retirement outcomes of future retirees. The challenge was three-fold:

- Defined Benefit provision was (and still is) in rapid decline
- Participation in Defined Contribution schemes was low
- Many of those who are saving for their retirement in a private pension scheme are not saving enough

This section deals specifically with the first two aspects of this challenge, which can broadly be described as the private pension participation challenge. The third aspect – how much people contribute – is dealt with in the subsequent section that addresses the adequacy of retirement incomes.

Low and falling private pension membership

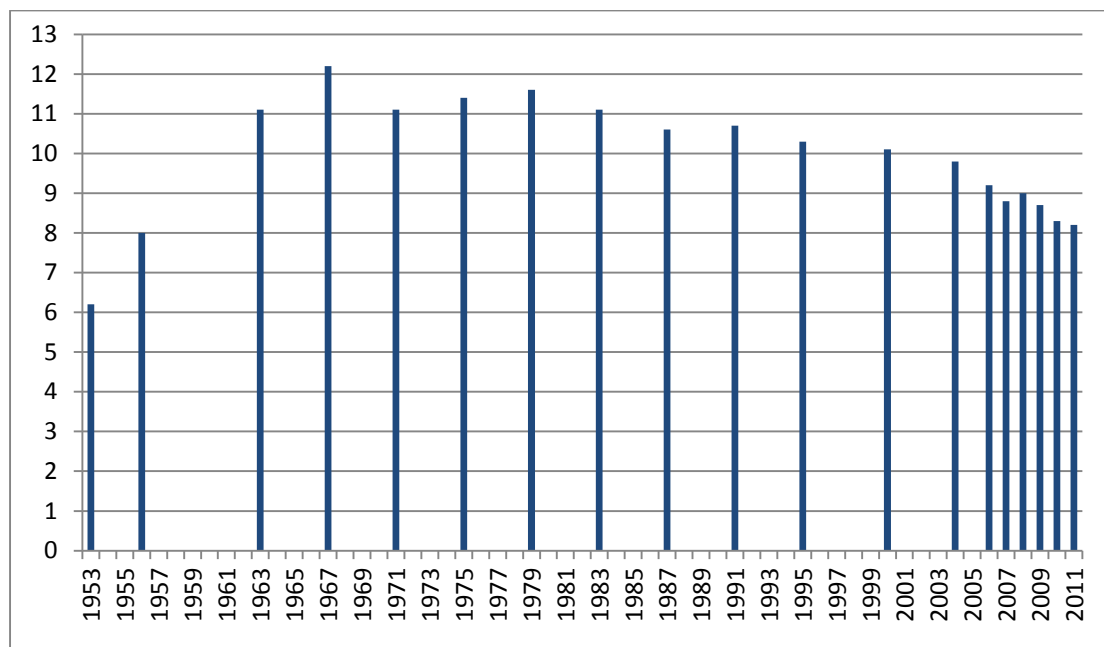
The Pensions Commission set out that the UK pensions system has worked well in the past because one of the least generous state pension systems in the developed world was complemented by the most developed system of voluntary private funded pensions. On average the system worked, with the percentage of GDP transferred to pensioners comparable to other countries.

However, private pension membership has been in decline in the UK from the 1970s and in rapid decline during the 1990s, coinciding with the closure of almost all private sector defined benefit schemes to new members and the closure of many schemes to any future accrual⁵⁹.

In 2011, there were 8.2 million active members of occupational pension schemes. This is the lowest level since the 1950s. In 2011, for those who were active members of occupational pension schemes, membership was higher in the public sector (65%) than in the private sector (35%).

⁵⁹ Turner, JA and Hughes, G (2008) Large Declines in Defined Benefit Plans are Not Inevitable: The experience of Canada, Ireland, the United Kingdom, and the United States. Available at: <http://www.pensions-institute.org/workingpapers/wp0821.pdf>

Figure 2.4: Active membership of occupational pension schemes 1953-2011



Source: ONS – pension trends

Most active members of Defined Benefit (DB) pension schemes in 2011 (56%) were in schemes that were closed to new members. The proportion of employees who belong to Defined Benefit (DB) occupational pension schemes has fallen from 46% in 1997 to 28% in 2012⁶⁰. Defined Benefit has declined because of the increasing cost to employers of providing this sort of scheme.

There was not only a contraction in the number of people participating in occupational pensions, but also in the overall generosity of pensions in accrual. The average contribution rates for Defined Benefit (DB) occupational pension schemes for both employees (4.9%) and employers (14.2%) were higher than those for Defined Contribution (DC) pensions. For DC schemes, employees and employers contributed an average of 2.8% and 6.6% respectively⁶¹.

Membership of personal pensions has been falling too. In the 2010/11 tax year, 5.7 million individuals in the UK contributed to individual or employer sponsored (group) personal pensions, including stakeholder pensions, lower than in recent years. In terms of employment status, 5.0 million were employees and 0.6 million were self-employed; the remaining individuals were not in employment.

⁶⁰ ONS Pension Trends – Chapter 7: Private Pension Scheme Membership, 2013 Edition. Available at: http://www.ons.gov.uk/ons/dcp171766_314955.pdf

⁶¹ ONS Pension Trends, Chapter 6: Private Pensions, 2013 edition

The need to tackle pensions 'inertia'

People have tended not to act when it comes to making decisions about their retirement. There are a number of reasons why people might not act, including unwillingness and affordability. However, behavioural scientists have shown that there are a number of behavioural tendencies that might prevent us from acting, even when we'd like to. These include:

- procrastination - the tendency to put off decision-making, especially when it is complex, onerous or dull
- status quo bias - a bias towards doing nothing or maintaining a current or previous decision
- regret aversion - forestalling the pain of regret associated with poor decision-making by simply avoiding a decision.

Initially, the response to the participation issue was to deliver initiatives aimed at educating the consumer⁶², whilst at the same time providing tax based and scheme structure incentives to save. The lack of success of these initiatives coincided with growing understanding of behavioural sciences and related evidence on default effects⁶³.

International experience showed simply by changing the default to being in a pension and needing to opt-out participation rates increased dramatically without the need to introduce a system of full compulsion⁶⁴.

Key policy responses to the pension participation challenge

Automatic enrolment

The current and key policy response to low participation in private pensions is automatic enrolment. Automatic enrolment is predicated on the power of inertia and effectively increases pension membership by default. It assumes that once people are defaulted into a private pension scheme, they will stay in it for the same reason

⁶² DWP Simplicity, Security and Choice 2002

⁶³ The ideas of Noble Prize winner, Daniel Kahneman, around how we make decisions and choices has been hugely influential. See Thaler, R.H. and Sunstein C. (2008). 'Nudge: Improving Decisions about Health, Wealth, and Happiness', (Yale University Press).

⁶⁴ Madrian B and Shea F (2001) The power of suggestion: Inertia in 401(k) participation and savings behaviour, Quarterly Journal of Economics. See also, Choi et al (2001) For Better or for Worse: Default effects and 401(k) Savings Behaviour, and, Choi, Laibson, Madrian, Metrick (2002) Defined Contribution Pensions: Plan rules, participant choices and the path of least resistance.

that they didn't actively participate – because they are inert. The experience of the US suggested that post-automatic enrolment, workplace pension participation stabilises at around 85% and that willingness to remain in does not vary substantially by income. Something similar was observed in KiwiSaver, where there has been a decreasing trend in the number of opt outs since its introduction⁶⁵.

Providing an underpin to private saving/ removing the disincentive to save

The current state pension system now involves a high degree of means testing to help keep pensioners on the lowest incomes out of poverty. Currently around 40% of pensioners are eligible for Pension Credit⁶⁶. Both the government and independent commentators perceived that this complicates pensioner incomes and makes it more difficult for people to recognise the value of saving. That is, it appears to send the message that the money saved would have been provided by the government anyway.

In addition, lack of clarity over what the state pension will be worth makes it difficult for people to plan and save for their retirement.

In response to this, as well as other objectives, the government is establishing a new single tier state pension whereby uncertain elements and means testing are removed.

Cap on charges/ DC quality standards

Given the automatic enrolment of millions of new pension savers in defined contribution schemes, attention has turned recently to the value and quality of what people are being automatically enrolled into. In March 2014, the Government announced new quality standards (effective from April 2015) for all defined contribution schemes⁶⁷. In particular they included a cap on charging (0.75% annual management charge) and measures to ensure schemes are run in their members' interests. Over the next 10 years, the government estimates that an extra £195 million of pension contributions will turn into pension savings, rather than being swallowed up by costs and charges⁶⁸.

⁶⁵ Madrian B and Shea F (2001) The power of suggestion: Inertia in 401(k) participation and savings behaviour, Quarterly Journal of Economics. See also, Choi et al (2001) For Better or for Worse: Default effects and 401(k) Savings Behavior

⁶⁶ DWP (2013) Single tier pension

⁶⁷ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/298436/better-workplace-pensions-march-2014.pdf

⁶⁸ DWP (2014) Better workplace pensions: Further measures for savers.

Impact of policy response to the pension participation challenge and related issues

Opt-out rates

Immediately before automatic enrolment, there were more people of working age not in a workplace pension (68%⁶⁹) than there were in one. Around 10 million people were not contributing to a workplace pension and were thought to be eligible for automatic enrolment. The participation, it is now widely agreed, is largely solved by automatic enrolment. By the time it is fully rolled out, automatic enrolment will have effectively created around 10 million new private pension savers and will have boosted the defined contribution sector by X [LOOK UP STAT] billions. Over 5 million people have already been automatically enrolled into a workplace pension scheme.

Rates of opt-out have been better than expected and potentially even better than in the US. DWP research suggests that opt out rates since the introduction of automatic enrolment have been stable at around 1 in 10 people opting out, or 9% overall⁷⁰. They were anticipated to be as high as X% DWP RESEARCH

Whilst automatic enrolment is a success story for private pension participation overall, the lowest earners are excluded from this reform and opt out rates are higher amongst certain groups (see section below on coverage).

It should be noted that current opt out rate is not based on full roll out of automatic enrolment. The current official figure is based on large employers, all of whom already have experience of administering a pension scheme. The challenge is perceived to be greater for small employers, many of whom will have no experience of running a pension scheme and will be doing so without the support of a human resource department. There may also be greater levels of resistance from small employers who could find the cost of contributions and administration more burdensome.

Levelling down

At its inception, some commentators were concerned that automatic enrolment, with its minimum contribution requirements for employers, could have a 'levelling down' effect on workplace provision. That is, in order to manage the costs of automatic enrolment, employers may choose to reduce contributions or outcomes for existing pension scheme members.

⁶⁹ Annual Survey of Hours and Earnings, ONS, 2011. Based on private sector workers.

⁷⁰ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/369572/research-report-9-opt-out.pdf

The picture on levelling down isn't straightforward as there are a number of definitions of being used. Overall so far, there is little evidence that employer contribution rates have been lowered for existing scheme members as a result of automatic enrolment. However, for new entrants, employer contributions are in line with the minimum set out by legislation. According to DWP research (which focus on the large employers reflecting those that have been required to automatically enrol employees first), the majority of large employers set their contributions at the minimum level required for automatically enrolled workers (i.e. initially one per cent employee contribution matched by one per cent employer contribution)⁷¹.

Default endorsement effect and auto-escalation

Another potential challenge associated with automatic enrolment is the so-called default endorsement effect. That is, default contribution levels and default funds, are perceived by consumers to be a recommendation, rather than a minimum. There is potential for minimum contribution rates to be construed as 'sufficient' given they are set as a default⁷². This has an impact for member retirement outcomes if they don't contribute enough as a result and also have an impact on scheme viability. A number of writers have pointed to the 'default endorsement effect' and the potential for this to be interpreted as ideal or correct.

There are a number of reasons why members might not contribute more than the minimum, including willingness, affordability and the behavioural tendencies outlined above. Evidence from DWP and anecdotal evidence from schemes reveals that very few members are contributing more than the minimum. It isn't possible to say whether the default endorsement effect has played a role in contribution decisions so far as the area is under-researched. However, the theory was found to be true in the US.

The government has committed to reviewing automatic enrolment contribution levels in 2017. At this point, default contribution levels may rise. The concept of contribution auto-escalation, whereby contributions proportionately rise with earnings, has been written about by the same behavioural architects who championed automatic enrolment⁷³. The 'save more tomorrow' approach is predicated on behavioural evidence showing that people find it easier to commit to

⁷¹ DWP (2013). Automatic Enrolment: Qualitative research with large employers. At: <https://www.gov.uk/government/publications/automatic-enrolment-qualitativeresearch-with-large-employers-rr851>

⁷² Choi, J, Laibson, D, Madrian, BC. (2009) The Importance of Default Options for Retirement Saving Outcomes: Evidence from the United States, Beshears, J, Social Security Policy in a Changing Environment. University of Chicago Press. Available at <http://www.nber.org/chapters/c4539.pdf>

⁷³ Thaler, RH. and Benartzi, S (2004) Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving University of Chicago

doing something in the future rather than in the present. That is, people plan to diet/ give up smoking/ save for their retirement later, but not today.

Auto-escalation would effectively mean that, unless consumers actively opt out, they will have committed to saving more in the future, as their wages rise. This would counteract the potentially undermining impact of automatic enrolment caused by the default endorsement effect. However, it would currently appear that further legislative change is some way off (both in terms of willingness and practicality). Auto-escalation was discussed by policy makers when automatic enrolment legislation was put together. However, the emphasis has been on addressing the participation issue first. In effect, automatic enrolment has been a behavioural experiment on a gargantuan scale. Whilst the international evidence supporting it was reasonable, there were a number of variables (economic, social and cultural) that could have meant that the experience in the UK would be different.

Given the freedoms consumers now have at the point at which they take their pension, there is some concern that increasing employer contributions is now less likely. Commentators have argued that, given that consumers can now take all of their money out of a pension at 55 and use this for whatever purpose they wish (where before they were required to buy an annuity with at least 75% of the money they have accumulated in a pension), this undermines the public/ private/ individual contract that was established with automatic enrolment to deliver better retirement incomes.

Meeting the needs of the new mainstream DC customer

As a result of automatic enrolment, the market for DC products has undergone a wholesale transformation. This has led to questions about the level of risk that members are now exposed to. At the same time, there has been acknowledgement of the record low levels of confidence in the financial sector⁷⁴ generally, and, not unrelated, consumers' concerns about the inherent uncertainty in the DC model⁷⁵.

The new market

Before automatic enrolment pensioned workers tended to earn more than the working population generally. Median earnings for unpensioned workers before automatic enrolment were substantially less than for those already in a pension - £19,800 compared to £29,500 - but only around 8% less than the £21,500 median

⁷⁴ The financial crises and the fall-out from it means that financial services and banks are now less trusted than the media. Globally, banks and financial services sit at the bottom of a list of industries that consumers' trust to do what is right'. Source: 13th annual Edelman Trust Barometer, as survey of more than 31,000 respondents in 26 markets around the world which measure trust in institutions, industries and leaders.

⁷⁵ DWP Reinvigorating workplace pensions. 2012

earnings of the working population as a whole⁷⁶. They were also far more likely to live in low earning households. Pensioned workers, as higher earners, were characterised by higher educational attainment, higher occupation level and higher financial literacy. The DC market prior to automatic enrolment had therefore been used to a rather different sort of customer. They had catered for DC members who had made an active decision to be in a scheme, were more financially aware, had more experience of financial products and pensions and were, given these factors, more likely to use advisors. They had also catered for higher risk appetites, or at least, delivered risk-based products on the basis that members were sufficiently familiar with the product set and able to access advice to make a judgement about their involvement with the product.

For the majority of newly automatically members, the DC product set is unfamiliar. Indeed, research has found that many don't realise that their contributions are invested, that they own all of the risk and that their outcome is uncertain. On learning that this is the case, many are incredulous. Research has also found that the tendency to be averse to loss is more pronounced amongst the lowest earners. Many consumers are concerned about how safe their money is. News stories of pensions being raided and savers losing all of their money still linger in the collective memory. Furthermore, the lay consumer is unable to differentiate between investment volatility and loss as a result of mismanagement and corruption.

Responding to consumer concerns about uncertainty and risk

Though there have been some legislative changes accompanying automatic enrolment with respect to scheme charges and governance, there isn't currently any legislation for the investment approach and the level of risk that DC schemes expose their members to. The government sponsored NEST scheme has sought to develop an investment approach that provides growth and offers better protection against volatility and loss than many other DC schemes on the market. However, it does not guarantee against capital loss or give any assurances about outcomes.

The DWP responded to the twin challenge of low confidence in the financial sector and of meeting the needs of the new pensions consumer with a consultation on potential new products that directly responds to concerns about lack of capital protection and uncertainty of outcomes. Following this consultation, the government legislated for the creation of a third type of pension – Defined Ambition⁷⁷. Defined Ambition is intended as a sort of third way between Defined Benefit (where employers own all of the risk) and Defined Contribution (where members own all of

⁷⁶ ASHE 2011 (Annual Survey of Household Income)

⁷⁷ Pension Schemes Act 2015 <https://www.gov.uk/government/collections/pension-schemes-bill-2014-to-2015>

the risk). New legislation is intended to encourage and enable 'shared risk' pension schemes and 'collective benefits'.

At present, the government has taken the steps it can to provide the context for the innovation of defined ambition schemes though DC still dominates.

Democratic permission

MINDSPACE⁷⁸, a government sponsored report for the use of behavioural economics in policy making, touches on the ethical dilemma of public buy-in to policy borne out of behavioural economics. The authors say that policies that use the insights from behavioural sciences to bring about behaviours that people don't consciously decide for themselves need to gain 'democratic permission'. That is, there needs to be an evidence base that strongly indicates that people approve of the behavioural outcome.

In many respects, democratic permission has been given for automatic enrolment. Research shows broad support for what the policy is designed to achieve. But whilst there is broad support for a concept that helps people address their lack of pension participation, there isn't broad support for the product set that they are currently being automatically enrolled into – nor might there ever be. The ethical question is now more complex and concerns the differential between what consumers say they want and what would be in their best interests. In this instance, democratic permission may need to be sought from consumers to decide best interests on their behalf, taking into account the need for good outcomes alongside consumers' emotional response to potentially unavoidable product traits like uncertainty.

⁷⁸ Dolan, P, et al (2010) MINDSPACE. Institute for Government/ Cabinet Office

In countries such as the Netherlands and Denmark, collective pensions offer a method for sharing risk between employees. The Pensions Bill 2014/15 aims to make it possible for schemes to offer collective benefits.

In a DC scheme offering collective benefits, employers and employees pay fixed contributions into a collective fund invested on behalf of all members of the scheme. The pension benefit paid to members in retirement is then, in part, determined by the collective investment performance of the scheme. Where a DC scheme offering collective benefits differs from a DC scheme is that risks are pooled between members of different ages, so that outcomes are more stable when faced with fluctuations in investment performance and in other factors.

As a consequence, individuals benefit from more stable growth in their pension fund compared to a DC scheme, as the impact of investment volatility can be smoothed across all members of the scheme rather than borne by individual members. Employer risk is the same in DC schemes offering collective benefits as it is within DC schemes: if DC schemes with collective benefits are underperforming then the employer is not required to make up the shortfall.

If collective schemes were to operate similarly to those in the Netherlands and Denmark then, when a member retires, rather than having a pension pot with which to purchase a retirement income product or take as a lump sum, they might receive an income paid from the fund. However, other scheme designs, that would allow an individual pension pot or annuity to be provided for retired members, are possible.

Multiple pension pots

The average number of jobs a British worker can expect to have over their lifetime is currently 11. As this is an average, over half of British people can expect to have more than 11 jobs in their lifetime. It is possible that they can pick up DC pension pots in each one of these jobs. Whilst they can remain members of any scheme they joined and (in the vast majority of cases) continue to contribute to these, when they move jobs they will have to join the scheme that their employer offers if they want to receive their employer's contribution. There is a risk that these pension pots will be forgotten about and that the process of consolidating them is time consuming and not without cost to the worker.

It was estimated that by 2050, without reform, automatic enrolment would result in 50 million dormant pension pots. Analysis also highlights in many cases it is inefficient for pension providers to administer small dormant pots, and the breakeven level where a small pot becomes profitable varies between schemes.

To address this problem the government introduced a legislative framework to enable pension pots to follow members as they move employment in the Pensions Act 2014. This will see the automatic consolidation of members' small pots into the workplace scheme they are actively saving in. These legislative powers set out a number of key features in the design of an automatic transfers system where the pension pot will effectively follow the member into their new pension scheme:

- The system will be facilitated by pension schemes, rather than by employers.
- Eligible pots below the pot size limit, built up in the money purchase default arrangement of workplace schemes will be automatically transferred.
- Members will be provided with information about the transfer and will have the ability to opt-out where they want to keep their pension pot with their current scheme⁷⁹.

Making the right decumulation choices

Now that defined contribution schemes are the dominant pension provision and the main type of scheme used for automatic enrolment, millions of people will be required to make active and informed choices about using their pension to fund their retirement. Unlike defined benefit provision, which provides a certain income in retirement, defined contribution provision simply delivers an accumulated pension pot for members to then access.

Up until April 2015, options open to DC scheme members wishing to access their pension were limited (see section x) to an optional tax free lump sum up to 25% and to purchasing an annuity⁸⁰. This stipulation was made in order to ensure that people used their pension to deliver them an income throughout their whole retirement. However, the annuity market (like pensions generally) is complicated and many consumers have either made poor choices or have failed to consider all of annuity options available and therefore haven't achieved the best value for money.

The rules around how people access their pension have now been relaxed and consumers are basically free to do whatever they wish with their accumulated pension pot. Whilst these new freedoms have been well received by consumers in principle, there has been widespread concern from consumers, industry and consumer organisations about the ability of consumers to make good choices. This area of financial decision-making is considered to be complex with significant room for error. The stakes are high and consumers could potentially make irrevocably

⁷⁹ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/402860/automatic-transfers.pdf

⁸⁰ Note that prior to April 2015 drawdown was only available to those who could demonstrate £20,000 income annually for the full duration of their retirement.

poor decisions that greatly impact their quality of life in retirement. It remains to be seen whether this will be the case in actuality but there are legitimate concerns around: consumers' access to good quality financial advice, financial literacy, tendency to discount the future in favour of the present and tendency to employ mental shortcuts when time is short and the decision is complex that can result in sub-optimal outcomes.

Some industry commentators and leaders, including NEST, are considering default decumulation paths in response to evidence that consumers might not wish to make this kind of complex decision for themselves and might not be well prepared to do so. Arguably an active decumulation phase is at odds with the passive accumulation journey, given the default nature of automatic enrolment and the reportedly low levels of engagement of members with their pension once they are enrolled.

Furthermore, there is now also a need to consider schemes' default accumulation strategies given that these have been designed with a path to an annuity in mind. For those who may wish to drawdown from their pension and/or keep some of it invested with their pension provider, an investment approach that seeks to slow down growth and look to match current annuity rates may not have been the most suitable path.

The decumulation journey, therefore, is complex and isn't mutually exclusive from accumulation. In an automatic enrolment context, there is no requirement for workers to act. As a result of doing nothing, they can find themselves contributing to a pension and, if they do nothing for their full working career, they will have a pension pot to access at the end. However, how well they realise their pension pot and use this to support their retirement requires their engagement and ideally, before they retire.

2.3 The adequacy challenge – how much is enough to live on in retirement?

Definitions of adequate

There are a number of different conventions used to understand what an adequate retirement income is. Broadly, these fall into two categories of conceiving of 'enough':

Minimum: an attempt to define adequacy based on a minimum level required. Attempts to set a minimum acceptable amount to live on in retirement falls into three areas:

1. Definitions of poverty, or, in practice, the definition of being out of it. This is based on the rationale that being just above poverty is the same thing as adequate. One interpretation of adequacy is that a sensible benchmark is the amount needed to ensure that an individual has sufficient resources to avoid poverty throughout their retirement. It should be noted that poverty definitions, like adequacy definitions, are also contested.
2. Some commentators argue that the minimum needed to live on is not the same thing as being just above a poverty line, but is instead a 'minimum income standard' which is defined as basic but acceptable. This takes account of changes in lifestyle rather than just focusing on what level of income is needed to ensure warmth, nourishment and shelter. So, for example, having internet access at home is included.

Relative: relative to individuals' previous earned income. This involves quantifying a rate of replacing earned income in retirement.

Poverty definitions

Poverty and low income can be defined and measured in a number of ways.

- Absolute poverty - The concept of absolute poverty is that there are minimum standards below which no one anywhere in the world should ever fall. It refers to a lack of the needs for physical subsistence.
- Relative poverty – this measure is linked to a threshold based on general living standards. As explained further below, the most commonly used definition is that someone is considered to be in poverty if they are living in a household with an income below 60 per cent of the UK median household income. This information can be found in the annual DWP publication Households Below Average Income (HBAI) which includes a wide range of data and tables about low income in the UK³
- Minimum income standards – this looks at the cost of goods and services required by different households in order to reach an acceptable standard of living. See for example work by the Joseph Rowntree Foundation
- Material deprivation – this is based on whether people lack what most people regard as necessities such as a warm waterproof coat or a damp free home. The Department for Work and Pensions (DWP) has used material deprivation questions as part of its measure of child poverty for some time and has included a measure of material deprivation among pensioners in the HBAI reports published from 2011 onwards.
- Self-reported measures - people are asked how well off they consider themselves.

Adequacy: poverty and minimum income measures

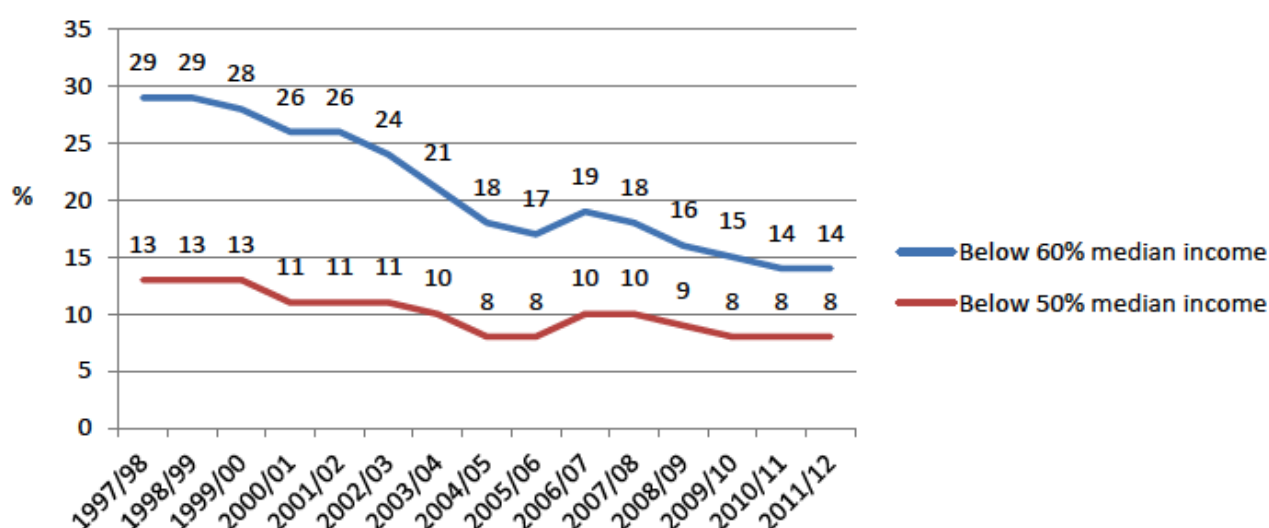
Since the turn of the century, pensioner incomes have been increasing faster than earnings as a new generation of pensioners retires with occupational pension income. This fact, coupled with a more rapid increase in the level of pension benefits

compared to working age benefits, has resulted in pensioner poverty being at its lowest level for 30 years⁸¹.

The most common definition of poverty is having an income of less than 60 per cent of typical household contemporary income adjusted for family size. At its peak in 1989, 39% of pensioners had incomes below the relative poverty line of 60% of median income, after housing costs (AHC). By 2005 this had fallen to around 18% of pensioners living in relative income poverty. The latest data for 2012/13 shows that 13% of pensioners were in relative poverty in 2012/13 (based on those with incomes below 60% of contemporary equivalised median income, after Housing Costs). This equates to around 1.6 million pensioners in relative poverty.

The historical trend suggests that, based on the 60 per cent median figure, pensioner poverty is gradually falling; however the picture is actually more complicated. The DWP estimates that 900,000 older people are living on incomes below 50 per cent median income. The proportion in severe poverty fell from 13% in 1998-99 to 8% in 2004-05 but since then has remained steady. This number has remained almost constant over the last 15 years, but it has been increasing as a proportion of older people in poverty: more and more older people who live in poverty are living in severe poverty. It is also important to factor in that about 1.1 million older people live on incomes just above the poverty line – that is between 60 and 69 per cent of median income. These figures have fallen from 38 per cent in 1998-99 to 23 per cent in 2011-12.

Figure 2.5: Percentage of pensioners in poverty in the UK 1998 2012



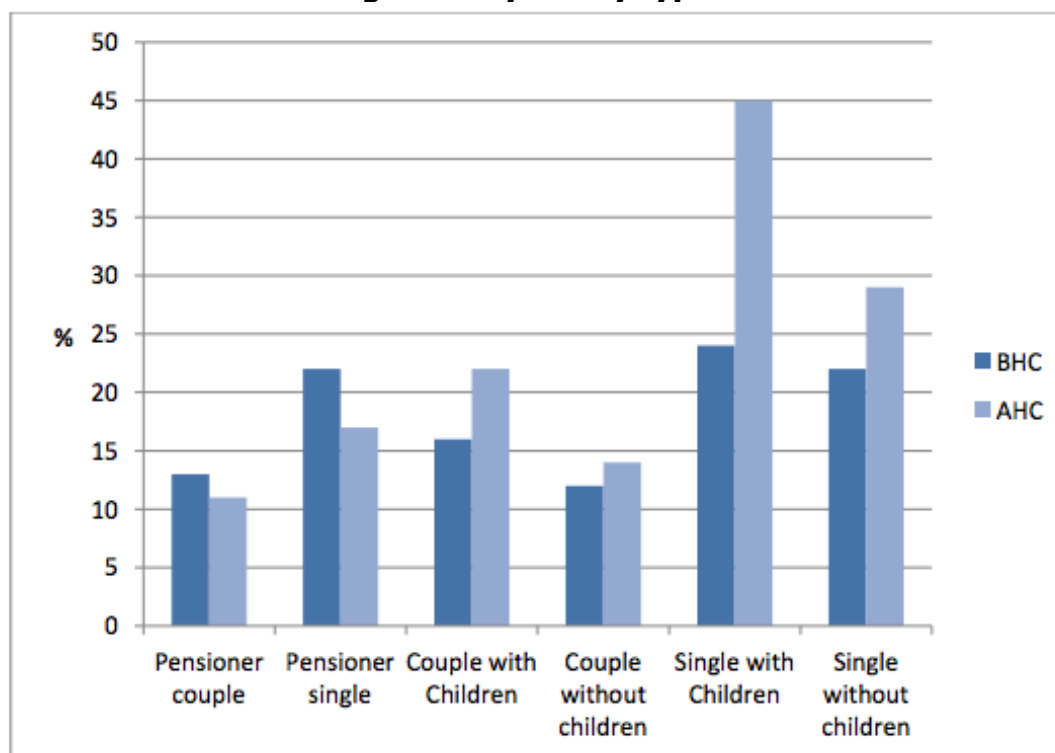
Source: DWP (2013) Low income and material deprivation in the UK

⁸¹ DWP, 2013, Pensioner Income Series 2011-12

Pensioner poverty compared to working age population

Older people are much less likely to be in poverty than the population in general. Before housing costs, single pensioners are more likely than many other groups to be in poverty. As many older people rely on benefits in retirement, the lower after housing costs poverty rates will reflect the fact that pensioner means-tested benefits tend to be higher than those for younger age groups. So for example, older people claiming Pension Credit and means-tested benefits to help with housing costs will normally be left with an income just above the poverty level after paying rent and Council Tax, whereas for many younger people benefits will fail to take them above the poverty line.

Figure 2.6: Percentage with incomes below 60 per cent median income before and after housing costs by family type



Source: HBAI 2011/12, DWP, 2013.

Pensioners and the minimum income standard (MIS)

Each year the Joseph Rowntree Foundation (JRF) produces 'A minimum income standard for the UK' (MIS), which sets out the income needed by different households based on the costs of items and services that members of the public think are needed to reach a minimum acceptable standard of living that allows household members to participate fully in society. In April 2013, the JRF estimated that a pensioner couple needs £241.25 per week after housing costs (AHC).

According to the MIS, if pensioners are claiming Pension Credit, they should have an income in line with the minimum income required for an appropriate standard of living.

Adequacy: measures relative to pre-retirement incomes

There has been substantial discussion on what proportion of pre-retirement earned income is necessary to achieve an adequate standard of living in retirement. The Pension Commission provided the following guide to replacement rates required by different income categories to achieve an adequate retirement income. This is based on not being substantially poorer in retirement than had been the case during working life. It also assumes modified spending and consumption patterns as a result of age and retirement.

What replacement rates are adequate?

Income	Replacement rate
Less than £9,500	80 %
£9,500 - £17,499	70 %
£17,500 - £24,999	67 %
£25,000 - £49,999	60 %
£50,000 and above	50 %

The Commission outlined that 60% of people over 35 were on track to an inadequate retirement income, if no action was taken, based on the replacement rates they identified to be necessary to secure an 'adequate' retirement.

Those at the greatest risk of inadequate retirement incomes are moderate and higher earners and those for whom private pensions needs to make up the greatest proportion of their income in retirement. A chief concern, then, for future replacement rates is the decline of DB provision.

Though pension membership prior to automatic enrolment was low, with only 36% people over 16 years of age contributing to a pension⁸², past pension membership amongst older age groups was high. 83% of men and 61% of women aged 52 and over in 2010 –11 had at some point accrued rights to a private pension⁸³.

Given the prevalence of occupational schemes that delivered income entitlement rather than capital, recent retirees overall have enjoyed reasonable pre-retirement income replacement rates. Income after retirement has been around 70 to 75 per cent of pre-retirement family income on average⁸⁴. This replacement rate does not vary greatly by factors such as sex, educational background or health. However, it's higher among those on lower pre-retirement incomes⁸⁵.

The median wealth held in defined contribution (DC) schemes among older age groups shows small pots. Data collected between 2010-2012 shows that median DC wealth was £14,500 for 55 to 64 year olds and £18,200 for those over 65. In contrast, wealth held in DB pensions is substantially higher. Median wealth defined benefit (DB) schemes was £140,300 for 55 to 64 year olds and £99,900 for those over 65 years of age⁸⁶.

In addition, Defined contribution (DC) pensions are currently not the primary source of income in retirement for many people. The small DC pots accumulated by recent retirees will for many be an 'in addition' resource to their DB pension. Within 20 years, with the rapid decline of DB, DC will need to be a much more significant component of a retiree's retirement portfolio. This puts the onus on individuals to contribute an amount sufficient to achieve a suitable replacement rate.

Evidence points to contributions as the single biggest driver of pension outcomes. Charges and investment approach matter (with charges mattering more than asset allocation) but analysis has shown that, all things being equal, it is how much is contributed that will most determine retirement income. Even with the recent cap on

⁸² ONS 2014 Wealth and assets survey. See Wealth in Great Britain Wave 3, 2010-2012 available at <http://www.ons.gov.uk/ons/rel/was/wealth-in-great-britain-wave-3/2010-2012/index.html>

⁸³ Banks, J, Nazroo, J and Steptoe, A (eds) October 2012 The Dynamics of Ageing: Evidence from the English Longitudinal Study of Ageing 2002-10 (Wave 5). Available at <http://www.elsa-project.ac.uk/publicationDetails/id/6367>

⁸⁴ Banks, J, Nazroo, J and Steptoe, A (eds) October 2012 The Dynamics of Ageing: Evidence from the English Longitudinal Study of Ageing 2002-10 (Wave 5). Available at <http://www.elsa-project.ac.uk/publicationDetails/id/6367>

⁸⁵ Note that the data from which this replacement rate is derived includes income from employment. Retirement is defined here as having left full time work. The sample includes older people who may be working part time, or have a partner in work.

⁸⁶ ONS 2014 Wealth and assets survey. See Wealth in Great Britain Wave 3, 2010-2012 available at <http://www.ons.gov.uk/ons/rel/was/wealth-in-great-britain-wave-3/2010-2012/index.html>

charges, many consumers won't see the kind of increase in the value of their pension pot that they need to secure an adequate income in retirement⁸⁷.

The policy response to the adequacy challenge

The current Government's aim is to help people maintain their standards of living in later life through providing a firm foundation from the state to support private saving. To achieve this, the Government has legislated to introduce a new single tier state pension, is rolling out Automatic Enrolment into workplace pensions, and has brought forward increases to State Pension age.

Tackling pensioner poverty

Ostensibly, the UK system is designed to ensure that pensioners do not live in poverty. The Labour Government's approach to reducing pensioner poverty was to increase the provision of means-tested benefits, most notably, through the introduction of Pension Credit. However, benefit take-up is nowhere near 100 per cent and around a third of pensioners entitled to Pension Credit are not claiming it⁸⁸.

The current government has legislated for the following in order to tackle pensioner poverty (and improve pension outcomes):

- Introduce a single tier state pension to simplify the system so people don't have to apply for means tested benefits.
- Protect the value of the state pension by introducing the 'triple lock guarantee' so that basic state pension is uprated by whichever is higher - earnings, prices, or 2.5%
- Protect key areas of support for pensioners, including free eye tests, free prescriptions, bus passes and TV licenses for the over-75s
- Winter fuel payments are available for all pensioners
- Cold weather payments have been permanently increased to £25 a week

Delivering adequate retirement incomes

The current and previous governments' response to the issue of the adequacy of people's pensions has been:

⁸⁷ Redwood, D, et al (2013) What level of pension contribution is needed to obtain an adequate retirement income? Pensions Policy Institute. See also Harrison, D, et al (2012) Caveat Venditor: The brave new world of auto-enrolment should be governed by the principle of seller not buyer beware. Pensions Institute

⁸⁸ PPI REF

- the introduction of automatic enrolment to boost private pension participation, along with a commitment to review contribution levels – for employers and individuals in 2017.
- Variety of efforts to extend working lives, thereby extending the amount of time individuals have to increase their pension pots (and potentially reduce the amount of time they need to make their pension last). Note that in order to achieve their target replacement rate a lower earner would need to defer retirement (based on SPA) by 1 year, a median earner (around £21,000) by 6 years and a higher earner by 8 years⁸⁹.

Individual	Replacement rate		Number of years need to defer to reach target replacement rate
	Target	No Deferral	
Low earner	70%	69%	1
Median earner	67%	55%	6
Higher earner	60%	44%	8

- In addition, the cap on charges, though not able to ensure adequate outcomes for savers, is intended to improve outcomes by limiting the impact of charges on the value of pension pots.
- Finally, the government’s efforts to stimulate the innovation of schemes that can offer greater certainty of outcome is in large part a response to concern that individuals may not voluntarily contribute more in the absence of some sort of guarantee about the outcome.

The impact of the policy response to the adequacy challenge and related issues

The impact of the single tier state pension on pensioner poverty remains to be seen. Low take-up of means-tested benefits amongst pensioners is a key cause of very low income in retirement. In theory, the new single tier state pension will provide a simpler mechanism to accessing an income above the guarantee credit threshold

⁸⁹ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/254321/framework-analysis-future-pensio-incomes.pdf

(see section X on Pension Credit). However, the impact of the single tier pension on pensioner poverty is not part of the Government's impact assessment of this reform.

Campaigners on the issue, such as Age UK, have argued strongly that it ought to be. They commissioned analysis of their own to explore the potential impact of the single tier state pension on pensioner poverty and found that pensioner poverty could be reduced to 10% by 2025, an accelerated decrease than if the current system remained⁹⁰.

With respect to replacement rates, overall, despite reform, replacement rates look worse for future retirees than for previous generations. Based on a cautious set of assumptions about changes in future saving behaviour, the Government's believes its pension reforms will:

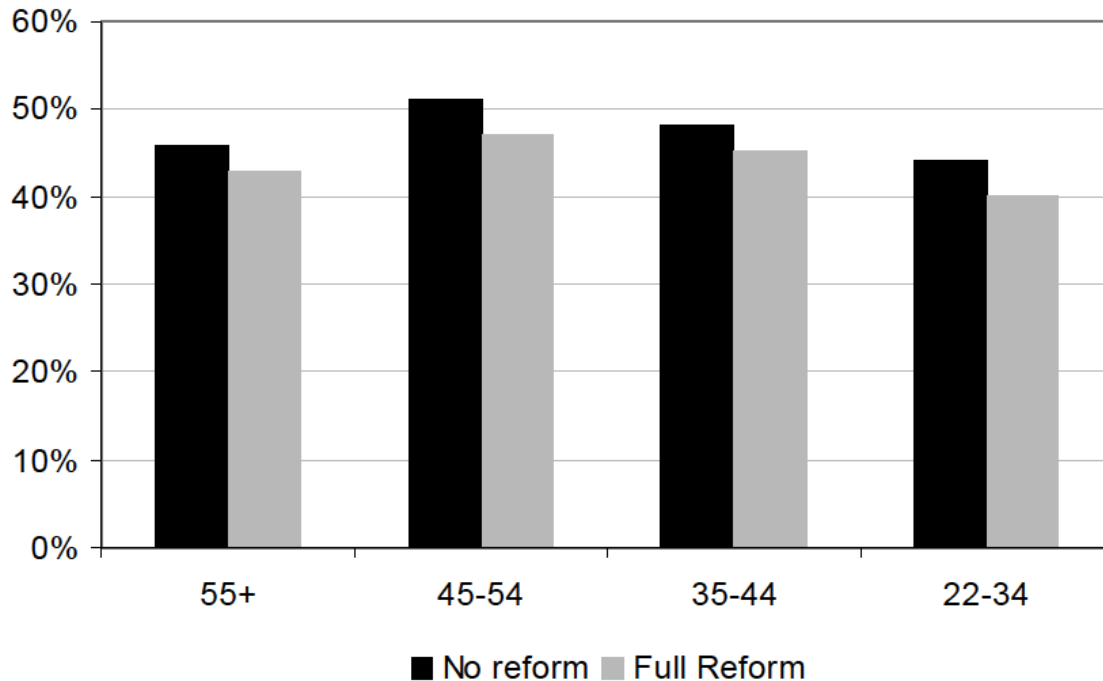
- Reduce the number of people facing inadequate retirement incomes by 1 million;
- Increase the incomes (and replacement rates) of 73 per cent of those facing inadequate retirement income, bringing them closer to their target income; and
- Halve the proportion of future pensioners who will retire with no private income at all from 27 per cent to 12 per cent in 2050⁹¹.

With the Government's reforms in place, over half of people currently of working age are expected to build adequate retirement incomes and maintain their living standards during their retirement. However, this leaves an estimated 12.2 million people facing inadequate retirement incomes. Roughly half of these are within 20% of their target amount, with the remainder facing a more significant challenge. The chart below shows that the automatic enrolment and the introduction of a single tie state pension deliver an improvement with respect to the number people facing inadequate incomes in retirement but the improvement isn't striking.

Figure 2.7: Proportion of people facing inadequate incomes by current age group with and without automatic enrolment and single tier state pension reforms

⁹⁰ PPI (2011) The implications of Government policy for future levels of pensioner poverty.

⁹¹ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/254321/framework-analysis-future-pensio-incomes.pdf



Source: DWP (Framework for the analysis of future pension incomes)

The reasons people face inadequate retirement incomes vary between income groups:

- Not working: for most low earners (earning up to £20,000 a year), the combination of the state pension and saving at the minimum contribution level into default funds through Automatic Enrolment will be enough to maintain similar living standards in retirement. For those low earners who face inadequate retirement incomes, the problem is mostly due to significant periods out of work.
- Not saving while in work: for moderate earners, the challenge is to ensure that they are saving for every year of working, and in some cases saving enough.
- Not saving enough: to ensure that they retire on at least half to two-thirds of their working age income, moderate and higher earners will need to save significantly more than the default Automatic Enrolment minimum combined contribution of 8 per cent of their earnings.

It's worth noting that although the evidence shows that many people are still on track to fall short of their target replacement rate, this doesn't necessarily mean that the same number of people will have retirements characterised by hardship.

Although replacement rates are higher for low income individuals, they may generally find it easier to meet replacement rate targets as a larger proportion of their retirement income is derived from state pensions. Higher earning individuals who do not meet their target replacement rate will not necessarily have incomes that might be considered low. For example, they may still have incomes well above poverty levels and even average earnings. Though they might be poorer in retirement, this does not mean they will be poor.

It is plausible those at the lower and higher ends of the pre-retirement income spectrum are in a better retirement income position. Lowest earners can expect good replacement rates and potentially even experience no fall in income on retirement. The highest earners, though potentially experiencing the sharpest falls in income at retirement, will likely have incomes that do not require an adjustment in their day to day spending habits. They are also most likely to have significant other assets to draw on. The group that occupies the space between these two, which are the majority, are likely to experience comparably worse replacement rates than those who earned less than them in work. At the same time they are more likely than those who earned comparably more than them in work to feel the impact of a fall in income.

Expectations of retirement income

The analysis above uses widely agreed and official replacement rates as the key indicator of an adequate retirement income. However, research finds that many people have much greater expectations for their retirement income which are even further out of step with current contribution rates.

Recent research identified a significant gap between what people said they needed to have the lifestyle they want and how much they actually expect to receive⁹². At an overall level, consumers anticipate needing £1,875 from their pension and other savings to live the life they desire in retirement, but will experience a shortfall of £408 when comparing this to the amount they could actually receive based on their pension (or expect to receive). Furthermore, it is those consumers with smaller pension pots where this shortfall is greatest. Those with a pension pot of less than £20k expect to be £1,130 a month on average short of the amount they would ideally desire.

Changing patterns of spending and consumption

Not unrelated to income expectations, patterns of spending and consumption are also changing – at a societal level and for pensioners. This matters because how

⁹² So Here's the Plan for Just Retirement, 2014

much is 'enough' to live on in retirement will depend on how much pensioners need and like to spend. There are some key notable trends that could impact how future pensioners' experience of their income.

- Spending doesn't differ in older and retired age groups as much as might be assumed. Whilst older people spend less per week than younger age groups, this is in large part accounted for by household size. People tend to spend and consume similarly overall in retirement as in pre-retirement, with two notable exceptions. Firstly housing costs fall most retired people as outright home ownership correlates with age. Secondly, recent data shows that spending in leisure has increased amongst pensioners today compared to previous generations. Minimum Income Standards research from JRF⁹³ detected convergence between the requirements of pensioners and those of other households without children. In 2008, a single pensioner's basket of goods cost about 10 per cent less than that of a single person of working age; in 2014 their baskets cost the same. The survey owners believe that this reflects pensioners' growing emphasis on social participation. They report that today's pensioners seem to be rejecting traditional self-denying attitudes associated with older people. At the same time, the mental picture of retirement for those yet to reach it is becoming more positive⁹⁴.
- With increased longevity, the number of people requiring care in later life is rising. Of all those aged 65 in 2009/10, half will face care costs of over £20,000 and 1 in 10 will face costs over £100,000⁹⁵.
- Housing costs are likely to be more significant for future pensioners. The percentage of owner-occupiers increases with age. The last census showed that 76 per cent of those aged 65-74 owned their own homes - the highest across all age groups⁹⁶. Looking at those who owned their homes outright, 88 per cent were aged 50 and over, reflecting the time it takes to pay off a mortgage⁹⁷. This points to people in retirement generally having dramatically lower housing costs than younger people in work. However, a number of notable trends in home ownership might change this picture. While the number of people who own their

⁹³ Minimum Income Standard 2014, JRF. Note that the aim of the MIS is to specify a realistic baseline. It makes a number of assumptions to do this and doesn't reflect necessarily the particularities of what every household needs to sustain itself. It instead offers what, based on the evidence, it sees as an income level sufficient to meet the spending needs to sustain a minimum standard of living.

⁹⁴ Ignition House/ Just Retirement (need to confirm which it is)

⁹⁵ National Audit Office. Adult Social Care in England. March 2014

⁹⁶ Home ownership and renting in England and Wales – Detailed Characteristics
Part of 2011 Census, Detailed Characteristics on Housing for Local Authorities in England and Wales Release.
Released: 28 June 2013

⁹⁷ Department for Communities and Local Government Housing Statistics. April 2014. Available at <https://www.gov.uk/government/collections/housing-market>

homes outright is at a record high, the number of people buying homes with a mortgage is falling. This coincides with marked growth in the private rental sector. The increase in private rentals is beginning to be seen in older age groups⁹⁸. People are also buying their first home later. Looking at the 25 to 34 age group in 2008, 66 per cent of all home purchases were for first homes. In 2012 this shifted to 72 per cent⁹⁹. As such, the cost of housing in retirement, based on mortgage payments and rents, could be higher for pensioners in the future.

Protecting the state pension from inflation

A key government measure to protect pensioners from poverty is the triple lock guarantee (see section X) to uprate the basic state pension. The triple lock, unlike measures before it, takes account of both earnings and prices. However, some pension campaigners believe that the triple lock should refer to the Retail Price Index, not the Consumer Price Index to inform the consideration of prices within the triple lock. The latest increase of 2.5%, for the year 2015/2016, is lower (by 0.5%) than it would have been if the RPI had been used instead of the CPI.

CPI, is designed to reflect changes in average prices. It is calculated according to what the “average” consumer buys, and by adding up the price changes within this average shopping basket. But can be more acutely felt by certain groups and individuals. Lower income groups will be more affected by rising food prices, for example, where spending in this area takes up a much larger proportion of income. As spending and income tend to change as we age, older age groups can be impacted differently by inflation than other age groups. Recent analysis suggests that those under 30 have the highest group inflation rate, followed by the over 75s¹⁰⁰.

Pensioner households, like households generally, are not homogenous. Whilst it is the case that spending increases in certain areas, like food and fuel, for older households, the extent to which these households are impact depends on how much income they have and the available assets they have to draw on. Where retired people are on a fixed income, perhaps on fixed annuities, they are more likely to be impacted by rising inflation.

⁹⁸ Department for Communities and Local Government. English Housing Survey. Available at <https://www.gov.uk/government/collections/english-housing-survey>

⁹⁹ Department for Communities and Local Government. English Housing Survey. Available at <https://www.gov.uk/government/collections/english-housing-survey>

¹⁰⁰ Alliance Trust. October 2014. Inflation by Age Group. Available at: <http://www.alliancetrust.co.uk/pdfs/InflationByAgeOctober2014.pdf>

The extent to which we are impacted by changes in average prices, a bit like average life expectancy, cannot be determined entirely by looking to the experience of those in a similar category to ourselves. No one is truly average, even for our income or age bracket. We all buy different things, which means our own experience of inflation - our 'personal inflation rate' will vary from the official measure.

2.4 The equality challenge

This final section discusses the extent to which the current system serves all groups equally. Historically, people's ability to accrue rights for a full basic state pension and to contribute to a private pension has been unequal and certain groups are more likely than others to experience poverty in retirement or have inadequate retirement incomes.

Overall, the key factor that reduces people's chance of achieving an adequate retirement income is periods out of work. This impacts the level of National Insurance contributions they are able to accrue for state pension entitlement, their access to additional state pension and their access to private pensions. The government estimates that of the 12.2 million people facing inadequate incomes post-reform, around 40% work for fewer than 35 years during their working life¹⁰¹.

Some groups are more impacted by career breaks than others. Those who have historically had the most significant breaks in their employment record, and therefore have had the least ability to achieve an adequate retirement income are women, carers (mostly women) and ethnic minorities.

Self-employed people

The point about career breaks is true for all groups except for self-employed people who, even without periods out of work across their full working lives, have unequal access to workplace pensions by default of their working status and cannot accrue any additional state pension entitlement. It is notable that whilst the trend for self-employment is upward (self-employment is higher than at any point for the last 40 years¹⁰²), the trend for private pension saving amongst the self-employed is clearly downward. The General Lifestyle Survey (GLF) provides the most consistent information on trends in pension scheme membership for the self-employed. 46% in 2011 have never belonged to a personal pension, up from 27% in 1991/92.

The policy response and implications to self-employed people's access to pensions

The new single tier state pension system will benefit self-employed people who previously were not able to accrue any additional state pension entitlement. For the (minority) of self-employed people who are self-employed for the majority of their working life, the single tier state pension will represent an increase in the state

¹⁰¹ DWP (2013) Framework for the analysis of future pension incomes

¹⁰² ONS Self employed workers in the UK 2014

pension support available to them. Self-employed people remain at a disadvantage with respect to their ability to save comparably to employees in private pensions.

Women

Women are more likely to be poorer in retirement than men and this is particularly the case for single women. This has historically been the situation and remains the case at the time of writing. This reflects their lower employment rates, lower average earnings and increased likelihood to be in part-time work than men. In addition, there have been specific features of the pension system that entailed married women gaining pension income through their husband – reflecting assumptions about family structure that have ceased to be valid.

Based on most recent available data, women receive less BSP than men, were less likely to be saving in a private pension prior to automatic enrolment than men and those who were contributing to a private pension saved less than men.

Average incomes of pensioners differ for men and women. Average (mean) net income After Housing Costs for single men was higher (at £262 per week) than for single women (£223 per week) in 2012/13.

The main difference between the genders occurs for occupational pension income. In 2012/13, single men received £105 per week on average from occupational pension income, compared with £69 per week for single women. Single men also received more investment and personal pension income. Correspondingly, single female pensioners have higher average benefit income than men.

The problem seems to be around how much women contribute, rather than the level of working women contributing to workplace pensions. The proportions of men and women in a pension scheme are prior to automatic enrolment is roughly similar¹⁰³. According to a leading DC pension provider, women typically save £206 a month compared to men who save an average of £298 a month for retirement¹⁰⁴.

¹⁰³ ASHE and FRS 2011, See NEST Insight 2013

¹⁰⁴ http://www.scottishwidows.co.uk/about_us/media_centre/reports_women.html

The average incomes of single pensioners by gender, 1996/97-2012/13

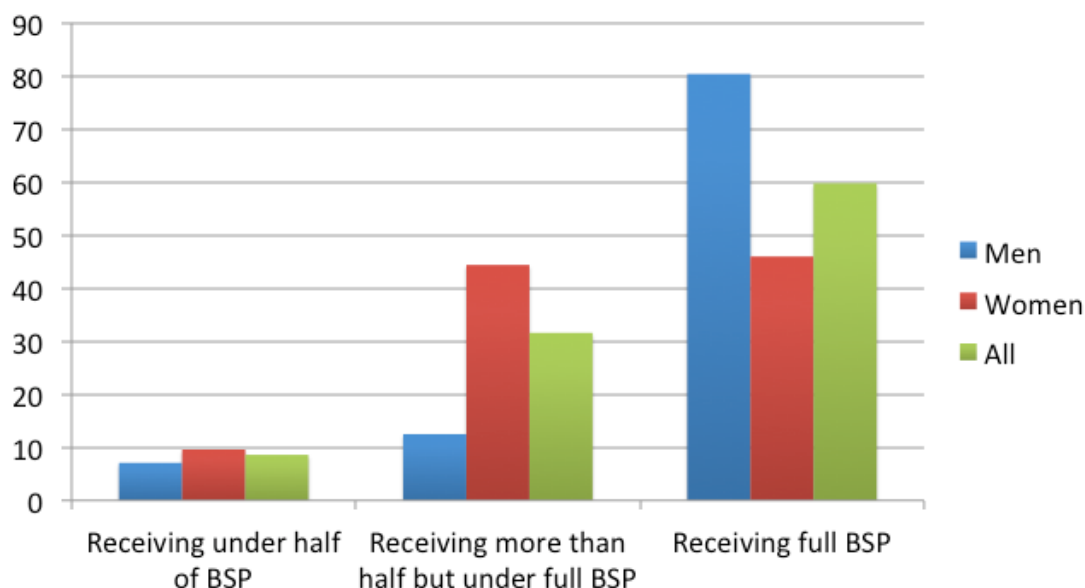
Incomes in £ per week, 2012/13 prices

	1996/97	1998/99	2010/11	2011/12	2012/13	As a % of gross income in 2012/13
Single male pensioners						
Gross income	258	272	370	356	350	100%
<i>of which</i>						
Benefit income	143	147	187	180	180	51%
Occupational pension	74	76	106	104	105	30%
Personal pension income	2	5	15	15	15	4%
Investment income	30	31	30	27	22	6%
Earnings	7	11	28	27	25	7%
Other income	1	2	4	3	3	1%
Net income BHC						
Mean	222	234	314	300	301	86%
Median	184	187	259	242	253	
Net income AHC						
Mean	181	196	279	263	262	75%
Median	141	143	225	207	207	
Single female pensioners						
Gross income	217	234	300	288	298	100%
<i>of which</i>						
Benefit income	143	150	191	183	186	62%
Occupational pension	43	46	64	63	69	23%
Personal pension income	1	1	5	4	4	1%
Investment income	20	23	14	14	14	5%
Earnings	9	11	23	21	21	7%
Other income	2	2	3	3	3	1%
Net income BHC						
Mean	192	204	262	252	260	87%
Median	168	174	239	226	232	
Net income AHC						
Mean	153	167	229	217	223	75%
Median	116	128	197	188	189	

Source: DWP, Pensioners income series, July 2014

A larger proportion of men than of women receive the full Basic State Pension (BSP): in September 2012, 80% of male pensioners received full BSP compared with only 46% of female pensioners.

Figure 2.8: Percentages of pensioners receiving different proportions of Basic State Pension, September 2012



Source: ONS Pension Trends

The policy response and implications to women’s access to pensions

The new single tier state pension will mean boosted state pensions for many women in the future. But others, mainly housewives and stay-at-home mothers, may still get less. This is because in the current system women are entitled to a proportion of their husband’s pension, despite having paid little or no National Insurance contributions.

However, from 2016 this system will no longer exist. Instead, everyone will be responsible for building up their own NI record. A temporary safety net for women who had expected to rely on their husband’s pension has been put in place. They will still be able to receive 60% of their husband’s pension under the new rules. But these women must have paid at least one year of the married women’s stamp in the 35 years before they hit the state pension age.

While the 2007 Pensions Act delivered improvements for women, the government estimate that if the single tier state pension was not introduced, the proportion of women who would qualify for a full BSP would not catch up with the proportion of men who qualify until 2020 and it would take a further 30 years for additional state pension outcomes to equalise. Under the new single tier system, the gap between men’s and women’s pensions is projected to close around 10 years earlier than under the current system (early 2040s rather than 2050s)¹⁰⁵.

¹⁰⁵ DWP (2014) Pensions Act 2014 Impact assessment

Around 650,000 women reaching State Pension age in the first ten years of the new state pension will receive an average of £8pw (in 2014/15 earnings terms) more due to the new State Pension valuation of their National Insurance record.

Automatic enrolment, whilst will undoubtedly boost the numbers of women saving in a private pension will not equalise the amount men and women save. Almost two-thirds of the target group for automatic enrolment at its introduction in 2012 were men. The earnings threshold for automatic enrolment eligibility (£10,000) takes out the lowest earners, many of whom are part-time workers and many of whom are women.

The journey of equalising access to basic state pension

Men and women have overtly been treated differently within the state pension system. Up until 2007, men were required to have a higher number of qualifying years (44) than women (39) in order to get a full basic state pension. Up until 2014, the system allowed married women to claim BSP based on their husband's NI record. Men and women have had different experiences of state support as a result of design issues that have disproportionately affected women. These have contributed to women's poorer pension outcomes and have meant that women have been substantially more reliant on means-tested support than men. Key issues have been:

- If someone had worked for less than 10 years during their working life, they would not receive any BSP.
- Home Responsibilities Protection provided only a partial offset to this for people with caring responsibilities. But the details of how HRP is calculated (it did not act as an accrual of years of contributions but as a multiplier of contributions of the years accrued as a result of employment) that this offset is less than total. As a result a woman with 20 years of home responsibilities and 10 years of employment would accrue only a 50% BSP, while a man with a 30 year employment record would accrue 70%. Also, HRP worked on whole years of caring and therefore failed to take account of women taking partial year breaks to care.
- Someone earning below a certain amount (the 'lower earnings limit' £79 per week in 2004), in any one job didn't accrue any state pension rights. People earning below this level paid no National Insurance contributions. Women were particularly affected given their over representation in part time and low earning jobs.

Changes were made shortly after the turn of the current century so that more of the lowest earners could accrue pension rights. At the same time, the additional state pension was reformed to include and favour low earners. In 2007, contribution conditions were changed for the basic state pension so that it was easier for everyone to build up some entitlement. The HRP system was replaced with a new system of weekly credits for parents and carers, for those receiving Child Benefit for a child under 12 years of age or caring for someone sick or disabled for 20 hours or more per week.

In 2014, the government legislated for a new state pension in which men and women would each accrue pension entitlements in their own right. In addition, given the transitional arrangements in place from the previous system to the new single tier system, many women will benefit in the short to medium term. In the longer term, the minimum number of qualifying years (10), the increase in qualifying years from 30 to 35 and the abolishment of entitlement based on their husband's record will not necessarily result in better outcomes for all women than they would have experienced in the previous system. It does, however, equalise access to full BSP between men and women.

Ethnic minorities

Ethnic minority pensioners have lower overall income than their white counterparts. For example, median net income (AHC) of White pensioner units is £286 per week compared with £212 per week and £209 per week for Black and Asian pensioners respectively). A key driver for this difference is the fact that ethnic minority pensioners are less likely to receive occupational or personal pensions. Ethnic diversity was substantially lower amongst those who were already in a pension at the onset of automatic enrolment (11% black minority ethnic in the pensioned group compared to 19% in the unpensioned group prior to automatic enrolment).

They are also less likely to receive comparable income from the State Pension. This reflects to a large extent ethnic minority individuals migrating to the UK in the middle of their working lives. This gave them a reduced chance to build up entitlement to state and private pension schemes.

The policy response and implications to ethnic minority access to pensions

This differential will have been corrected to a large extent by automatic enrolment. In addition, most ethnic minorities have younger populations than the majority white

British population¹⁰⁶. Accrual of state pension entitlement therefore, will equalise contingent on the number and age of further newcomers to the UK.

It is notable that the White Other group is the fastest growing minority population in the UK and that the largest immigrant group to the UK comes from inside the EU. It is possible that many of these individuals will choose not to retire in the UK, though they may have accumulated private pensions through automatic enrolment.

¹⁰⁶ Runnymede 2010 Older BME People and Financial Inclusion Report. Available at: <http://www.cpa.org.uk/information/reviews/thefutureageingoftheethnicminoritypopulationofenglandandwales.pdf>

Conclusions

The role of the state in funding later life

The history of the UK system up to the present day shows it is one that has struggled at different times with its purpose. That is, protecting against absolute pensioner poverty, relative pensioner poverty and playing a role in replacing pre-retirement income. Different governments have had to struggle with increasing longevity and the increasing costs associated with this, fairness between groups and generations with respect to pension outcomes and the relationship between the state and private systems. The ambiguity about the objectives of the UK pension system largely explains the complexity of the current system.

In addition, different governments have had different points of views on what role the state should play in supporting people in retirement and these reflect ideological views on the extent of the role of the state in people's lives generally. For this reason, the Pensions Commission - the catalyst for the wide-ranging reform now occurring, was keen to develop a political consensus to protect the system from further complication.

Today, the role of the state in the pension system is clearer and there is greater agreement about the objectives of state support and intervention. As the UK population ages, it is more important than ever that the UK pension system supports people to provide for their own retirement but also helps those who reach retirement without enough wealth to maintain an acceptable standard of living. In short, the objective is to prevent relative pensioner poverty and to support individuals to support themselves.

The new single tier state pension, together with the triple lock guarantee, represents a commitment to protecting pensioners against relative poverty. It seeks to remove the disincentive to save that existed in the means testing system (since people knew the state would help if they cannot provide for themselves) and provide a firm foundation to private saving. The intention is that people will be more likely to save with the certainty of what they will get from the state and the certainty that this will be an amount that will only just keep people out of poverty.

In addition, the state is seeking to encourage private pension saving in recognition that the state pension will not deliver an adequate income in retirement for the majority of people. The private pension system, largely delivered through employers, has been an important part of the UK pension system since the 1950s but not because government had legislated for it. It wasn't until the pensions act in 2007

(and related acts that followed) that the government legislated for all employers to offer and contribute to workplace pension schemes.

The state, through the new state pension, is able to deliver adequacy based on target replacement rates for those who had the lowest pre-retirement income (derived through benefits or work). The extent to which those with incomes beyond this achieve their target replacement rate is the responsibility of the individual, not the state.

The next big challenge: the moderate earning majority

Pensioners as a group have stopped being poor. Or rather the UK situation has moved on from 30 years ago when pensioners were much more likely to be poor than their younger counterparts. Now pensioners are much less likely to be poor. In 2011, for the first time, the average incomes of pensioner households, adjusted for housing costs and the costs of children, rose above the average incomes of the rest of the population. Most people retiring now will be better off in retirement than they were on average over their working lives¹⁰⁷.

Pensioner poverty is in rapid decline and the combination of the new single tier state pension (which means that the poorest pensions will now not have to apply for pension credit to top up their state pension to meet a minimum income threshold) means that pensioner poverty overall is set to decline further. Pensioner poverty is on track to be below 10% before 2025¹⁰⁸.

The greatest challenge now facing the UK pension system is the adequacy of the outcomes of the majority of pension savers. Looking ahead to 20, 30 years from now, when DC is the dominant pensions provision, and based on current contribution levels, outcomes are likely to fall quite far short of target replacement rates. Whilst pensioner poverty is less of an issue than it was 3 decades ago, it seems both likely and probable that many people will be far poorer in retirement than they had been throughout their working.

The state has confirmed its role in protecting pensioners from relative poverty and in legislating for mechanisms that support individuals to support themselves. But debates about adequacy are ongoing and, as a result, so too are debates about whether the state has gone far enough in its 'parental' role.

Early signs suggest that automatic enrolment has been a success; millions more are now participating in a workplace pension. But the 'saving more' challenge set out

¹⁰⁷ <http://www.ifs.org.uk/publications/7461hnm>

¹⁰⁸ PPI/ Age UK (2014) Poverty in Old Age

more than ten years ago by the Pensions Commission is only met in part. We are collectively saving more but we are individually not saving enough to secure an adequate pension outcome by anyone's definition.

Full compulsion, increasing the minimum level of contributions, auto-escalation and defaulted decumulation paths would shift the responsibility for individuals' saving and retirement decision making to the state. There is little indication that these measures will be legislated for in the near future leaving pensions adequacy for above median earners the responsibility of the individual.

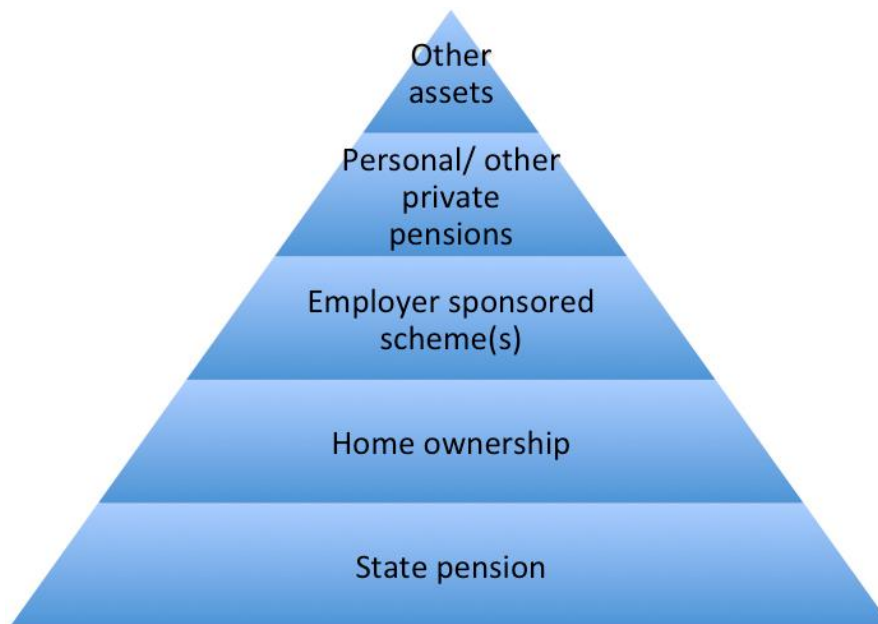
Whilst it is the intention of the single tier state pension to provide a foundation to private pension saving (be signalling only subsistence support from the state and removing savings disincentives) there is scant evidence to suggest that this will have any behavioural effects in terms of how much people contribute to private pensions. People don't act to participate in private pension savings because they are inert and myopic and they don't contribute more once they are in a scheme for exactly the same reasons.

Replacement rates and financial preparedness for retirement

Traditionally, a lot of emphasis has been placed on retirement income levels derived from pensions as an indicator of how well people are able to cope financially in later life. The focus has been on what proportion of working age income pensions deliver. The State Pension, occupational and personal pensions have each been considered a 'pillar' and the accepted wisdom is that everyone should have some of each.

More recent thinking takes in wider circumstances that contribute to quality of life and ability to cope during retirement.

The 'retirement pyramid' presents an alternative model. It shows active sources of income and other sources that could potentially be drawn on, and their relative importance. Crucially, it features home ownership which is an asset but also has significant implications for expenditure and disposable income. The State Pension provides the broad base of the pyramid with other sources of income or assets providing a higher level of income or playing a more significant role in financial circumstances. Home ownership is the next broadest level in the pyramid as it denotes a significant outgoing to be saved. Further factors like household composition and care needs could be part of the retirement pyramid, given the impact these have on how much people need to live on in retirement.



The financial experience of retired people is impacted by several factors and pension income, whilst clearly key, is only one of these. This conceptual framework looks beyond pensions and income to take a more holistic view of financial preparedness for later life. With this model, spending patterns are as important as income in considering whether someone has enough to live on in retirement.

Whilst this doesn't negate consideration of replacement rates, it illustrates that replacement rates can only be a general guide to how much money will be sufficient in retirement. A moderate earner with housing costs will be significantly more affected by missing their target replacement rate than someone with no housing costs (owns their home outright). Indeed, the target replacement rate of a moderate earner who anticipates housing costs in retirement would be significantly higher than 60%. Arguably replacement rates used by government in the UK (developed by the Pensions Commission in 2004 and using data older than this) to calculate the proportion of people who can anticipate an adequate retirement, based on the current UK pension system, do not adequately reflect current trends in spending in retirement.

The pyramid also helps to understand why recent retirees are so much better off in retirement than future retirees are likely to be. The key difference for the new retiree consumer base is not simply the differential in incomes, but a lack of diversity in retirement resources from which to draw incomes and potentially higher costs in retirement. As DB coverage declines, DC provision proliferates, and home ownership levels change, levels of uncertainty about pension income and what they can achieve looks set to increase. Arguably it's this that will differentiate the future population of retirees from those that have retired more recently.

The increasingly dynamic nature between work and retirement

In order to manage the cost of state support, the UK has legislated several times in recent years to increase the state pension age. In 2004, when the Pension Commission first reported to Government, it seemed that this would be a difficult change to pass and that there would be a high level of public resistance to it. Since then, the SPA has increased with little fuss and is set to increase further and faster than would have been imaginable a decade ago. As well as helping to manage the cost to the state, it is also encouraging longer terms of private saving and is therefore playing a role in improving pensioner outcomes.

At the same time, attitudes to working for longer are changing and labour markets are occurring later, seemingly in spite of increases to the SPA. A more dynamic scenario in which work and pensions operate hand in hand is increasingly replacing the traditional retirement model. Retirement is now longer a single event for many people and is increasingly becoming a phase journey in which people are drawing on a pension whilst working. The widely assumed definition of retirement as a complete exit from the labour market is now out of step with many people's experience. This has significant implications for how pensions and retirement are conceptualised in the UK.

Equality of opportunity but not outcome

Reforms between 2007 and 2014 have seen the UK offer greater equality of access to pension entitlement – state and private – than has ever been seen before. Changes to crediting unpaid activities, the introduction of a single tier and the scrapping of the additional state pension and automatic enrolment have benefited groups who have previously had unequal access to state and private pensions and have had poorer pension outcomes as a result. Though access has improved, it isn't perfect. Very low earners – who are often part time workers and women, will effectively remain outside of private pension saving as a result of the minimum income threshold for automatic enrolment. Those with fewer than 10 contributing years will not be entitled to any state pension so newcomers to the UK will be impacted.

Whilst equality of access has improved greatly, outcomes will continue to be unequal. Though the government can mandate for private pension participation and equalise entitlement to state pension between different groups, it can't fully mandate for how much people save, when and investment performance. Equality of outcomes is therefore contingent on a number of variables which are outside of government control.