1. Introduction

> *'When I use a word', Humpty Dumpty said, in rather a scornful tone, 'it means just what I choose it to mean—neither more nor less'.*

Lewis Carroll (1871) *Through the Looking-Glass, and What Alice Found There*

This Chapter is a scene-setter for the remainder of the Report. We begin by considering how pension schemes have traditionally been used and also how they are likely to be used in future following the introduction of the pension reforms announced in the 2014 Budget. These reforms furnish us with an opportunity to ask anew what a 'good' pension scheme should aim to achieve. There are also risks involved in the provision of pensions and we discuss the key ones. Unfortunately, widespread evidence shows that many if not most pension scheme members do not understand these risks and are unlikely ever to do so, however much guidance or education they receive. This will make it difficult for many of them to make informed choices about how they spend their retirement savings that takes these risks into account. This, in turn, raises the question about whether scheme members should be nudged (or even defaulted) into a well-designed decumulation product that has dealt with these risks in the most efficient and cost-effective ways possible – with the option to opt out, as in the case of auto-enrolment. We then consider the different types of pension member affected by the reforms. Finally, we discuss the attitudes of employers, consultants, providers, investment managers, and trade unions to the reforms.

1.1 Pension schemes – uses and risks

1.1.1 Uses

The primary purpose of a pension scheme is to provide life-long retirement income security for however long the scheme member lives.[2] This Report will examine retirement income in private-sector pension schemes, principally workplace schemes set up by employers for their employees. There are currently two types of such schemes in the UK – defined benefit (DB) and defined contribution (DC) schemes. DB schemes – which aim to deliver a pre-defined pension in retirement, typically linked to average or final salary, together with the option of a tax-free cash lump sum – are in decline in the UK private sector and are being replaced by DC schemes – which specify what goes into the scheme in terms of contributions, but not what comes out in terms of the size of the pension. The Report will therefore concentrate on DC schemes, the type of scheme most people will have in the

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[2] This definition of a pension scheme as providing insurance against outliving one's resources is well established in the academic literature, see, e.g., Zvi Bodie (1990) Pensions as Retirement Income Insurance, *Journal of Economic Literature*, 28, 28-49; and Nicholas Barr and Peter Diamond (2008) *Reforming Pensions: Principles and Policy Choices*, Oxford University Press, New York and Oxford.

future, although it will also look at transfers from DB to DC schemes. The Government's 'freedom and choice' agenda introduced in the Budget on 19 March 2014 is intended to apply to both DC and funded DB schemes, but not to unfunded DB schemes which most public-sector workers have.[3]

Table 1.1 Criteria for a good DC pension scheme
• Delivers adequate and sustainable pensions;[4] by sustainable, we mean having support mechanisms in place that help people not to spend their pension fund too quickly after retirement • Produces stable and predictable lifelong retirement incomes, even if those incomes cannot be guaranteed (unless a lifetime annuity is purchased) • Offers the flexibility to purchase a lifetime annuity at any time (or at regular predetermined intervals) • Has the flexibility for members to withdraw funds to meet 'lumpy' expenses, such as the cost of a new boiler • Provides an investment strategy that reflects the scheme member's attitude to and capacity to take risk, and generates a return at least as high as inflation • Provides value for money for every pound saved in the scheme • Has transparent charges and costs • Provides reliable and efficient administration • Delivers effective communications to members • Protects scheme assets from fraud or theft • Has minimum quality standards in terms of operational efficiency, charges and governance with a duty by the governance committee to act in members' best interests • If individuals are constructing their own pension scheme, they should use products that are effective and easy to understand[5]

In order to make any assessment about the retirement income from a DC pension scheme, we need to establish a benchmark for comparison. In other words, we need to establish what 'good' outcomes would be in a DC scheme. On the basis of our analysis and feedback

[3] H M Treasury (2014) *Freedom and Choice in Pensions*, Cm 8835 (Session 2013-14), 19 March; https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/294795/freedom_and_choice_in_pensions_web_210314.pdf.

[4] European Commission (2003), *Adequate and Sustainable Pensions*, Publication Office, Luxembourg.

[5] In a similar way as was imposed on default funds in the accumulation phase. See Department for Work and Pensions (2014) *Better Workplace Pensions: Further Measures For Savers*, Cm 8840, March; https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/298436/better-workplace-pensions-march-2014.pdf

from our various discussions, we believe that a good DC pension scheme will meet the criteria set out in Table 1.1.[6,7,8]

The 2014 Budget added two new possible uses for a pension scheme. The first of these is inheritability – the residual pension fund on the death of the scheme member can be inherited by a nominated beneficiary.[9] Further, the 2014 Taxation of Pensions Act abolished the so-called 'death tax', the 55% tax charge on pension death benefits if the member dies before 75, so that the nominated beneficiary can inherit the residual pension fund without paying any tax. If the member dies after 75, the nominated beneficiary pays tax on the residual pension fund at their marginal tax rate. Given the generally low level of pension savings in DC schemes in this country, this outcome is likely to only be of real benefit to a relatively small number of well-off pensioners.[10] But the consequences will be much more widespread. The inheritability of the pension fund became possible because the Chancellor removed the requirement to annuitise the assets in the pension scheme.[11] At a stroke, the Chancellor converted all pension schemes in the UK – including DB schemes – into savings schemes, with no essential difference between them and other savings schemes, such as independent savings accounts (ISAs). However, the Chancellor *cannot* change the definition of a pension scheme which is to pay a pension until the member dies. Nevertheless, a key implication of his decision is that the risks involved in retirement income provision – in particular longevity risk – have been almost entirely individualised. The benefits from any form of collective risk sharing have been removed.

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[6] The criteria listed in Table 1.1 will need quantifying for the table to be operationally useful.

[7] The Pensions Regulator has identified the following 6 elements necessary to achieve the good member outcome of an adequate income in retirement in DC schemes:

- Appropriate contribution decisions
- Appropriate investment decisions
- Efficient and effective administration
- Protection of assets
- Value for money
- Appropriate decumulation decisions.

See The Pensions Regulator (2011) *Enabling Good Member Outcomes In Work-Based Pension Provision*, Discussion Paper, January; http://www.thepensionsregulator.gov.uk/docs/dc-discussion-paper-2011.pdf

[8] Note that following 'freedom and choice', it might well be the case that a 'good' pension scheme is no longer provided by a single organisation: there might be one organisation providing the accumulation stage and another providing the decumulation stage. Table 1.1 would have to be modified to reflect this.

[9] David Cameron MP, the Prime Minister, said: 'we want to make sure we complete this great revolution where we're giving people much more power to save, to access their pension and pass their pension on to their children' (reported in Steven Swinford and Dan Hyde (2015) Crackdown on banks that deny loans to the elderly, Daily Telegraph, 18 April).

[10] Very few people will have amassed a significant sum in their pension pot by age 55.

[11] The Chancellor, George Osborne MP, announced in the Budget: 'Pensioners will have complete freedom to draw down as much or as little of their pension pot as they want, any time they want. No caps. No drawdown limit. Let me be clear. No one will have to buy an annuity … People who have worked hard and saved hard all their lives, and done the right thing, should be trusted with their own finances'.

The second new potential use is debt clearance. Previously, pensions could not be assigned to pay off a loan. After April 2015, everyone over 55 can take their pension as a lump sum. Strong supporters of the new pension regime are banks and building societies with customers with interest-only mortgages who earmarked no specific savings arrangements to pay back the mortgage loan. If these customers have pension schemes, the mortgage lender can now invite them to exercise their pension 'freedom' and pay off the mortgage.[12]

1.1.2 Risks

It is important to be aware of the risks involved in the generation of retirement income from pension savings. The key risks are listed in Table 1.2. Following 'freedom and choice', these risks are now borne directly by DC scheme members.

Table 1.2 – Key risks involved in the generation of retirement income from pension savings

Contribution risk	The risk that pension contributions (and hence pension savings) are lower than planned, e.g., because the scheme member becomes unemployed, is unable to work due to ill health, or is unable to pay off their debts
Retirement timing risk	Uncertainty about when the scheme member will retire and/or begin to make withdrawals
Product choice risk	Uncertainty about how the scheme member will make withdrawals, not least because of the very large set of choices now available
Investment risk	The risk that investment performance is worse than expected or the risk that investments do not generate incomes in a way that matches the desired pattern of consumption in retirement. A particularly important example of investment risk is sequence-of-returns risk
Inflation risk	The risk that inflation is higher than anticipated
Interest rate risk	The risk that interest rates are low at the point of annuity purchase

[12] But at the risk of ending up with an inadequate retirement income and the potential cost to tax payers of additional welfare benefits.

Longevity risk	The risk that the individual savers live longer than their life expectancy (i.e., idiosyncratic longevity risk) and the risk that savers as a whole live longer than anticipated (i.e., systematic or aggregate longevity risk)
Cost risk	The risk that the total costs of running the pension scheme during accumulation and decumulation are higher than expected or understood
Political risk	The risk that the Government changes the rules in an adverse way (e.g., reduces the level of tax relief)
Regulatory risk	The risk that regulations change in an adverse way (e.g., the regulator increases regulatory capital requirements, which has the effect of reducing annuity rates)
Demographic/cultural risk	The risk that younger cohorts refuse or are unable to honour the implicit intergenerational contract that underlies many pension schemes. For example, the next generation of workers refuses – or is unable – to pay the pensions the retired generation expects to receive, because they are unwilling to honour the implicit contract or because there are too few of them in relation to the size of the retired population. Also, an arrangement that works in one culture (e.g., Holland) might not work in another (e.g., the UK)
Market conduct risk	The risk that those who provide services to the scheme act in a way that disadvantages scheme members (e.g., investment managers subject to a charge cap negate the effects of the charge cap by increasing portfolio turnover, or the benefits of economies of scale go to scheme providers' shareholders rather than to members); fraud and the activities of scammers would be included here
Behavioural risk	The risk that scheme members behave in a way that is not considered to be rational (i.e., is not in their long term interests, since

	they make short-term decisions that they subsequently regret and are unable to learn from past mistakes). Inertia and lack of engagement would be included here, as would be the risk that members fail to understand the risks they face
Financial knowledge and understanding risk	The risk that a member's financial knowledge and understanding are insufficient for the member ever to make an 'informed choice'
Mental impairment risk	The risk that a scheme member's mental faculties are reduced due to the onset of dementia, for example

There are a number of ways of dealing with such risks in general:

- The risks can be assumed or 'run' – this might be deliberate (e.g., in the case where a scheme member increases the level of investment risk in their pension fund in the hope of achieving a higher investment return and, hence, a higher anticipated pension[13]) or unavoidable (e.g., in the case of contribution, political or regulatory risk)
- The risks can be regulated against – effective regulation can reduce cost and market conduct risk, for example
- The risks can be explained – by informing people well in advance the importance of giving providers reliable signals of when and how the pension pot will be accessed, or explaining behavioural biases and nudging people towards making optimal decisions

[13] An early example of investment risk following the introduction of the pension reforms was the Chinese stock market crash in August 2015 (dubbed the Great Fall of China), which elicited the following headlines in the Daily Mail (above to an article by Louise Eccles published on 25 August):

> *Don't risk cashing in your pension: Retirees warned they could cause 'irreparable damage' if they withdraw lump sums from their pots at such a volatile time*
>
> - *The top 100 companies in the UK – in which many pensions are invested – have had £170billion wiped off their value in the past two weeks*
> - *FTSE 100 down by almost 10% triggered by Chinese stock market crash*
> - *Fall means pensions invested in market have also plunged by up to 10%*
> - *Britons warned to hold fire on big decisions until markets have stabilised*

- The risks can be reduced – by careful design of the scheme. For example, by careful design of the investment strategy and by making the most of diversification, investment risk can be reduced
- The risks can be pooled amongst members of a given cohort (known as intra-generational risk pooling) – idiosyncratic longevity risk can be pooled and hence made more stable and predictable, but this, in turn, requires scale (i.e., only large pension schemes can do this)
- The risks can be shared between members of different cohorts (known as inter-generational risk sharing) – investment returns can be smoothed across different cohorts using a smoothing fund
- The risks can be hedged if there are suitable hedging instruments – e.g., inflation and interest rate risk can be hedged using inflation and interest rate derivatives, but systematic longevity risk cannot currently be hedged due to the absence of longevity bonds and indexed longevity swaps
- The risks can be managed within a carefully designed default plan into which the members are auto-enrolled. When someone first starts work, this will be a default accumulation plan with a default contribution rate and investment strategy. When someone retires, this could be a default retirement expenditure plan. The onset of a mental impairment, such as dementia, needs to be identified early and carefully managed
- Finally and most worryingly, the risks can be ignored.

Unfortunately, many people do not understand the risks in Table 1.2, especially longevity risk, although they are unavoidable aspects of building up pension savings over a 40-year (or longer) working life and then running down those savings over a retirement period that could last 30 years or more. Even with improved financial education,[14] it is unlikely that many people will fully understand some of these risks. This is because some risks have to be experienced before they can be genuinely understood, and often it is too late by that stage to do anything about them. In addition, many people will have problems understanding the full range of product choices that are now available. All this makes it difficult for many people to be in a position to make 'informed' choices. The Government is offering only 45 minutes of guidance under the 'guidance guarantee' to cover all these issues.[15]

If a large group of people cannot understand the risks they face in their pension scheme, despite being provided with information about those risks, then they should not be

[14] The Government has encouraged improvements in financial education for years now, although there is little evidence that this has been effective. See, e.g., H M Treasury (2008) *Thoresen Review of Generic Financial Advice: Final Report*, March;
webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/media/8/3/thoresenreview_final.pdf

[15] Provided by Pension Wise – see Chapter 3.

expected to manage these risks themselves.[16] Instead, if people can have confidence that those designing and regulating pension schemes have dealt with these risks in the most efficient and cost-effective ways possible, then it might be possible to nudge (or even default) savers into making the right choice at retirement for them and their family. To do this, we will need to build on the lessons of auto-enrolment and, in particular, the issue of having a well-designed default decumulation process at retirement.

One of the principal lessons of finance theory is that some risks can be reduced through diversification, that is, by pooling or sharing risks. Diversification has been called 'the only free lunch in finance'. As mentioned above, two key risks that can be reduced in this way are investment and longevity risk. This is one of the key benefits of saving for a pension in a large pension scheme. By individualising the risks listed in Table 1.2, the 2014 Budget encourages pension scheme members to give up their free lunch. The inevitable consequence will be that workers with similar salary histories and pension contributions will end up with very different pension outcomes: while some outcomes will be very good, others will undoubtedly be very poor. Many people would regard this as undesirable. We will examine how diversification benefits can be recaptured either in large schemes like NEST (National Employment Savings Trust) or with new types of collective pension schemes.

1.2 Pension scheme members

1.2.1 Who will be affected by the pension reforms?

One of the principal arguments of economic theory is that competition and market forces can deliver good outcomes for consumers. However, the Office of Fair Trading's (OFT) *Defined Contribution Workplace Pension Market Study*[17] in 2013 provided evidence that competition and market forces are not working effectively when it comes to pensions and that the market for buyers is 'one of the weakest that the OFT has analysed in recent years'. This is because 'most employees do not engage with or understand their pensions. Pensions are complicated products, the benefits of which occur, for many people, a long time in the future'.

A wide class of pension scheme members will be affected by the new 'freedom and choice' regime:

- Members of workplace DC auto-enrolment schemes: active, deferred and pensioners
- Private-sector defined benefit (DB) scheme members who transfer to a DC scheme. Those who take advantage of the DB-to-DC transfer rules might use the DC scheme

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[16] One of the reasons why pension schemes were first set up was because people did not understand and did not manage well these risks.

[17] http://webarchive.nationalarchives.gov.uk/20131101164215/http:/www.oft.gov.uk/shared_oft/market-studies/oft1505

offered by their employer, if this includes a drawdown facility. Otherwise, they will have to switch to another provider

- The self-employed
- Workers with employment contracts that do not qualify them for auto-enrolment.

We will examine the characteristics and challenges presented by each group in relation to achieving good retirement outcomes. Our main emphasis will be on the first group, although we will consider how DB-to-DC transferees, the self-employed and those with employment contracts that do not qualify them for auto-enrolment can also be helped.

1.2.2 The impact of the pension reforms on welfare benefits

If things do go badly for members of some of these groups and they run out of money before they die or invest unwisely and end up in poverty in old age, this will be a tragedy for them individually. But it will not be costless for the rest of society. This is because such people can claim certain means-tested welfare benefits which are funded by local and national taxation. The main local benefit is council tax support (previously council tax benefit, but now localised).

In March 2015, the Department for Work and Pensions (DWP) issued a factsheet[18] showing the qualification rules for the following income-related means-tested welfare benefits that will apply in respect of the new flexibilities for accessing pension pots after 6 April 2015:

- Employment and Support Allowance (income-related)
- Housing Benefit
- Income Support
- Jobseeker's Allowance (income-based)
- Pension Credit
- Universal Credit.

The rules are extremely complicated. For those below the qualifying age for a state pension, withdrawals from a pension pot will be treated as either income or capital, depending on certain factors, such as how regular the withdrawals are. If no money has been taken from the pot, it will not be taken into account when calculating benefit. For those over the qualifying age who choose not to buy an annuity, the DWP will assume they have 'notional income' equivalent to that of an annuity, based on 100% of GAD rates.[19] Notional income must be reviewed: after every drawdown of capital; after every drawdown of income which

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[18] *Pension Flexibilities and DWP Benefits*; https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/417473/pension-flexibilities-dwp-benefits.pdf.

[19] These are the maximum withdrawal rates periodically set by the Government Actuary's Department for capped drawdown (which caps the level of income that can be withdrawn to reduce the risk the fund will run out – see Chapter 2); https://www.gov.uk/government/publications/drawdown-pension-tables.

exceeds the notional income level; and at the claimant's request. If people take an income from their pension pot, it will be treated as the actual income if it amounts to more than the notional income.

People who take a cash lump sum will have this treated as a capital withdrawal. Ad hoc withdrawals will be regarded as capital (despite potentially being entirely taxed as income). If the claimant has savings or investments of an amount greater than the 'capital disregard' (currently £10,000), the excess will be deemed to provide an assumed weekly income, currently £1 for every £500 (or part) of the excess.

Pension income may affect entitlement to contributory benefits. For Employment and Support Allowance (contribution-based), all pension income over £85 per week, and, for Jobseekers Allowance (contribution-based), all pension income over £50 per week will be taken into account. Uncrystallised benefits[20] will not impact upon contributory benefits.

Individuals are warned to avoid 'deliberate deprivation'. The factsheet explains the 'deprivation rule' which states that if an eligible individual spends, transfers or gives away any money taken from their pension pot, the DWP will consider whether they had deliberately deprived themselves of that money in order to secure (or increase) entitlement to benefits. If it is decided that the individual has deliberately deprived themselves, they will be treated as still having that money and it will be taken into account as income or capital when any benefit entitlement is worked out.

However, the factsheet does not make clear how the DWP will decide whether someone has deliberately deprived themselves. Commentators have questioned whether people who have made poor investment decisions or been a victim of pension fraudsters would be caught out by this. For example, Neil Lovatt, director at Scottish Friendly, said: 'The Government is promoting the right of the individual to have control of their pension, while reserving the right to decide whether they have used that money wisely. [If a pensioner spends their pot on a Lamborghini, the DWP is likely to take a dim view of this], but if a pensioner loses money after investing in a buy-to-let property, will that be considered reckless? [The rules need to be much clearer about this], otherwise we [will] have bureaucrats making judgments on pensioners with the benefit of hindsight'.[21]

Entitlement to means-tested benefits is also likely to be influenced by the introduction of the new single-tier state pension for future pensioners on 6 April 2016.[22,23] This is to be set

[20] These relate to that part of the pension pot which has not been accessed in any way – see Chapter 2.

[21] Quoted in Harvey Jones (2015) Pension reform may lead to poverty: State will not support spenders with benefits, Daily Express, 1 April.

[22] The following is based on a note from Djuna Thurley, House of Commons Library, 27 March 2015 (1503-243). The new single-tier state pension will replace the basic state pension, the state earnings-related pension (SERPS) and the state pension (S2P).

[23] Pensions Act 2014, s1.

at £155.65, just above the level of the basic means-tested guarantee (i.e., £155.60 per week in 2016-17).[24] Thirty-five qualifying years will be needed to be entitled to the full amount. People with fewer qualifying years will be entitled to a proportionate amount, provided they have at least ten qualifying years.[25] The new state pension is expected to reduce eligibility for Pension Credit, with the main driver for this being the abolition of Savings Credit.

Pensioners with relatively low incomes may qualify for means-tested support through the Pension Credit. This currently has two elements:

- The Guarantee Credit tops up weekly income to a 'standard minimum guarantee' (£151.20 for a single person in 2015-16). Additional amounts are payable in respect of severe disability, certain caring responsibilities and housing costs.
- The Savings Credit aims to provide an additional amount for those aged 65 or over who have made some provision for their retirement. The maximum Savings Credit for a single person is £14.82 in 2015-16. However, Savings Credit is to be abolished for future pensioners from 6 April 2016.[26]

Pensioners with housing assets could also be affected by the Care Act 2014. This introduced new measures for both financing and limiting the costs of long-term residential or nursing care which affects around 150,000 people per year.[27] First, it established a mandatory local-authority-run 'universal deferred payment scheme' from April 2015, which means that people might not need to sell their home in their lifetime to pay for their care costs. Instead, if a local resident meets the eligibility criteria, the local authority pays certain care costs and a debt is established against the local resident's main home. This is a loan against the value of the property which is repaid on the local resident's death. The Department of Health states that most people can use 'around 80% to 90% of the equity available in their home. The limit on equity is to protect you from not having enough money to pay sales costs of the property - like solicitors' fees - and to protect the council against a drop in housing prices and the risk that it may not get all of the money back'. Councils can charge interest linked to the cost of government borrowing, up a current maximum of 2.65% p.a.

Second, the Act establishes a £72,000 cap on care costs. The original plan was to introduce the cap in April 2016, but, in July 2015, the Government announced that this would be delayed until 2020. The cap will be means-tested. Those with assets of less than

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[24] The Prime Minister, David Cameron MP, claims the single-tier pension will be adequate to live on (reported in Michael Klimes (2014) David Cameron claims single-tier pension is adequate safety net, Professional Pensions, 20 October).

[25] Pensions Act 2014, s2. In July 2015, the DWP announced that only 37% (222,000 out of 600,000) of pensioners will be able to claim the full amount in 2016. This is expected to rise to 50% by 2020 and to 84% by 2035.

[26] Pensions Act 2014, s23 and Sch 12 Part 3.

[27] http://www.local.gov.uk/care-support-reform/-/journal_content/56/10180/6522542/ARTICLE

£17,500 receive free care. There is then a sliding scale of state support up to a threshold of £123,000. Those with assets (including pension assets) above £123,000 will receive no help towards the cap. In addition, the cap covers only the cost of personal care (help with washing, dressing, eating and mobility) and medical care (requiring nursing supervision), but not 'hotel costs' such as food and accommodation. Each council will use a 'resource allocation system' (RAS) to determine the notional cost of care in its area, with costs capped at £230 a week. One council, for example, might determine the cost is £200 a week and, if total care costs are £700 a week, then the resident is responsible for paying the remaining £500 per week. What all this means is that a cap of £72,000 on personal spending on care is likely to be a severe underestimate of the true cost of long-term care. According to Partnership, a care cost funding provider, the true cost could be double the £72,000 cap.

When the means test is applied, different sources of income and capital are assessed in different ways. In the case of pension or annuity income, 50% of this is disregarded if the claimant has a partner. In the case of flexi-drawdown,[28] the entire drawdown fund will be treated as a capital asset, with an income tariff, equivalent to a single life, non-escalating annuity, applied to it. This could mean that the care resident needs to make a greater personal contribution in the case of drawdown than in the case of an annuity.

1.2.3 Pension adequacy and pension inheritance

We note that one of the good outcomes of a DC pension scheme was an 'adequate' pension. But this will largely depend on the level of contributions made to the scheme and the investment returns on these prior to retirement. It is generally not possible – due to the risks involved – to achieve this objective from low levels of pension savings that rely on unrealistically high real rates of investment return being realised over extended periods. Since our Report is about retirement income, we will be looking at good outcomes, conditional on the contributions made during the accumulation phase. We have not been asked to address the question of the adequacy of pensions or the adequacy of pension savings.

Nevertheless, we note that, as a society, we are collectively not saving enough for our pensions.[29] Amongst 'baby boomers' in the 55 to 74 age range, 40% have not yet begun to save for a pension, according to a recent Blackrock Investor Pulse survey.[30] Of those with savings, 63% hold them in cash which has lost 15% of its purchasing power over the last 5 years due to inflation. At the other end of the age range, saving is also a very low priority for 'millennials' – those born after 1980 – according to recent research by BNY Mellon.[31] Yet for

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[28] This is discussed in Chapter 2.

[29] See the Appendix to this Chapter for a review of some recent studies investigating this proposition.

[30] Natasha Browne (2015), Research - 40% of baby boomers not saving for retirement, Professional Pensions, 27 January.

[31] Paul Traynor (2015), The Generation Game – Savings for the New Millennial;

living standards to grow, we need to invest in increasing the economy's capital stock and the only sustainable source of long-term investment is long-term savings.[32, 33]

Aegon has reported research which shows that people have difficulty in calculating how much they need to save for retirement, since they are not clear what they will get from the state pension scheme in future. A man aged 65 would need approximately a £200,000 pension pot to buy a £150-a-week income (roughly the same as the new single-tier state pension from April 2016). Duncan Jarrett, of Aegon UK, said: 'This is significantly more than the £63,815 those approaching retirement have on average in their private pension, highlighting just how fundamental the state pension is to people's retirement plans'.[34] In 2014, the Joseph Rowntree Foundation published research which suggests that the minimum income needed in retirement is £13,500.[35] Since the new single-tier state pension is approximately £8,000 p.a., then someone needs a minimum of £5,500 in annuity income. At age 65, this costs £103,000 for a level annuity and £145,000 for an index-linked annuity. If someone delays the annuity purchase until age 75, the costs are £76,000 and £102,000, respectively.[36] Even these minimum amounts are well in excess of what most people currently have in their DC pot.

A couple of surveys were published in April 2015 on attitudes to inheritance of the pension fund after the member's death. The first was a survey sponsored by Zurich of 1,000 people aged over 50 with DC pensions. Although 79% valued the reforms, 55% said they would have no effect on how they spend or save in retirement, while 35% reported that they did not expect to leave much of the pension fund to pass on to their family. Only 5% said they would change their behaviour, knowing their beneficiaries would inherit more of the pension following the removal of the 55% 'death tax'.[37] The second was a survey sponsored by HSBC, and contained in a report called *Choices for Later Life* which found that 26% of UK respondents said retirees should spend all their money, while just 5% thought they should save as much as possible for their inheritors. The 'spend versus save gap' of 21 percentage

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http://www2.deloitte.com/content/dam/Deloitte/lu/Documents/financial-services/performancemagazine/articles/lu-generation-game-savings-millenial-012015.pdf

[32] No society can indefinitely borrow to invest.

[33] There is, of course, an alternative to saving for retirement and that is not retiring at all. It was not many generations ago that this is what happened in the UK and elsewhere, one worked until one dropped. This is some evidence that this is returning to the UK: there are some people who simply cannot afford to retire. Around 12% of the UK population over statutory retirement age still work (Labour Market Statistics, Office for National Statistics, March 2015).

[34] Reported in Amy Frizell (2015) Pension system changes are putting people off saving for their retirement, experts warn, Independent, 24 August.

[35] Abigail Davis, Donald Hirsch, and Matt Padley (2014) *A Minimum Income Standard for the UK in 2014*, Joseph Rowntree Foundation, June; http://www.jrf.org.uk/publications/minimum-income-standard-2014.

[36] http://www.sharingpensions.co.uk/annuity_rates.htm#text5

[37] Reported in 'Death tax cut fails to sway savers' plans – study', Professional Adviser, 30 April 2015.

points was higher than for any of the other 15 countries involved in the survey; the overall average was 8 percentage points.[38] Despite these findings, there has been a significant increase in the demand for advice about pensions and inheritance tax planning since the Budget announcements, according to a survey of accountants by Investec Wealth & Investment.[39]

1.3 Employers and consultants

We held a number of meetings with employers, as sponsors of occupational pension schemes, and their consultants between January and April 2015. One example was a meeting with members of the CBI's pensions panel on 25 February 2015 and another was with the Society of Pension Professionals on 6 January 2015. There were also many separate face-to-face meetings. We discussed a broad range of issues which we summarise under the following headings.

<u>What are the attitudes of employers in general to 'freedom and choice'?</u>

A typical response from a consultant was this: 'We know that employers are absolutely disenchanted with Government pension policy about "freedom and choice". In particular, it does not help them with retirement management now that employees can take their pot as cash from age 55 and continue working for as long as they want/need to. So, for employers, the DC scheme is no longer a key feature of the reward structure – if they want to improve attraction/reward, they do this through a share scheme, for example'.

Overwhelmingly, employers called for a period of stability in pensions policy. They noted that the 2014 Budget was completely unexpected, massive in impact, and the reforms were introduced without any consultation. Employers need stability from a business perspective – they are still dealing with a whole range of major issues, including auto-enrolment (AE), the ending of contracting out, DB funding issues, etc. Business systems take time to adapt in response to major changes. Employers believed it was essential that policy makers really made an effort to understand how the pensions market works in practice and how it works for different types of employers. Currently, this is not the case: 'How can ministers and civil servants understand if they are remote from the real world and if they were auto-enrolled into a gold-plated, tax-payer-funded DB scheme when they started employment?' In view of this, some employers were keen to explore the idea of a permanent pensions commission.

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[38] http://www.hsbc.com/news-and-insight/2015/easing-into-retirement

[39] Reported in Carmen Reichman (2015) Pensions and IHT behind 'sharp rise in demand for financial advice', Professional Adviser, 24 April. This is likely to mainly from those with above-average incomes and/or savings.

Do employers differ in their responses to 'freedom and choice'?

Employers are grouped along a spectrum. At one end are those employers and their advisers who want to encourage their scheme members to transfer out of the DB scheme in order to de-risk it. Some employers expected 50% of their members to transfer and are promoting/advertising transfer values (TV):

- using all communications channels
- actively targeting those above age 50
- TV information in retirement packs
- TV information in annual benefit statement.

At the other end are large long-established employers running a single trust-based DC scheme which was set up when the DB scheme was closed down. Such employers:

- are more paternalistic partly by nature or history and partly because they have a reputation to protect
- feel the need to do *something* to protect employees from themselves; they want current and future employees to know that they look after their staff at the point of retirement and beyond
- are not commercial – they are not trying to sell anything
- are big, compared with new AE schemes – some go back more than 20 years.

Other employers in this second group include the outsourcing industry, facilities management, former-public-sector companies, etc. They have a very high staff turnover rate for a lot of workers, but also a significant number of long-service employees – and they need to be able to retire them efficiently.

Employers' attitudes on value for money for scheme members

One employer told us that having paid 16% p.a. into employees' pension pots, he wanted to ensure members secured value for money in drawdown. This type of employer is likely to ensure members get the right sort of help. This might not be just because they are altruistic, it is also because it makes good business sense, since efficient retirement solutions avoid the HR log-jam.

When addressing the needs of the majority of auto-enrolled members, the employers that we interviewed recognised the importance of caution when assessing the pot size. The pensions industry (providers and advisers) tends to assume that £80,000 is a large sum, even though this buys a relative small annuity of only around £4,000 p.a. Employers were concerned that the industry would focus more on the fee/commission/profit that can be made than on the solutions it could provide. Many thought that retail drawdown products were expensive.

However, the OFT's *Defined Contribution Workplace Pension Market Study* cited earlier also pointed out that 'many employers may not have the capability or the incentive to drive competition on the key elements of value for money in the interests of scheme members…Employers may also seek to prioritise the interests of scheme members that are current employees, over those scheme members that are former employees'. The last point is likely to be very important when it comes to retirement income in the new pensions environment: we were told on numerous occasions that many employers will just want to see the their retired employees off their books and will have little interest in how they spend their pension pot.

Value for money for employers

Employers also told us they are keen to secure value for money in return for company pension contributions. The benefit to the employer of running a scheme has changed significantly since the hey-day of final-salary schemes. The extent to which employers 'care' about employees' pensions is closely linked to staff turnover and age. Many employers still use the pension scheme for traditional recruitment/retention purposes, e.g., they offer a 2-for-1 match (so if the employee puts in 5%, the employer will put in 10%, giving a total contribution of 15%). Some employers still have low staff turnover (one employer told us this was just 2% in his company) and so being able to provide an adequate secure retirement income is a very important benefit and really valued by employees. Attitudes will be different in the case of a call centre with 200% annual staff turnover of mainly young employees. In such businesses, the cost of a pension scheme above the legal minimum is disproportionate to the benefit to the business.

The 2014 Budget combined with the loss of the right to retire employees at a specific age (as a result of age discrimination legislation) means that, for employers, the pension scheme 'has fallen apart' as the key tool in retirement management. So pensions are deferred pay, but key questions employers are asking are (a) to what age is pay deferred? and (b) how long does our commitment last after that? The Budget changes actually push some decisions out to an older age than ever before. If employers offer scheme drawdown, they need to know when to annuitise and this will be at a much older age than employers are used to dealing with. Employers will have a long-term risk on their books, especially in relation to the cognitive issues many of their older former employees will face – this is very worrying for employers.

Employers are very keen to regain control of human resource management in their businesses. Even HR managers – generally the strongest supporters of a pension scheme in any business – are beginning to think that the cost of the scheme does not represent value for money for the business. Finance directors – traditionally amongst those in a business who are the least interested in the company pension scheme – have become very focused on this and are increasingly convinced that even a DC scheme is not a worthwhile business cost – especially given the level of contribution needed to deliver an adequate pension and the risk that employees can no longer afford to retire.

Furthermore, we were told that the following attitude was common amongst trustees: 'Trustees really, *really* don't want a pensioner category added to the existing active and deferred member categories. In fact, they don't even want deferred members and get rid of them whenever they can.' The treatment of deferred members gives us an indication of what is likely to happen to retirees in some trust-based DC schemes. We understand that trustees usually have the right to force annuitisation by default. We were told that many trustees conduct an annual 'sweep up' exercise and transfer deferred members to contract-based arrangements. Since this is likely to be the existing provider's personal pension (rather than an aggregator contract-based DC scheme), it is quite possible that the annual charge would be higher (some trustees insist on no increase; others do not). We were told that many trustees will take this same approach to retired members, which means that unless the member has already taken action, he or she will be transferred into a contract-based DC pension within the first year. We understand that trustees have the right to do this without seeking the member's permission.

The implication of this trend, if the 'sweep up' practice becomes extensive and if retirees are transferred from trust- to contract-based arrangements, is that the trust-based model for auto-enrolment could unravel. Employers – the buyers of schemes – will decide that it is much easier to use a contract-based scheme from the outset.

So the future of private sector pension provision in the UK might well be very different from the past as a result of recent policy changes, and not just because of 'freedom and choice', but also because of the reductions in the annual allowance and the lifetime allowance and possible changes to the system of pension tax relief. These latter changes and potential changes significantly reduce the value of directors' pension benefits – so why should directors be interested in pensions for their employees? In future, firms might provide just the minimum level of contributions to an AE scheme and offer some other employee benefits (e.g., SAYE), but also set up non-pension corporate trust or custody accounts for certain high valued employees. The aim would be to use a non-pension route to maintain corporate control over when employees can afford to retire.

1.4 Providers and investment managers

We participated in a number of meetings and events between January and March 2015 with providers – mainly insurance companies – and their representative body, the ABI. We also met a selection of investment managers and their representative body, the Investment Association. This section summarises the various views expressed by individuals representing these organisations under the following headings.

What are the attitudes of providers and investment managers in general to 'freedom and choice'?

The following points emerged from our discussions:

- 'The 2014 Budget changes were introduced without consultation with industry: "once the genie is out of the bottle, it's very hard to put it back in"'
- 'There has been no stability in pensions policy since the 1988 Income and Corporation Taxes Act introduced personal pensions to replace retirement annuity contracts and Section 226 policies from 1 July 1988'
- 'The only policy success in recent years has been auto-enrolment. There has been no success in increasing engagement, or in financial education, or in getting people to understand the risks they face. Safeguards only work if people are engaged and understand these risks'
- 'No further quick changes. We may need change, but it must be done slowly and carefully. Any further changes need to take account of existing policy changes'
- Insurers (including those with investment management arms) need to address the lack of consumer trust. An interviewee – from a provider – told us: 'Currently, provider self-interest drives outcomes'
- 'The various mis-selling scandals over the last 25 years are "open sores". Insurers are trusted less than banks and estate agents'
- 'Insurers need to reform to meet the entire set of needs in decumulation, which comprise not only insurance products, but also investment management. They need to adapt to survive'
- Insurers accept that it is the clients' money and that the clients can do what they like with it –'we don't want to be in the press saying we wouldn't give it to them'
- 'A key issue which we cannot duck is the inadequacy of savings. The best decumulation market in the world cannot compensate for this'
- 'Another key challenge is the younger generation which will rely entirely on DC. One in three babies born in 2015 will live beyond age 100'
- 'Innovation is essential. In other sectors, providers offer automatic upgrades in terms of tariffs and products (e.g., mobile phone). There was no reason why the pension industry should not do the same. Existing customers should be offered the latest products and pricing. Old products should be decommissioned without penalties to existing customers'
- 'Retirement will no longer be a point-in-time event'
- '"Freedom and choice" has not changed customers' needs'.

What is a 'good' pension scheme trying to achieve?

A good pension scheme needs to deliver a minimum of three things:

- Accessibility

- Inflation protection via investment performance
- Longevity insurance.

Good outcomes for a pension scheme will be:

- A sustainable income
- The flexibility to take into account personal circumstances
- Customers do not want to be surprised by what could happen in 10 years' time, i.e., running out of money.

However:

- 'Good' is not defined in policy or regulation
- It is difficult to construct a definition because needs vary
- We must also decide if 'good' means the individual gets what they need, rather than what they want.

What are the biggest challenges to achieving these objectives?

The biggest challenge is to stop people from self-harm in terms of tax, charges, investment risk, etc. The biggest risks relate to:

- Tax: if people withdraw too much in a single tax year, they could put themselves into a higher tax bracket for that year
- Charges: the impact of charges relative to returns
- Market volatility risk: taking income after the market has fallen. One provider told us: 'We manage volatility by balancing the source of withdrawals between capital growth and dividends – dividends are important because they still tend to be paid even if the market falls significantly'.
- Composure risk: people need to avoid over-reacting to market volatility – the risk is that if the market 'tanks', people will sell at the bottom; this mainly affects non-advised customers
- Underspending: many people are scared of running out of money, so a big risk is that they under-draw and therefore do not enjoy the retirement they could afford; this is common behaviour in the US.

Another challenge relates to the issue of multiple pension pots. People might have a different pension pot for every job. This fragmentation of DC pots makes it difficult to aggregate. This is compounded by the fact that back books are often sold and resold. One implication is that 'pot size is a terrible proxy for wealth – people could have secure DB pensions and might need a bridging pension for a few years'. There was support for the concept of a ‘pension dashboard’ which shows the state pension, any DB pension and up to three DC pension pots. This would need HMRC and state pension calculators to plug in.[40]

1.5 Trade unions

A panel of trade unionists and TUC officials (together with two consumer group participants) met with us on 12 January 2015 to address the following questions.

What should be the primary aims of a ‘good’ DC scheme?

The view of the panel members was that the primary aim of a good DC scheme should be to provide a lifelong index-linked income in retirement. This is because there is a ‘lack of longevity risk awareness’ and because there is ‘little merit in a predictable income that is declining in real terms’. One participant said: ‘People do not understand inflation or longevity very well. I think the answer is that we need to have good defaults so people are nudged into having some kind of inflation-linked income. Why is the only choice level or RPI-linked annuities? Is there not a sense that people spend more in their early retirement? However, not everybody has a predictable U-shaped expenditure need; spending more in early retirement then becoming frailer. These are the sorts of things we might think about in a default strategy’. However, the same participant conceded that: ‘It is rational to take out a level annuity if you have a small pot. Most of your income is from the state pension. This suggests that there should be some inflation linking but not quite the expense of RPI’.

Another participant said: ‘There is also the issue of who pays for social care. This is crucial for knowing what is an adequate pension. Could it be something like a 50% target replacement ratio? Similarly, who is paying the pension contributions? What is the employer’s role in that? Historically, employers have paid much more in contributions into DB schemes. Are we still expecting good DC schemes to replicate the proportion of income that DB does? It doesn’t do that. Good DC only comes about with adequate contributions’.

How do you assess value for money?

We next asked about value for money as a primary aim of a good scheme which led to the following discussion:

- ‘It is difficult to define value for money. It is impossible when you do not know what the charges are. No-one knows the full extent of hidden charges’
- ‘For accumulation, NEST provides some sort of target or benchmark for other schemes regarding their charges. A NEST-like vehicle in decumulation might echo that by providing a standard others could match’
- ‘If you think how difficult shopping around for an annuity is, it’s going to be even more difficult in future under drawdown. There will be investment charges,

[40] These would have to deal with the different inflation uprating rules for the different schemes.

administration charges, platform charges, even before you get into the transaction costs. It is going to be very difficult for people to compare'

- 'Given that we know retired people will not be rational consumers in a market place, how do we get institutional arrangements that have trust-based decumulation vehicles of sufficient size and scale to negotiate good value contracts? In the same way NEST has done well to secure low charges from fund managers because they know pots will get much bigger in future; and People's and NOW probably have got charges down too. We need a limited number of large trust-based schemes that can really push the investment managers down to the lowest possible charges'.

What are the longer term consequences of 'freedom and choice'?

One participant said: 'An unintended consequence might be that companies switch to contract-based schemes. I think it is unrealistic to expect an employer-sponsored trust-based DC scheme to be to be looking after their pensioners too – as well as current workers. I wonder whether there should be a way for occupational trust-based single-employer schemes to pass on assets to a trust-based decumulation vehicle. It could be NEST. We need to learn the lesson of auto-enrolment which is that the market failed, particularly, low and middle income earners. You need to have a new public policy-based, trust-based decumulation vehicle. It would provide an option for schemes that do not want to carry on doing that. I am worried about what small contract-based providers can offer in terms of decumulation. I am also worried about the expense of advice. For small pots, guidance is probably sufficient. Members with large pots have more need for advice, but are also more capable of paying for that usually. I think there is a vested interest in the pensions industry for making everything as complicated as possible. For low and middle income earners, it should be a commodity product. Only a minority of employers will want to operate decumulation options for their workforce. It is easy to get wrong. The advantages to the employer are minimal'.

Another participant agreed: 'Employers might be keen to look after current contributors, but not so when they have left their employment. Few employers make good contributions to DC schemes. What does that tell you about their likely enthusiasm for providing decumulation products?'. Yet another said: 'If an employer is putting in extra into pensions, they will want it to go as a benefit to existing staff, not those who have left. There is no point providing benefits at that stage'.

1.6 Wider issues

The 2014 Budget changes will have wider macro-economic consequences beyond those that affect pension scheme members and sponsors. Of particular importance is what will happen to the UK bond market. The gilts market is the longest maturity bond market in the world as a result of the demand by pension schemes and insurance companies for long maturity bonds to match their pension and annuity payments. This has helped to drive down long-term bond yields, which have been driven down further by the Government's quantitative easing programme. The corporate bond market has also benefited from this as insurers have switched to this sector in search of higher yields. However, annuity sales have fallen by 60% in the year since the Budget[41] and this has had a significant impact on the corporate bond market. According to Andreas Michalitsianos, manager of J.P. Morgan Asset Management's Sterling Corporate Bond Fund, issuance in the long-dated sterling corporate bond market has been driven to the point of extinction. He said: 'What [the pension reforms] did was take away a natural buyer of long-dated investment grade corporates. The market for annuities was £11bn p.a., and two-thirds of that made its way into the sterling corporate bond market so, in context, that means a significant slowdown….The trend is likely to be here for the long term, as future demand for annuities is unlikely to return to previous levels'.[42] The Government could also find it much harder to issue long-term bonds in the future due to reduced demand from annuity providers.

However a report from CREATE-Research and Northern Trust was more optimistic about the future of annuities. Based on interviews with 15 insurance companies and investment managers, the report stated: 'Over time annuities will make a comeback within a new hierarchy of products, with diversified income funds at the bottom and annuities at the top. In between, two new product sets will emerge: pathway funds that target retirement income in the accumulation phase (e.g., target date funds, diversified growth funds) and managed drawdown funds offering a steady income'.[43] The Budget also had a significant impact on annuity pricing. According to Billy Burrows, the annuity expert: 'The pension freedoms have played havoc with annuity pricing', with average standard annuity rates at their lowest ever level in April 2015.[44]

As a final point, we note that the ending of both private-sector defined-benefit pension provision in the UK and the requirement to annuitise private-sector DC pension pots will radically change the concentration of longevity risk in the UK. Until recently, this was shared between the state – via state pension provision – and the private sector – via company DB pensions and annuities sold by insurers. Under 'freedom and choice', individuals now bear their own idiosyncratic longevity risk. But if things go wrong and a significant proportion of these individuals outlive their pension pots, the burden for bailing them out will fall exclusively on the state – in other words, the next generation of tax payers. They might, in

[41] Reported in Hannah Smith (2015) Pensions freedom - L&G explores new business areas as annuity sales drop, Investment Week, 6 May.

[42] Reported in Alice Rigby (2015) UK long-dated credit is 'on the brink of extinction', Investment Week, 5 May.

[43] Reported in Sebastian Cheek (2015) Designing a secure retirement, meeting the evolving needs of DC schemes, portfolio international, April.

[44] Reported in Josephine Cumbo (2015) Annuity rates fall to record lows after sweeping pension reforms, Financial Times, 23 April.

turn, refuse to help out their reckless and profligate forebears, leading to intergenerational conflict.[45]

1.7 Responses to the consultation paper

We will summarise the responses to the first two questions in the consultation paper here.

1. *(a) What should be the primary aims of a 'good' DC scheme? Please explain. (b) If the provision of a predictable income should be a primary aim of a 'good' DC scheme, how should this be defined? (c) If value for money should be a primary aim of a 'good' DC scheme, how should this be defined?*

Responses to this question were quite varied (and some respondents listed many desiderata while others noted just one). However, there was surprisingly little agreement amongst pension professionals about what the aims of a good DC pension scheme should be. With this important point in mind, three themes did stand out as being important. First, the level of pension savings should be adequate. Second, pension savers need choice and flexibility. Finally, pension savers need simplicity to help them engage with the process.

2. *(a) Do you agree with the breakdown of risks listed in the Introduction? (b) Are there any important risks we have not identified?*

Ninety-five per cent of respondents agreed or largely agreed with the breakdown of risks. Additional risks (or issues) were also mentioned: health and long-term care risk; risk via shocks to a partner or family; lack of engagement by savers; sequence-of-returns risks and shocks; delays in realising that mistakes had been made and consequent delays in taking remedial action; the risk that regulation might stifle competition and raise costs.

1.8 Analysis

Our discussions with representatives of employers, consultants, providers, investment managers and unions together with the feedback we received from the consultation have provided invaluable inputs into our analysis in this Report as well as the recommendations we make. In terms of this Chapter, they have helped us develop the criteria for a good DC pension scheme that we propose in Table 1.1 and complete the list of key risks involved in the generation of retirement income from pension savings in Table 1.2. The discussions have also provided an insight into the longer term consequences that might follow from the introduction of 'freedom and choice'.

One of the key reasons why enlightened employers established pension schemes in the nineteenth century was to manage the exit of their employees from the company when they were no longer capable of productive work, while ensuring that their former

[45] See, e.g., David Blake (2012, p.51) It's the demographics, stupid!, ai-CIO.com, May/June.

employees did not live in poverty in old age. In those days, retirement was a single event, while today it is a process. This, in turn, has meant that age management has become an increasingly important aspect of human resource management, especially in large organisations. However, this becomes considerably more difficult following the 2014 Budget. If employees over the age of 55 spend their pension pot unwisely, they may not be able to retire as planned and may be forced to stay in post, often with little or no notice given to the company. Our interviews revealed that employers are not at all happy with this prospect. Inevitably, it will lead to many of them questioning why they now need to have a pension scheme. They are, of course, required to provide their employees with access to a pension scheme at the AE minimum, but many will begin to wonder why they even need to do that, given that many of their employees do not appear to value pension benefits and that recent governments have massively reduced the incentives for company directors to accrue pension benefits for themselves.

We might well look back at the 2014 Budget as the event that marked the end of private-sector employer commitment to providing any pension provision above the legal required minimum. Naturally, we would regard that as little short of tragic. This is because: (a) we find it hard to see what alternative cost-effective age management tools are available to employers, (b) we find it hard to see what other vehicles will enable employees to save enough to provide a decent life-long standard of living after they retire, and (c) we believe it will put great pressure on governments to raise the value of the minimum safety net provided by the state pension or to increase the state pension age even more rapidly than is currently planned. Nevertheless, our Report is about the decumulation of existing pension assets and we devote the rest of this Report to this task.[46]

Our interviews appear to show that employers are bifurcating into two groups. On the one hand, there are those employers who see 'freedom and choice' as a unique opportunity to reduce their DB pension deficits, by encouraging scheme members to transfer out into a DC scheme – when they do this, they take their share of the deficit with them. How often is an employer given the opportunity to cut their workers' (deferred) pay[47] by 15% or more and the workers believe they are better off as a result?

On the other hand, there are paternalistic employers who want the best for their former employees, but who are terrified of being sued if things go wrong. An interesting message from our interviews is that 'freedom and choice' has increased risk aversion on the part of employers. Some employers would like to provide advice for their soon-to-be former employees, but are reluctant to do so in case it later backfires. Some employers are even considering scheme drawdown, e.g., by offering decumulation defaults that involve drawdown with automatic annuitisation triggers if the fund falls below a certain level to

[46] There is, however, a brief discussion of the adequacy of pension savings in the appendix to this Chapter.
[47] Pensions are deferred pay under EU legislation.

protect against longevity risk. Yet, we are not aware of any employers that have actually gone ahead with this idea and it is clear that many employers would be uncomfortable with any sort of scheme defaults due to the associated long-term liability associated with poor outcomes.

1.9 Recommendations

Our analysis in this Chapter leads to the following two recommendations.

Recommendation 1.1: Criteria for a good DC pension scheme

We recommend that scheme providers should be required to demonstrate to scheme trustee (or governance) committees and to regulators how their schemes provide good outcomes for members in terms of the following criteria:

- **Delivers adequate and sustainable pensions; by sustainable, we mean having support mechanisms in place that help people not to spend their pension fund too quickly after retirement**
- **Produces stable and predictable lifelong retirement incomes, even if those incomes cannot be guaranteed (unless a lifetime annuity is purchased)**
- **Offers the flexibility to purchase a lifetime annuity at any time (or at regular predetermined intervals)**
- **Has the flexibility for members to withdraw funds to meet 'lumpy' expenses, such as the cost of a new boiler**
- **Provides an investment strategy that reflects the scheme member's attitude to and capacity to take risk, and generates a return at least as high as inflation**
- **Provides value for money for every pound saved in the scheme**
- **Has transparent charges and costs**
- **Provides reliable and efficient administration**
- **Delivers effective communications to members**
- **Protects scheme assets from fraud or theft**
- **Has minimum quality standards in terms of operational efficiency, charges and governance with a duty by the governance committee to act in members' best interests.**

As part of this recommendation, each qualitative term (such as adequate, sustainable, stable, predictable, suitable, reliable, effective and efficient) needs to be given a quantitative measure that would gain wide acceptance by the industry, regulators and policy makers, along the lines of what is specified in, say, a service level agreement.

It is important to note that the recommendation implicitly assumes that the pension scheme provides both the accumulation and decumulation stages. If, as it is becoming increasingly likely, the accumulation and decumulation stages are separated and different providers service the different stages, then the above list of criteria would have to modified to reflect this.

Recommendation 1.2: Explaining key risks involved in the generation of retirement income from pension savings

We recommend that scheme providers should be required to explain to scheme trustee (or governance) committees (and where possible to members) the following key risks in retirement income provision and how their scheme deals with these risks:

- **Contribution risk – The risk that pension contributions (and hence pension savings) are lower than planned, e.g., because the scheme member becomes unemployed, is unable to work due to ill health, or is unable to pay off their debts**
- **Retirement timing risk – Uncertainty about when the scheme member will retire and/or begin to make withdrawals**
- **Product choice risk – Uncertainty about how the scheme member will make withdrawals, not least because of the very large set of choices now available**
- **Investment risk – The risk that investment performance is worse than expected or the risk that investments do not generate incomes in a way that matches the desired pattern of consumption in retirement. A particularly important example of investment risk is sequence-of-returns risk**
- **Inflation risk – The risk that inflation is higher than anticipated**
- **Interest rate risk – The risk that interest rates are low at the point of annuity purchase**
- **Longevity risk – The risk that individual savers live longer than their life expectancy (i.e., idiosyncratic longevity risk) and the risk that savers as a whole live longer than anticipated (i.e., systematic or aggregate longevity risk)**
- **Cost risk – The risk that the total costs of running the pension scheme during accumulation and decumulation are higher than expected or understood**
- **Political risk – The risk that the Government changes the rules in an adverse way (e.g., reduces the level of tax relief)**
- **Regulatory risk – The risk that regulations change in an adverse way (e.g., the regulator increases regulatory capital requirements, which has the effect of reducing annuity rates)**
- **Demographic/cultural risk – The risk that younger cohorts refuse or are unable to honour the implicit intergenerational contract that underlies many pension schemes. For example, the next generation of workers refuses – or is unable – to pay the pensions the retired generation expects to receive, because they are unwilling to honour the implicit contract or because there are too few of them in relation to the size of the retired population. Also, an arrangement that works in one culture (e.g., Holland) might not work in another (e.g., the UK)**

- **Market conduct risk – The risk that those who provide services to the scheme act in a way that disadvantages scheme members (e.g., investment managers subject to a charge cap negate the effects of the charge cap by increasing portfolio turnover, or the benefits of economies of scale go to scheme providers' shareholders rather than to members); fraud and the activities of scammers would be included here**
- **Behavioural risk – The risk that scheme members behave in a way that is not considered to be rational (i.e., is not in their long-term interests, since they make short-term decisions that they subsequently regret and are unable to learn from past mistakes). Inertia and lack of engagement would be included here, as would be the risk that members fail to understand the risks they face**
- **Financial knowledge and understanding risk – The risk that a member's financial knowledge and understanding are insufficient for the member ever to make an 'informed' choice**
- **Mental impairment risk – The risk that a scheme member's mental faculties are reduced due to the onset of dementia, for example.**

1.10 The remainder of the Report

Chapters 2-6 will address the following issues and make recommendations:

- How to ensure that the workplace pension retirement products available to people are those best suited to ensure they have security and confidence in retirement
- The support savers need to make the right choice at retirement for them and their family and how to build on the lessons of auto-enrolment
- How savers can be helped to manage longevity risk
- The role of the National Employment Savings Trust in helping savers to access good quality retirement products
- The role of collective pension schemes and how these could be introduced in the UK.

Chapter 7 will conclude the Report and present our overarching recommendations.

Appendix: Studies on the adequacy of pension savings

Most studies going back over a number of years show that the level of pension savings in the UK is not adequate to produce a reasonable standard of living in retirement:

- Aegon and the Association of Independent Financial Advisers (2010) *Saving Britain: A White Paper on Rebuilding Britain's Savings Culture*
- Aviva (2010) *Mind The Gap: Quantifying The Pensions Gap In The UK*
- Aviva (2011) *Big Picture Thinking – Towards Sustainable Savings*
- Aviva (2012) *Tackling the Savings Gap: Engagement and Empowerment*
- Chartered Insurance Institute (2011) *An Age-old Problem: Developing Solutions for Funding Retirement*

- Chatham House (2011) *Squeezed in Retirement: The Future of Middle Britain*
- Strategic Society Centre (2011) *Who Saves for Retirement?*

More recently, in March 2015, the Savings and Investments Policy Project (TSIP), managed by the Tax Incentivised Savings Association (TISA), published a report, *Our Financial Future,* found that:

- The average pension pot size at retirement is £28,000, but at least £230,000 is needed for the average household to retire on two thirds of pre-retirement income
- Two thirds of adults recognise they are not saving enough, one fifth do not save anything
- More than half of people would like to save more but cannot afford to
- One third of the population has less than £250 in savings
- Fewer than half (45%) of people of working age are saving for retirement.

The report found that inadequate financial education and a lack of trust in financial services had created a savings gap, which will lead to 'crisis point' in 2035 when the 'auto-enrolment generation' begins to retire. TSIP wants to establish a forum, comprising industry, Government and the Financial Conduct Authority, to agree on a common approach to financial education. It wants to simplify pension taxation so that the benefits of pension saving are made clearer and it wants to see the abolition of the lifetime allowance which acts as a disincentive to save. It also wants pension contributions to increase slowly to around 15%.

In September 2015, the Office for National Statistics published the results of its *Occupational Pension Schemes Survey 2014*. Active membership of occupational DC pension schemes has increased by two million since 2013 to 3.2 million, as a result of auto-enrolment, but average contributions have halved from 9.1% of earnings to 4.7%, because most of these members will have been auto-enrolled on the minimum contribution rate.[48] In December 2015, the ONS revealed that 69% of employees in occupational DC schemes had employer contributions of less than 4%.[49]

A study by PwC, also published in September 2015, reported the results of a survey of 1,200 working adults. It found that 60% have put off saving more into their pension scheme because they are so confused about the current pensions system, with women and younger workers particularly unlikely to put money aside. The survey respondents are only saving an average of 5% of their salary towards their retirement, independent of age. Only 5% are saving more than 10% of their salary and this is mostly those earning over £100,000 a year.

[48] Reported in Michael Klimes (2015) ONS: DC membership jumps by 2m but contributions halved, Professional Pensions, 24 September. Active membership of private sector defined benefit schemes is only 0.6 million.

[49] Office for National Statistics (2015) *Active Members of Occupational Pensions-Employer Contribution Rates*, December.

Average employer contributions are 6%. Philip Smith, head of defined contribution pensions at PwC, said: 'Efforts need to focus on improving saver awareness, increasing auto-enrolment contribution levels and improving financial education, so people can plan for the retirement they hope for'.[50]

Another study published in September 2015 was commissioned by Royal London and conducted by the Centre for Economics and Business Research. This again found that millions of young people are not saving enough for their retirement, yet will face much higher expenses when they retire than the current generation of pensioners. The study estimates that 8.3 million people aged between 30 and 40 are not saving for a pension, but will have to spend 148 per cent more than today's pensioners to maintain living standards by 2050, with the minimum income needed of £33,000 per annum. The implication is that the average 35-year-old who is halfway to retirement in 2050 with a pension pot of just £14,000 will need a fund of at least £666,000 – not including any state pension. Today, a typical pensioner spends £1,084 a month on housing, food, heating and transport. With inflation, this will rise to £1,715 a month by 2050.[51]

In October 2015, the Association of Consulting Actuaries (ACA) published the results of a survey of contributions to auto-enrolment schemes. A total of 477 employers sponsoring over 620 pension schemes responded to the survey. Of these, 46% had reached their staging date for auto-enrolling employees into a qualifying scheme, while many of the rest had not reached their staging date and did not have an existing pension scheme. When scaled up to the level of the economy, the survey suggests that millions of workers having been enrolled into pension schemes since 2012 at the minimum level of combined employer and employee contributions of barely 2% of total earnings. This has had a dramatic effect in reducing the average contribution rate into DC schemes over the last couple of years as Table 1.3 reveals. The table shows the 2% combined minimum contribution rate into NEST, but it also shows that the combined contribution rate into trust-based DC schemes has fallen from 11.4% to 9% since 2013. This contrasts with contributions of up to 26% in DB schemes.

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[50] Reported in Lauren Fedor (2015) Pension confusion is leaving British workers unprepared for retirement – PwC, City A.M., 30 September.

[51] Reported in Sarah O'Grady (2015) Poverty warning to millions in their 30s who scorn pensions, Daily Express, 29 September. Another problem is that fewer young people will be able to afford to buy their own homes in future which means that they will not be able to subsequently sell their homes to pay for long-term care. This will have a knock-on effect on future welfare payments.

Table 1.3: Median contribution rates into pension arrangements provided by responding employers		
	Employer	Employee
Group personal pension	4% (5.8%)	3% (4.2%)
Trust-based DC	5% (6.9%)	4% (4.5%)
NEST	1% (NA)	1% (NA)
Other multi-employer schemes	3% (NA)	1% (NA)
Mixed DB/DC	11-15% (NA)	5% (NA)
Defined benefit	16-20% (21.9%)	6% (6.1%)
Note: Figures in brackets are 2013 mean figures from ACA (2013) *Pension Trends Survey Report* Source: Figure 3 in ACA (2015) *Pension Trends Survey, First Report*, Table 8, page 21, and ACA (2015) *Pension Trends Survey, Second Report*, page 25		

In October 2015, Equiniti published the results of a survey of 1,200 employees which showed that 27% of them were unable to save on a regular basis, despite being keen to do so. Only about a third were saving on a regular basis with savings of at least 5% of earnings. Most of the rest had made no financial provision for their future or were focused on paying off their mortgage and clearing other debts. Equiniti concluded that there is a 'long term savings gap which threatens to become a financial time bomb'.[52]

In November 2015, Scottish Widows and the Fawcett Society released a report called *Women in Retirement* which showed that only half of British women are saving enough for their retirement, while nearly a quarter are saving nothing at all. By contrast, 60% of men save adequately for retirement, and 15% do not save at all. Jackie Leiper of Scottish Widows said: 'When it comes to attitudes towards retirement saving, young men and women appear to be almost on a par, yet our research has identified an alarming divergence in the 30s which needs to be addressed. Whether it's having a family, taking a career break or

[52] Reported in Carmen Reichman (2015) Quarter of workers willing but unable to save – research, Professional Adviser, 20 October.

changing working patterns, we need to ensure that these life changes impacting women do not jeopardise their future security'.[53]

A Scottish Widows Retirement Report published in June 2015 paints a slightly more optimistic picture of the nation's retirement savings, based on a survey of 5,000 people. Whilst acknowledging that 6.2 million people (or 20% of the population) are still saving nothing for retirement and a further 19% have no savings or investments whatsoever, the report finds that 56% of the population are now making 'adequate' pension contributions which the insurer defines as 12% of earnings. This is more than twice the 2006 contribution level (6%) and a third higher than the 9% level reached in 2013.[54] A survey published by National Savings & Investments in July 2015 showed that monthly per capita savings have increased by 50% over the past decade from £68.85 in 2005 to £104.56 in 2015. However, this would not be adequate to provide a decent standard of living in retirement.[55]

Despite these encouraging glimmers, we believe, on balance, that the following assessment is more realistic: 'The DWP has warned that 11.9m UK adults are failing to save enough for an "adequate income" in later years. No wonder the Chartered Insurance Institute estimated the total savings gap – just to deliver pensions at a level most people expect for a tolerable lifestyle – at around £9 trillion'.[56] This means that there will be a 'crisis point' and it will happen much sooner than people possibly imagine. Robert Gardner, chief executive of investment consultant Redington, speaking at the 2015 NAPF annual conference, predicts that widespread social and economic unrest will be created by the UK's ageing population. Currently, one in six pensioners (1.8 million people) live in poverty. He expects this to increase to five in six pensioners over the coming decades.[57]

The 2015 Melbourne Mercer Global Pension Index places the UK pension system at the bottom of category B for good pension systems with a score of 65 out of 100, putting it in ninth position behind countries such as Denmark, the Netherlands and Australia. A key reason for this is low contribution rates. Glyn Bradley, senior associate at Mercer, said: 'Despite the introduction of auto-enrolment and record numbers of people in the UK enrolled in pension schemes, the UK is unlikely to make the A grade soon. "Having a pension" is not the same as having an adequate pension. The UK lacks the savings culture of other countries and current minimum auto-enrolment contributions are unlikely to deliver

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[53] Reported in Rebecca Shahoud (2015), Only half of UK women saving enough for retirement, Professional Pensions, 18 November.

[54] http://www.scottishwidows.co.uk/extranet/working/about/reports/pension-report

[55] Reported in Carmen Reichman (2015) National savings up by half – is the message finally getting through?, Professional Adviser, 14 July.

[56] Quoted from KPMG (2015) 11.9 million failing to save enough for an adequate retirement income, advertorial in Financial News, 21-27 September.

[57] Reported in Andrew Pearce (2015) UK is heading towards a 'pension crisis', Financial News, 15 October 2015.

adequate retirement outcomes. [The UK is] also an aging society, with relatively high debt, and [its] public sector and state pensions are almost entirely unfunded. [Its] pensions system has a high degree of integrity by international standards, but its low scores on adequacy and sustainability are putting [it] in danger of being relegated to the 'C' league'.[58]

In September 2015, BlackRock launched a retirement income tool, called CoRI, to allow consumers to determine how much they need to save to avoid running out of money in retirement. CoRI tells people of a given age what the cost of receiving a 'pound for life' from the age of 65. For example, on 22 September 2015, a 60-year-old (who will be 65 in 2020) would have to save £23.15 for every pound they want in their retirement. Users can then take the figure of their total savings and divide it by the value the index has produced to arrive at their annual retirement income for life. Someone with a pension pot of £250,000 at age 65 would receive a lifetime income of £10,799 (i.e., £250,000/23.15). The aim of CoRI is to inform people how much they need to save during their working lives to achieve a desired standard of living in retirement. Suppose someone wanted to have a pension of £5,000 p.a. in retirement. They would need a pension pot of £115,750 (£5,000 x 23.15). With an interest rate of 5% p.a., they would need to save £958 each year for 40 years. Chip Castille, chief retirement strategist at Blackrock said: 'We have a once-in-a-generation opportunity to change people's attitudes – they need to understand with certainty whether their savings will provide a sufficient income to support their desired lifestyle in retirement'.[59]

The alternative to saving for retirement is to delay retirement, possibly indefinitely. This is the fate awaiting one in 10 Britons who are preparing to work until they drop, according to research by Baring Asset Management published in November 2015. One in three admitted they have no formal pension savings at all.[60] A report entitled *The Death of Retirement*, released by Royal London in February 2016, found that someone contributing 8% of earnings from age 22 would need to work until 85 if they want to enjoy the 'gold standard' of 67% of pre-retirement income which is then indexed to inflation and also provides a partner's pension. If they were content to live on the 'silver standard' of 50% of pre-retirement income they would have to work until 80.[61]

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[58] Reported in Jack Jones (2015) Freedom and choice blamed for weakening UK savings system, Professional Pensions, 20 October.

[59] Reported in Carmen Reichman (2015) BlackRock launches 'future value of a pound' retirement tool, Professional Adviser, 22 September.

[60] Reported in Harvey Jones (2015) Millions of Britons are facing up to a retirement pot shortfall, Daily Express, 24 November.

[61] Reported in Rebecca Shahoud (2016) Royal London: Decent retirement might mean working until age 85, Professional Pensions, 15 February.