The Death of Retirement
A CSFI report on innovations in work-based pensions

Jane Fuller
The Centre for the Study of Financial Innovation is a non-profit think-tank, established in 1993 to look at future developments in the international financial field – particularly from the point of view of practitioners. Its goals include identifying new areas of business, flagging areas of danger and provoking a debate about key financial issues. The Centre has no ideological brief, beyond a belief in open markets.

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Foreword

This is an important paper, and we are grateful to Pension Insurance Corporation for having funded the Fellowship of which it is a product. I am also grateful to the Fellow, Jane Fuller – who is also co-director of the CSFI. Her report is the most comprehensive attempt I know of to tackle the thorny issue of workplace pension provision and what can be done (in a ‘joined-up’ way, which respects the parallel need to pay down debt) to ensure that more people in Britain are making adequate provision for an old age that may well go on longer than they expect.

Pensions – or, better the provision of income once one’s working years are over – are one of the most important political issues in Britain today. Along with reforms of the NHS, they are also among the most toxic.

But reform is urgent – partly because of demographics, partly because of the collapse of ‘traditional’ defined benefit schemes (as the idea of a single, lifetime employer disappears) and partly because a prolonged period of near-zero interest rates has brought into sharp relief just how inadequate most people’s provision for old age has become.

Jane’s provocative title – The Death of Retirement – gives the game away. It is not just that we will all have to work longer (if we can, which is a big issue); we will have to change our mind-set. While the State will continue to provide a basic income which (one hopes) will be sufficiently generous to avoid genuine hardship, anything above that will depend on our own efforts – and will require greater awareness and greater involvement by both individuals and their employers. It means, for instance, that pension pots will have to be mobile; it means contribution rates (by both employees and employers) will almost certainly have to rise; it means the entire savings system will have to be made fairer and simpler. That, of course, means that there will be losers as well as winners; tax rebates, for instance, may have to be adjusted downwards, and the many individual benefits that are currently aimed at the elderly (from free bus passes to free television licences for the over-75s) may have to be ditched.

The reforms that Jane puts forward won’t be easy politically – as, I am sure, Ros (now Baroness) Altmann will find. But they are intellectually coherent and convincing. As Bruce Bairnsfather’s ‘Old Bill’ said, many years ago, “if you knows of a better ‘ole, go to it.”

Andrew Hilton
Director
CSFI
About Pension Insurance Corporation

Pension Insurance Corporation plc ("PIC") provides tailored pension insurance buyouts and buy-ins to the trustees and sponsors of UK defined benefit pension funds. PIC brings safety and security to scheme members' benefits through innovative, bespoke insurance solutions, which include deferred premiums and the use of company assets as part payment. PIC has £14bn in assets and has insured 100,000 pension fund members. Clients include FTSE 100 companies, multinationals and the public sector. PIC is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and Prudential Regulation Authority (FRN 454345). For further information please visit www.pensioncorporation.com
The Death of Retirement
A CSFI report on innovation in work-based pensions

Jane Fuller

Introduction

The poet William Blake talks of seeing “a world in a grain of sand”. That could well be applied to the world of pensions and retirement. It covers demographics, economics and fiscal policy, human behaviour and the sort of society we want to live in, and all the related politics. In individual terms it extends from the willingness of a young adult, perhaps heavily indebted, to lock money away for decades to the capacity of an older person to supplement the state pension with earnings, savings and other assets.

This report, part of the CSFI pensions programme, narrows the subject by focusing on work-based pensions in the private sector and, within that, on the new “auto-enrolment” regime for mass retirement saving. Public sector pensions (net present value of future pension payments about £1.2 trillion) and legacy private sector defined benefit schemes (deficit of £241bn at the end of May 2015) are largely ignored. They do, however, demonstrate the unaffordable nature of the 20th century approach to workplace pensions, which hardened up generous pension promises – backed by employers or the taxpayer – without factoring in the rapid rise in longevity. Too many workers missed out on that anyway, with the result that about 9 million of them have little or no funds to supplement the state pension. Between all or nothing, there is plenty of space to facilitate and encourage work-based saving.

The report also offers a broader perspective. Policies that promote long-term saving cannot be seen in isolation from personal debt, taxation and access to benefits. This calls for joined-up thinking between government departments, which is one of the themes. The overlapping nature of these issues ensures that policy-making is difficult enough, but the complexity of regulation within each silo has amplified that difficulty. So, another theme is simplification.

The 2010-15 Conservative-Liberal Democrat coalition government took a number of important steps. It recognised the longevity problem, simplified the state pension and removed other disincentives to private-sector work-based saving. The next steps will be taken by the new government, with Baroness (Ros) Altmann as pension minister. (The House of Commons Work and Pensions Committee proposed an independent pension commission, but the issues remain the same whoever makes policy.)

Much remains to be done. This report offers suggestions on how to approach some of the policy questions. It does so in the belief that retirement at a set age and for a long period is an outmoded concept. The government offers the safety net of the state pension to older people and has an interest in encouraging long-term saving to supplement it. But beyond that, individual circumstances vary too much to make detailed prescription a sensible policy option. Helping people to be independent is desirable whatever their age.
Summary and main recommendations

Chapter 1: Longevity and the state pension age

The report is sceptical about both the policy principle that people should expect to spend a third of their adult life (counted as over the age of 20) receiving a state pension and the triple lock guarantee, which ensures that the state pension rises by at least 2.5% a year. The aim should be to help people be independent in old age, rather than encouraging the lengthening of retirement. Two changes to current principles would support this:

- Limit the period covered by the state pension to the last 20 years of average forecast life expectancy, which means accelerating the raising of the state pension age to 70 – and beyond as longevity increases.

- Link the single-tier state pension to wages. A target of 60% of the national living wage might be set, with a starting point for the new state pension of £160 a week.

Policy should focus on increasing economic activity among those aged over 50, when it starts to tail off. Abolition of the retirement age was a good start.

Chapter 2: Saving for Retirement

Under the auto-enrolment (AE) regime, the aim should be to nudge contribution rates towards 12% with the breakdown as follows: 5% employee, 5% employer and 2% tax rebate. This could be achieved first by equalising the rate for tax relief at about 30%, then by making it mandatory for employers to match the employees’ contribution, and finally by raising the contribution level. This should remain voluntary for employees via the opt-out system.
Chapter 3: Barriers to saving

Debt cannot be ignored, especially mortgage debt. There needs to be joined-up thinking between the Department for Work and Pensions, the Financial Conduct Authority and mortgage providers over the diversion of savings earmarked for retirement into repayment of mortgage debt. Whatever the type of mortgage, there should be a “credible repayment plan” by the state pension age.

The interaction of savings with benefits remains far from simple. The new government should make rationalisation of pensioner benefits a priority. Other than the state pension, set at a level that lifts many households out of means-tested income support, pensioner-specific benefits should be scrapped.

Because for some people it would make more sense to pay off debt than contribute to a pension fund, it is better to stick to auto-enrolment for employees, rather than compulsion. Wage trends need to be factored into pensions policy because of their influence on people’s capacity to save.

Chapter 4: Incentives to save

The aim should be to have a fairer, simpler system that preserves incentives for the bulk of the workforce to save for retirement, while limiting tax relief for the better-off. This report supports the principle that contributions and investment gains should be tax-exempt, and withdrawals taxed – or EET. But it does not advocate compulsory saving for retirement: not all can afford it and for some paying off debt would be a better priority. This means relying on employers’ contributions and tax rebates to incentivise long-term saving.

*Tax relief for individuals*

- A flat rate for tax-based relief of 30% (you put in 70p, the government 30p) would increase the incentive for most workers to save, while reducing the expense of rebates for those on 40% or 45% tax rates.

- Tax allowances should focus on contributions, not on the unpredictable size of accumulated funds. Some flexibility is desirable because some people find it easier to put in fewer, larger amounts.

- £30,000 is generous enough as an annual contribution allowance.
Tax relief for employers

- The first priority is to bed down the auto-enrolment regime. Then employers should be required to match the employees’ contributions.

- The shelter from National Insurance Contributions on the amounts paid in by employers should also be reviewed.

Tax-free lump sum

- Following the EET principle, the 25% of a pension fund that can be withdrawn tax-free (costing £4bn a year) should first be capped in absolute terms and then phased out.

Sticking to the principle of simplifying benefits and taxation, it would be relatively easy to find savings of £7bn. This would fund an increase of £10 a week in the state pension.

Chapter 5: Who manages the money?

Fragmentation is the bane of the UK’s work-based pensions system, so making it easy to aggregate pots is crucial. But the government’s “pot follows member” plan lacks ambition.

- Arguments against a central database do not look convincing, unless the proposed “federated” network can effectively become one.

- To create a comprehensive database enabling individuals to see a personalised dashboard, the new network and the Pension Tracing Service need to work together to identify and input all savings pots.

- Restrictions on transfer of pots should be lifted, other than that money has to be transferred to a regulated pension fund.

- Ways should be explored to encourage the industry to make the necessary investment to upgrade technology.
Chapter 6: Charges and investment issues

The downward pressure on asset management charges for AE default funds will continue, through competition, because 0.75% remains much higher than the charges paid either by large institutional funds or by individuals investing in popular passively managed funds.

The visibility of market prices has led to attention being focused on current asset values, which can detract from the long-term goal of building up a pension fund.

- To steady the nerves of AE scheme members, it is worth emphasising that funds are locked in until a person reaches at least 55, and contributions from employers and tax rebates cushion losses.

- Far more courage is needed in explaining the risk-reward equation to long-term savers, including the case for contrarian positions.

Chapter 7: Retirement Income

Policy-making needs to shift away from a stereotypical view of people retiring at the state pension age, and towards helping them make rational financial decisions based on individual circumstances.

Ending the effective requirement to buy lifetime annuities at a set retirement date was the right thing to do. Liberalisation enables people to:

- cover specific periods when a secure income is a priority, which might be for very old age or a fixed term;

- use income drawdown to provide maximum flexibility in combination with earnings, equity release from a house, legacies etc.;

- continue to invest in return-seeking assets according to individual risk appetite.

- maintain ownership of savings with residual amounts passed to heirs.

Annuities still have a place eg as insurance through deferred products, or for fixed terms, where value for money is easier to assess. There may be scope for the government to enter the annuity market.
Chapter 8: Whatever happened to “Defined Ambition”?

Employers are never again going to guarantee employees’ pensions. While there is evidence that risk-sharing between individuals in collective defined contribution schemes has delivered better outcomes than individual provision, much of this is due to higher contribution rates, lower charges, economies of scale and continued investment in return-seeking assets. None of these factors is exclusive to CDC. So, while the government is right to remove obstacles to such risk-sharing arrangements, this report does not expect them to take off in the UK.

Every other government move – from access to the pot at 55 to the abolition of compulsory annuitisation – has raised barriers to risk-sharing and cemented the UK’s individualistic approach.
Chapter 1: Longevity and the state pension age

More people, living longer – but pension age fell

It is worth remembering that mass retirement, funded at least in part by the state, is a modern idea. In Germany in 1889, Chancellor Otto Von Bismarck was the first to offer to pay a pension to any citizen reaching 65 years of age. The UK’s initial move, the Old Age Pensions Act 1908, consisted of means-tested, non-contributory benefits. The state pension age was set at 70, an age only about one in four people reached.

It was not until the 1942 Beveridge Report – “Social Insurance and Allied Services” – that universal coverage via a flat-rate pension was introduced in the UK. Meanwhile, in 1925, a work-based pension scheme with contributions from employer and employee had been launched, with a pension age of 65. The pension age for women was reduced to 60 in 1940, an aberration that lasted until 2010.

The astonishing thing about this growing commitment to fund retirement, either through general taxation or specific saving out of salary, is that it has coincided with a marked increase in longevity. Life expectancy has doubled in the past couple of hundred years. The key point for retirement analysis is the escalation in the number of years people can expect to live once they reach 65. In the 100 years to 2012, average remaining life expectancy at that age for a man went up from less than 11 years to more than 18 years (ie 83) and, for a woman, from about 12 years to nearly 21 years (ie 86).

With people also starting work later, thanks to a higher school leaving age and expansion of tertiary education, this means that time spent earning has greatly diminished compared with a life-time of consumption.
Period expectation of life at age 65 according to mortality rates experienced in given years, 1912–2012, United Kingdom

A man aged 65 can expect to live to 87

Source: ONS

Taking into account the latest projections from the UK’s Institute of Actuaries, Edmund Cannon, reader in economics at the University of Bristol and a fellow of the Pensions Institute at Cass Business School, London, reckons that a man aged 65 can now expect to live until 87.

In the UK, a demographic boost to the economics of supporting a lengthy retirement has come from the baby boom generation. Born in the two decades after the Second World War, they started to retire in the first decade of this century.

The upshot of these trends is that one in six Britons – more than 10m people – is 65 or over. The number is likely to increase by about 50% by 2030. It should, however, be noted that the UK has about 12m people of state pension age because the male/female SPA will not be equalised at 65 until 2018.

<table>
<thead>
<tr>
<th>Projected number of people of SPA or older (thousands)</th>
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<tbody>
<tr>
<td>2011</td>
</tr>
<tr>
<td>-------</td>
</tr>
<tr>
<td>Women</td>
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<td>Men</td>
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<td>Total</td>
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Source: PPI
The ageing population was seen as one of the “Key Issues for the New Parliament” in 2010. In a briefing by Richard Cracknell, the following chart from the Government Actuary Department was used to bring home the fact that the projected increase in the UK’s population between 2008 and 2033 is concentrated in older groups. That helped set the scene for the reforms enacted by the coalition government.

The UK government is implementing a plan to cope with the increase in longevity. The SPA for women is increasing to 65 by November 2018. For both men and women it will then rise to 66 by October 2020 and 67 by 2028. Further increases to 68 by the mid-2030s and 70 by the early 2060s are penciled in.

This is based on a generous policy principle that people should expect to spend a third of their adult life (over 20) receiving a state pension. A second policy, implemented from 2011, is the triple guarantee, or triple lock, which ensures that the state pension rises each year by the greater of earnings, prices or 2.5%. This has helped to reverse a decline in the basic state pension from 24% of average earnings in 1974 to 16% in 2009.

The new single-tier pension, assuming about £155 a week, or £8,000 a year, for 2016-17, will be roughly 29% of the median wage (assuming about £28,000 in 2016) and about 54% of the new national living wage (assuming £7.20 an hour for a 40-hour week). This compares with a basic state pension of only £97.65 in 2010-11, when the last government took office. However, this is replacing a two-tier system, with an earnings-related top-up.
The new single-tier state pension

The coalition government (2010-15) aimed to return the state pension to Beveridge’s original concept: a simple flat-rate pension set above the basic level of the means test to provide a firm foundation for saving*. To achieve this the UK will, from April 2016, have a new single-tier pension set above the basic level of means-tested support, which is £151.25 in 2015-16. Uprating by 2.5% for 2016-17 would take it to £155.

Simplification is a laudable aim. But the new system is not as simple as it appears and the transition from a two-tier state pension system, with overlapping arrangements for occupational schemes, was never going to be simple.

The single-tier pension, like the old basic state pension, relies on contributions; it is not a universal benefit. To receive the full amount, 35 (up from 30) “qualifying” years of National Insurance Contributions, or a combination of NICs and care credits, will be needed. Those with less will receive a pro-rated amount, subject to a minimum of 10 qualifying years.

The new pension will be available to men born on or after April 6 1951 and women born on or after April 6 1953. It is designed for individuals, so (with some transitional protection) rules for married couples, divorce and bereavement will be swept away.

Bringing in a single tier will, eventually, put an end to payments of an additional, earnings-related, state pension (known as SERPs or the Second State Pension). Based on the larger NICs paid by higher earners, the maximum additional payment in 2014-15 was £163 a week, on top of a state pension of £113.10. While accumulated rights will be protected, higher earners will lose the opportunity to accrue further NIC-based credits. The system of contracting out, whereby NIC rebates were paid because an employer or individual had taken responsibility for pension provision, will end. For contracted-out occupational schemes, employers will no longer receive the rebate and retirees will have a deduction from their new single-tier pension. Workers in defined benefit schemes will see their NIC payments rise to the standard level.

Brought in when the UK was trying to rein in its fiscal deficit, the new regime is designed to be revenue neutral, so winners and losers will roughly balance out. Over the longer term – from about 2040 – the Department for Work & Pensions has estimated that spending on state pensions and pensioner benefits will rise more slowly under the single-tier system, so that “by 2060, pension expenditure under single tier is around 8.1 per cent of GDP, compared to 8.5 per cent if the current system was rolled forward”.*

* The Single-Tier Pension: a Simple Foundation for Saving, DWP, January 2013
The UK’s state pension arrangements are not generous by comparison with other developed countries. In a report entitled “How might the UK pensions landscape evolve to support more flexible retirements?” (April 2015), the Pensions Policy Institute (PPI) points out that the relatively low UK state pension means “individuals will typically require another source of income in retirement”.

The chart below shows the average received from the state pension, the underpinning provided by income guarantees, or a combination of the two, as a percentage of average earnings. In the UK the average replacement rate is enhanced by the S2P. It should be noted that the data are derived from a 2013 OECD report and since then the “triple lock” has pushed up (and still is pushing up) the state pension faster than average earnings.

Recommendation: The policy should explicitly be to help people be independent in old age, rather than encouraging the lengthening of retirement. Two changes to current principles would support this:

- Limit the period covered by the state pension to the last 20 years of average forecast life expectancy, which means accelerating the raising of the state pension age to 70 – and beyond as longevity increases.

- Link the single-tier state pension to wages. A target of 60% of the national living wage might be set, with a starting point of £160 a week for the new state pension for 2016-17, paid for by cuts in pensioner-specific benefits (see Chapter 4).
The cost to the taxpayer runs well beyond pensions

The impact is considerably wider than the bill for state pensions. In the Key Issues briefing for the new parliament in 2010, it was stated that 65% of DWP benefit expenditure was going to “those over working age, equivalent to £100bn in 2010-11 or one-seventh of public expenditure”. Without action, each additional 1m people over working age “would mean additional spending of £10bn a year”.

This does not include the impact on the NHS. The paper said that in 2007-08 the average value of NHS services for retired households was £5,200 compared with £2,800 for non-retired households. And the Department of Health has estimated that the average cost of providing hospital and community health services for a person aged 85 or more is around three times greater than for a person aged 65 to 74 years.

Dependency ratio

One of the key ratios that causes concern is the “dependency ratio”, which divides the number aged 20-64 by those aged 65-plus. This was about 3.7 times from 1980 until 2006, when it started to turn down, sinking potentially to about 2.3 in 2040, according to projections by Professor Les Mayhew, of Cass Business School, London. To reduce the impact on taxpayer-funded pension costs, raising the SPA looks effective. Current action, first to equalise women’s and men’s pension rights and then to raise the SPA for all, keeps the (recalculated) dependency ratio above 3 times.

Professor Mayhew’s work also focuses on healthy life expectancy because it enables people to work for longer, increasing their tax contribution and reducing the cost of benefits and healthcare. The term “dependency ratio” has attracted criticism for portraying a negative stereotype of older people. In any case, it is misleading since not all members of the 0-19, 20-64 and 65-plus are either working or not working.

Economic activity is a more useful concept than the dependency ratio in assessing the future cost of an ageing population. Between 1984 and 2013, the number of economically active people in the UK rose by 8m to 31m, nearly two-thirds of the adult population. The biggest contributor was an increasing proportion of women in work – 56% according to Prof Mayhew – more than offsetting a decline in male participation to 70%. However, the percentage of males working beyond 65 increased from 8% to 12% between 2000 and 2013.
A key consideration is the increase in healthy life expectancy. Prof Mayhew, speaking in 2013 at a Nicholas Barbon lecture at the Chartered Institute for Insurance, concluded: “Any scenario that involves improvements in health relative to life expectancy, increases in participation rates, or improvements in wage productivity delivers lower taxes and higher net wages, greater social security and greater GDP/capita.”

Recommendation: Policy should focus on increasing economic activity among those aged over 50 when, as the chart shows, it starts to tail off. The abolition of the retirement age was a good start. Baroness Altmann’s 2015 report to the government, “A New Vision for Older Workers: Retain, Retrain, Recruit,” suggests several other ways to keep older people in work. Policies on healthcare for older people should focus on improving healthy life expectancy, rather than just life expectancy.
Longevity predictions

One of the assumptions is that increases in life expectancy can be extrapolated forwards in a smooth way. This makes for eye-catching forecasts. For instance: at the current rate, a third of the babies born in 2012 will celebrate their 100th birthdays, according to the International Longevity Centre-UK.

But it is worth remembering that the rate of change has not been smooth. According to ONS population projections (published 2014, based on data up to 2012), much of the increase in life expectancy at birth in the first half of the 20th century can be attributed to the reduction of infant and child mortality. From about 1940, the number of early adult deaths was reduced by control of infectious diseases. Since the 1970s, death from circulatory diseases in older adults has fallen by more than two-thirds. The death rate from cancer has been falling for the past two decades.

A cohort born around the early 1930s has experienced a more rapid increase in life expectancy than those born earlier or later. They may have enjoyed an optimal combination of advanced medical practices and healthy lifestyles. Some demographers believe that the law of diminishing returns may apply, especially if the trend towards healthier lifestyles stalls.

Actuaries try to incorporate “longevity catalysts” into their calculations. At a CSFI event, Khurram Khan, Head of Longevity Risk at Pension Insurance Corporation and a Fellow of the Institute and Faculty of Actuaries, described a series of factors that could further improve (healthy) life expectancy. These included a universal flu vaccine, screening for bowel cancer and stem cell therapy for Parkinson’s disease.
Chapter 2: Saving for Retirement

The problem

The average savings rate of UK households saw a temporary revival in the wake of the financial crisis, rising from 6% of available resources\(^1\) to about 11% in 2010. But it has come back down to about 6% since then. A commonly cited estimate is that 13m people have insufficient savings for retirement.

A decline in work-based contributions to pension funds has exacerbated the problem in the private sector. Some 46% of employees were members of a workplace pension scheme from 1997 to 2001, but in the decade to 2012 there was a decline to 32%. The closing of defined benefit (DB) schemes to new members was one of the reasons. It was only from 2012 that this began to be mitigated by the new government policy of auto-enrolment (AE) into work-based pension schemes. According to The Pensions Regulator, in its 2014 commentary on progress: “In 2013 the proportion of employees in a workplace pension scheme rose to 50%, the first increase since 2006.”

The issue is not just whether people are in a pension scheme or not; it is the small size of most people’s pension savings. According to the ONS in a chapter on private pension wealth (Wealth in Great Britain 2010-12, May 2014), the median level of total pension wealth (present value of future pension income for DB and reported value of the fund for DC) was £82,300. This would buy a 65-year-old male a flat (no inflation proofing) annuity of about £4,500.

Private pension wealth is skewed in two ways. First, the top decile has 48% of aggregate wealth (see chart), with the value of pensions in payment – the legacy of generous DB schemes – the biggest factor. Second, DB scores better than defined contribution (DC) schemes on all counts. For instance, the median value of funds from which individuals have yet to draw an income is £39,900 for DB compared with £15,000 for DC. As for contribution rates: the average employee plus employer amount for private sector DB schemes was 20.6% of salary, while for DC schemes it was 9.1%.

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1. Total resources are comprised of gross disposable income and an adjustment for the change in the net equity of households in pension funds. ONS: Recent Developments in the household savings ratio, Economic & Labour Market Review, Vol 4 No 5, May 2010.
The new AE regime

Auto-enrolment applies to workers aged 22 and over and earning more than the personal income tax threshold of £10,000 (2014-15 figures). Younger workers and those earning less have a right to “opt in”. There are about 31m people in work in the UK and the DWP says the target is to get 9m of them either as new savers into work-based schemes, or to increase the amount they are saving. It estimates that this could amount to an additional £8bn-£12bn a year being saved in private sector pension funds.

The minimum contribution applies to earnings over £5,772 up to a limit of £41,865. Between October 2012 and September 2017, auto-enrolled DC schemes must receive contributions of at least 2% of qualifying salary, with at least 1% coming from the employer. From October 2017 to September 2018 the minimum contribution will be 5%, with at least 2% from the employer. This goes up to 8% – with at least 3% coming from the employer – in October 2018.

Source: ONS

The new regime (see below), which started in 2012, has brought in more DC savers at lower rates. The 2013 Occupational Pension Schemes Survey found that average employer contribution rates for DC schemes had fallen from 6.6% in 2012 to 6.1% in 2013. “Whilst it is not possible to isolate the effect of these reforms, an increase in the number of new members starting pensions on the minimum contribution rates would lower the average rate.”

Target of 9m people with little or no pension saving
According to the Annual Survey of Hours and Earnings (2014 provisional results), median gross earnings for a full-time employee were £27,200 and the bottom 10% earned less than £15,000. At 8% of pay, the median employee would contribute 4% of qualifying salary, or about £855 a year, which would be matched by the employer (3%) and a tax rebate (1%). So the total amount saved annually would be just over £1,700. For a worker on £15,000, the total saved would be £734. The Money Advice Service, set up by the government, supplies an easy-to-use model for this.

The idea is that the individual will save from the age of 22 (they can opt in earlier) to the state pension age, 44-48 years later. They can take breaks but there are provisions to auto-enrol them back in.

Employers are being phased into the scheme, working from the largest to the smallest over a period of nearly five years. In the first half of 2015, the last wave of companies with 50 or more staff were launching AE schemes. Then come employers with 30-49 staff and, between January 2016 and April 2017, companies with fewer than 30 people will join. In all, by 2018, the new regime is supposed to have captured 750,000 businesses that had no scheme.

According to The Pensions Regulator’s “declaration of compliance” report for January 2015, more than 44,000 employers had “met their duties”. About half their nearly 20m employees were already members of an active scheme. New recruits to pension saving under the AE regime numbered 5.1m. The opt-out rate, as measured by the DWP in 2014, was running at an average of 12%, so that left about 4.5m in. So far, opt-out rates have been much lower among younger than older workers – 7% of under-30s versus 23% of 50-pluses. Part-time workers were nearly twice as likely to opt out as full-time ones.

The big question is whether opt-out rates will increase once contributions are quadrupled from the current 1% for employees. As this is ratcheted up to 4% of salary, pension deductions could result in a cut to take-home pay. Wage rises have averaged between 1% and 2% since 2012, only beating inflation since last autumn, so workers impatient with stagnant pay packets may be more inclined to opt out.

Opt-out rates will be closely watched by the new government. The House of Commons Work and Pensions Committee report, “Progress with Automatic Enrolment and Pension Reforms” (March 2015) put review of AE implementation at the top of the agenda. The committee did not regard low initial opt-out rates as “a meaningful measure of the effectiveness of AE policy in the longer term”.

What happens if the policy is ineffective is not pre-judged, but the emphasis placed on mass participation suggests that compulsion will be considered if opt-out rates rise significantly. This report does not support compulsory employee contributions.
Is 8% enough?

The new single-tier state pension, due from April 2016, is to be set above the basic level of means-tested support (Guarantee Credit), implying about £155. In addition, pensioners have free bus passes, TV licences (over 75) and winter fuel payments. About three-quarters of pensioner households are owner-occupied, and more than 9 out of 10 have no mortgage and, therefore, no accommodation costs (council tax relief starts to drop once income reaches £165.15 a week for a single pensioner and £247.70 for a couple).

One way to consider the adequacy of saving for retirement is to model what will happen under the new AE regime. NEST (National Employment Savings Trust), the government-backed AE pension fund, has an easy to use pension calculator (although the simplicity contains some important assumptions, such as an uninterrupted contribution record and a real investment growth rate of 2-3% a year).

Take a 22-year-old with annual pay of £18,000 – two-thirds of the 2014 median of £27,200. By state pension age of 68, the pension pot (in today’s money) is forecast at £130,000. After taking out a tax-free lump sum of £33,000, the residual funds would buy a non-inflation-proofed income of £5,290. Add this to a state pension of about £8,000 and initial retirement income would be nearly £13,300. This is less than full-time annual earnings on the proposed national living wage of £7.20 per hour from April 2016, and less than half median pay – and hence below common definitions of low income, which are 60-67% of the median.

The attraction is that the individual’s weekly contribution will be less than £10, which looks affordable. Altogether, the lifetime contributions amount to £33,000, a quarter of that £130,000 pot, with the rest coming from the employer, tax rebates – and, most importantly, investment growth. The last, which is the least certain, is predicted to account for nearly half the ultimate pot size.

Traditional DB schemes aimed to provide two-thirds of final salary (although this assumes at least 40 years of pensionable service, uninterrupted contributions to one occupational scheme and staying in the job until the designated pension age). A study by the Pensions Policy Institute (PPI) and King’s College London, entitled “What level of pension contribution is needed to obtain an adequate retirement income?” (October 2013), looked at the probability of achieving two-thirds of late career salary by the future state pension age of 68. The results were better for a lower earner because the state pension makes up a bigger proportion of retirement income. If contributing from 22 to 68, “a lower earner has a 63% probability of achieving their target replacement income, compared to 49% for a median earner and 40% for a higher earner.”
The required contribution rate for a good chance of reaching a target replacement income increases with earnings

Contribution rates needed for different individuals to reach a 66% or 75% probability of achieving their target replacement income, if they start saving at age 22, retire at SPA and follow a traditional lifestyle investment approach. Single-tier state pension triple locked

- Lower earner
  - Two-thirds: 9%
  - Three-quarters: 11%
- Median earner
  - Two-thirds: 11%
  - Three-quarters: 13%
- Higher earner
  - Two-thirds: 12%
  - Three-quarters: 14%

Source: PPI

To improve the probability of achieving two-thirds replacement income to 75%, contribution rates would need to rise to 11% for a low earner, 13% for a median earner and 14% for a higher earner.

This explains calls for “auto-escalation” of contributions. In Australia, which introduced a compulsory superannuation scheme in 1992, contribution rates for employers rose from 3% to 9% over the first decade and have recently started to rise towards 12%. Steve Webb, UK pensions minister until May 2015, advocated “auto-escalation”. He told the Liberal Democrats’ autumn 2014 conference: “We need to get them saving more than the bare statutory minimum of 8%. I am quite attracted to the idea that when you start a job the norm is that each time you get a pay rise a part of the extra cash goes into your pension.” That, too, could be subject to opt-out, so that it is still voluntary.

Recommendation: The aim should be to nudge AE contribution rates towards 12% with the breakdown as follows: 5% employee, 5% employer and 2% tax rebate. This could be achieved first by equalising the rate for tax relief at 30% (see chapter 4), then by making it mandatory for employers to match the employees’ contribution, and finally by raising the contribution level. This should remain voluntary for employees via the opt-out system.
Chapter 3: Barriers to saving and investment

Much of the above argument assumes a simple world in which people have disposable income after meeting everyday needs, no expensive debt and regular employment. The DWP has reported that affordability is a key reason cited for opting out of pension saving. The Social Market Foundation (SMF), in “Savings in the Balance” (November 2014), found that people had a strong bias towards accessible savings. “When broken down by age, we find that affordability is a particularly strong barrier between 35 and 44, when nearly half (48%) of all cases where someone stops saving into a pension were influenced by cash flow problems.”

<table>
<thead>
<tr>
<th>Share of population reporting factors as important or very important in savings and investment decisions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Affordability</td>
</tr>
<tr>
<td>Rates of return (interest rates)</td>
</tr>
<tr>
<td>Finding products that work for me</td>
</tr>
<tr>
<td>Trust in banks and financial institutions</td>
</tr>
<tr>
<td>Availability of information about saving and investment products</td>
</tr>
<tr>
<td>Family circumstances</td>
</tr>
<tr>
<td>Age</td>
</tr>
<tr>
<td>Work circumstances</td>
</tr>
<tr>
<td>Personalised information about which products are right for me</td>
</tr>
<tr>
<td>Wanting to spend rather than save</td>
</tr>
</tbody>
</table>

Source: SMF/Populus Savings in the Balance Survey 1-2 October 2014

Motives for saving are precautionary and short term

A survey published in the 2014 Gleneagles Report on the savings challenge facing the UK found that the leading concerns of the average UK household were “having enough money to get by day-to-day” and “paying off my mortgage”, closely followed by “paying off my debts”. Saving for retirement was near the bottom of “The top 10 concerns” list.

According to the SMF, people’s primary motives for saving are precautionary: “for a rainy day”, for short-term goals – a car, a holiday and/or for a deposit for a house. This
helps explain the popularity of Individual Savings Accounts (ISAs). According to HM Revenue and Customs, at the end of 2013-14 the market value of adult ISA holdings stood at £470bn, split almost equally between cash ISAs and stocks & shares ISAs.

NEST has found that many of its target group, who are often new to pension saving, are not comfortable with the idea of investment. In its 2014 report, “Improving consumer confidence in saving for retirement”, it said that the financial crisis had been “particularly damaging” for the image of investment. Those it surveyed regarded saving and investment as two distinct practices, with the latter “only for the professionals, the wealthy and indeed only the foolhardy”. They were worried about losses and volatile valuations. “Most are surprised to find out their [pension fund] money is invested at all.”

Debt cannot be ignored, especially mortgage debt

Effectively, in the UK, buying a house has priority over saving for retirement. In the decade to 2005, the average household debt of the heaviest borrowers – those in their late 20s to about 40 – more than doubled from less than £30,000 to nearly £70,000, according to the Bank of England.

Average household debt by age

![Graph showing average household debt by age](image)

Source: British Household Panel Survey (BHPS) and Bank calculations.
Average household gross wealth (including housing assets) by age

Source: British Household Panel Survey (BHPS) and Bank calculations.

Thanks to rising house values, however, this borrowing helped produce considerable increases in household gross wealth, which averaged about £80,000 for people aged 50-60 in 1995 and shot up to around £200,000 a decade later. But the impact of the financial crisis and subsequent recession, which saw house prices fall, was amplified as those with mortgage debt of at least twice their income cut spending significantly.

If cash flows fluctuate for people because of redundancy and so does the wealth effect of housing values, attitudes to disposable income – including the amount available to lock away in pensions – will also vary. The SMF survey found that “making it easier to access invested money in an emergency” was top of the list of actions that might encourage a switch from short-term savings to longer-term investment. It suggests extending pension fund freedom to allow access at, say, the age of 35. In the US, many participants in 401(k) retirement plans have a loan option and, according to the Employee Benefit Research Institute, about one in five has an outstanding loan.

So more flexibility would encourage pension saving but, as with the existing freedom to halt contributions, it detracts from the ultimate size of the pot. There is also a danger that regarding pension pots as security for loans simply encourages borrowing, rather than the accumulation of unencumbered assets that can be used to fund retirement.
Australia provides a cautionary tale. CPA Australia, the professional accounting body, published a report in 2013 entitled “Twenty years of the superannuation guarantee: The verdict”. The author, Professor Simon Kelly, found: “After two decades of saving, Australians now have A$1.5 trillion in superannuation savings. However, the growth in superannuation has been matched by households taking on an equivalent amount of personal debt.”

The chief concern of Prof Kelly was that the baby boomer generation was entering retirement with significant debt, knowing that their pension savings could help repay it. He pointed to an alarming combination of higher expectations of retirement income with higher outgoings to service debt, including a mortgage that has not been paid off.

In the UK there are worrying signs of a similar trend. These include:

- The number of first-time buyers choosing a mortgage term of more than 25 years is up by a third since 2010; nearly one in three borrowers is going for this. Terms of up to 40 years are becoming more common.

- An HSBC survey in 2014 showed that most young people do not expect to have enough saved for a deposit until they are 35.

- While interest-only mortgages have been clamped down on in the wake of the FCA’s Mortgage Market Review, there is a legacy of more than 2m of them.

- All of the above suggest that more people will enter “retirement” – or pass the age of 65 – with mortgage debt.

Partnership, the enhanced annuity provider, conducted a survey in 2014 that indicated that more people expect to be paying housing costs of one form or another “in retirement”.

### Proportion of people who believe that they will be paying rent/mortgage in retirement

<table>
<thead>
<tr>
<th></th>
<th>All</th>
<th>40-50</th>
<th>51-55</th>
<th>56-60</th>
<th>61-65</th>
<th>66-70</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proportion paying rent (%)</td>
<td>31</td>
<td>42</td>
<td>37</td>
<td>22</td>
<td>21</td>
<td>18</td>
</tr>
<tr>
<td>Proportion paying mortgage (%)</td>
<td>20</td>
<td>26</td>
<td>18</td>
<td>15</td>
<td>16</td>
<td>15</td>
</tr>
</tbody>
</table>

Source: Partnership

How will they repay their mortgages? Partnership conducted another survey in which 15% of respondents planned either to use the tax-free lump sum or otherwise “use my pension” to repay the mortgage. That was in 2014. New pension freedoms from April 2015 are likely to draw more people down this route.
How will you repay your mortgage?

<table>
<thead>
<tr>
<th>Plan to repay mortgage by state pension age</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Percentage of respondents</strong></td>
</tr>
<tr>
<td>Keep making monthly payments until it is repaid</td>
</tr>
<tr>
<td>Make some lump sum repayments in addition to my monthly payments</td>
</tr>
<tr>
<td>Use my tax free pension lump sum to repay outstanding balance</td>
</tr>
<tr>
<td>Have savings/investments set aside to repay outstanding balance</td>
</tr>
<tr>
<td>Use an inheritance</td>
</tr>
<tr>
<td>Use my pension to repay outstanding balance</td>
</tr>
<tr>
<td>Will take in a lodger to help repay my mortgage</td>
</tr>
</tbody>
</table>

Source: Partnership

Commentary on access to mortgages and their affordability seems fixated on monthly repayments. As an article in the Financial Mail on Sunday (13 September 2014) said: “The long-life deals also help borrowers beat the tough new affordability tests being imposed by lenders since the Mortgage Market Review was introduced in the spring.” This included “a forensic look” at potential customers’ monthly spending patterns.

By contrast, a credible repayment plan is only emphasised for interest-only mortgages. If it is called a repayment mortgage, will the mortgage lender question whether the term is too long for a 30-something?

Recommendation: There needs to be joined-up thinking between the DWP, the FCA and mortgage providers over the diversion of savings earmarked for retirement into repayment of mortgage debt. Whatever the type of mortgage, there should be a “credible repayment plan” by the state pension age.

Further into debt

The debate about pension saving tends to be focused on those with rising incomes and relatively inexpensive mortgage debt. This is disconnected from the equally loud debates about low pay and indebtedness, despite common headlines about credit-fuelled spending in the UK. In the wake of the financial crisis, saving went up and short-term credit fell; both trends have since reversed. Unsecured borrowing grew by £1.25bn during November 2014, the biggest rise since February 2008. The figures, from the BoE, show total unsecured debt at £168bn – more than £5,800 per household. (A peak of £208bn was reached in September 2008.)
Such debt may be expensive, raising the question of whether it makes sense to save at current relatively low rates of return into accounts with limited access. This highlights the importance of the matching contributions made by the employer and the government, between them adding £1 for every £1 saved. But even so, with overdraft and credit card interest charges (after the interest free period) in the high teens, and much higher rates for unauthorised overdrafts and payday lending, the case for saving may not necessarily add up.

Legal & General poses the question on its website: “Is a pension right for me?” Its answer acknowledges the debt issue:

“For most people, joining a company pension is a very good way of building up a pot of money to provide a regular income in retirement…However there may be times when paying into a pension may not be the best option. For instance if you have outstanding debts which need to be cleared or other financial considerations take precedence.”

And then there is student debt. According to a 2014 report by The Institute for Fiscal Studies, “Payback time? Student debt and loan repayments: what will the 2012 reforms mean for graduates?”, average debt for those graduating under the new system (with much higher tuition fees) will be £44,000. The graduate starts to pay 9% of gross salary in interest and principal repayments once his/her salary reaches £21,000 and any residual debt is written off after 30 years. (The 30-year limit looks like a welcome example of joined-up government thinking by reducing obligations at around the time the transition away from full-time work is likely to start.)

The IFS estimates that almost three-quarters of graduates will not repay in full and that, on average, two-thirds of the debt will be written off. The interest charged is relatively low, inflation plus up to three percentage points depending on income. Overall, it looks more like an income-related graduate tax than a commercial lending operation.

In the context of capacity to save for retirement, what matters is the 9% deduction. It needs to be added to national insurance contributions that kick in at 12% above a threshold of nearly £8,000 and income tax at 20% above £10,000 (rising to £10,600 from April 2015). Already this gives an effective marginal tax rate of more than 40% for graduates earning more than the threshold amount (set to rise from £15,795 in 2012 to £21,000 in 2016), reaching more than 50% for higher earners.
Pension contributions are yet another deduction.

Source: IFS

Pension contributions are yet another deduction. For basic-rate taxpayers, the 4% deduction will apply to pay from £5,772. Added to 12% NICs and 20% income tax, some 36% will be deducted from salaries above £10,000. Since pension contributions are voluntary, this highlights the crucial nature of the incentives provided by the matching amount from employer and tax rebate.

Deductions for a graduate on median salary of £27,200 (or nearly £2,270 per month) *

<table>
<thead>
<tr>
<th></th>
<th>Annual (£)</th>
<th>Per Month (£)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income tax</td>
<td>3,230 **</td>
<td>270</td>
</tr>
<tr>
<td>NICs</td>
<td>2,310</td>
<td>190</td>
</tr>
<tr>
<td>Pension</td>
<td>855</td>
<td>71</td>
</tr>
<tr>
<td>Student debt</td>
<td>560</td>
<td>47</td>
</tr>
<tr>
<td>Total</td>
<td>6,955 ***</td>
<td>580</td>
</tr>
</tbody>
</table>

Source: author’s calculations

* As well as the rounding of numbers, there is some anachronism, eg using 2014-15 income tax and NIC thresholds alongside the planned (2018) level of pension contribution.

** Reduced by pension rebate.

*** A quarter of gross salary.
The Higher Education Initial Participation Rate (HEIPR), published by the Department for Business, Innovation and Skills, shows about 45% of 17 to 30-year-olds entering higher education. About 1 in 10 leave without a degree. The IFS report shows median annual earnings of a graduate at about £38,000, 40% higher than the level for the whole working population.

It is worth remembering that AE, at least initially, is aimed at those not currently saving. They tend to be at the lower end of the income scale, which makes them less likely to be graduates.

**Deductions for someone earning £18,000 (or £1,500 per month)**

<table>
<thead>
<tr>
<th></th>
<th>Annual (£)</th>
<th>Per Month (£)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income tax</td>
<td>1,480 *</td>
<td>123</td>
</tr>
<tr>
<td>NICs</td>
<td>1,200</td>
<td>100</td>
</tr>
<tr>
<td>Pension</td>
<td>490</td>
<td>41</td>
</tr>
<tr>
<td>Student debt</td>
<td>Below threshold for repayment of student debt.</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>3,170 **</td>
<td>264</td>
</tr>
</tbody>
</table>

Source: author’s calculations

* Reduced by pension rebate.

** About 18% of gross salary.

**Interaction with benefits**

The overall cost of benefits received by pensioners and the interaction between savings and benefits are serious issues. Baroness Altmann, when serving as the government’s business champion for older workers, in a blog in February 2015 on Pensioner Benefits, said:

“At the moment, there are over twenty – yes twenty! – benefits that pensioners could be entitled to, they all have different rules and different qualification criteria, some will be payable to every pensioner, some only to older ones, some are tax free, some are taxable, some are means-tested and they need to be administered, claimed, assessed and paid.”

In November 2014, the Institute for Fiscal Studies (IFS) produced a paper entitled “What is welfare spending?” by Andrew Hood and Paul Johnson, which showed a “large chunk being spent on the elderly”. Using 2013-14 figures, state pensions
cost £83bn, or 12% of total public expenditure of £686bn. A further £28 billion was spent on other benefits either specifically for pensioners or on their share of general entitlements. For 2015-16, in its Election “Topics” page on Benefits and Tax Credits, the IFS calculates that pensioners will account for £121bn of the £220bn total.

**Benefit expenditure by benefit (2015–16)**

<table>
<thead>
<tr>
<th>Benefit</th>
<th>Amount Spent (£ billions)</th>
<th>Percentage of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>State pension</td>
<td>92.1</td>
<td>41.8</td>
</tr>
<tr>
<td>Child and working tax credits</td>
<td>29.9</td>
<td>13.6</td>
</tr>
<tr>
<td>Housing benefit</td>
<td>26.0</td>
<td>11.8</td>
</tr>
<tr>
<td>Disability living allowance, personal independence payments and attendance allowance</td>
<td>21.6</td>
<td>9.8</td>
</tr>
<tr>
<td>Incapacity benefit and employment and support allowance</td>
<td>15.1</td>
<td>6.9</td>
</tr>
<tr>
<td>Child benefit</td>
<td>11.7</td>
<td>5.3</td>
</tr>
<tr>
<td>Pension credit</td>
<td>6.5</td>
<td>3.0</td>
</tr>
<tr>
<td>Other</td>
<td>16.9</td>
<td>7.7</td>
</tr>
</tbody>
</table>

Source: IFS calculations using DWP benefit expenditure forecasts

Overall benefit spending has been fairly flat in absolute terms since 2010-11, but falling as percentage of GDP since 2012-13, when it peaked at 12.6%. Under the previous government’s policy and assuming continued GDP growth, benefit spending would decline to 11.1% of GDP in 2018–19, according to the IFS. The cost of prioritising an improvement to the state pension has been more than offset by cuts to other benefits.

That’s the economy-wide view. But at an individual level the picture is more complicated. For those living in rented accommodation and retiring at state pension age, means-tested support will persist even if a pension pot has been amassed. Bernie Hickman, of Legal & General, produced some revealing case studies for the Pension Reform Summit, in London, organised by City & Financial Global. For someone retiring from a low-paid job, living in rented accommodation and with pension savings of £16,000, the most rational thing to do would be to protect £9,840 a year of state benefits. These comfortably exceed the state pension of £7,714 (using about £148 a week in this example). The best solution is to draw down his savings in tax-free lump sums, with no impact on benefits.
A further complication is the interaction between pension savings, other types of assets and the benefits system. Michael Johnson, research fellow at the Centre for Policy Studies, described the treatment of assets for the purpose of assessing means-tested benefits as “ridiculous”, in an article for the April/May 2015 edition of *Financial World* magazine. For example, “Isa assets in excess of £16,000 are included, whereas pension assets are not.”

Then there’s means-testing for care costs. The Dilnot report in 2011, “Fairer Care Funding”, looked at both the level of care costs and the way the value of a person’s home could be used up to fund them. As a result, The Care Act, being implemented from April 2015, caps the total costs at £72,000 and quintuples to £118,000 the upper limit on property value that determines eligibility for local authority support.

And finally, there are all the bells and whistles for pensioners. Winter fuel payments, free bus passes and free TV licences, for instance, together cost £3bn a year. There is no justification for universal benefits of this kind for pensioners of all incomes. It is better to focus on raising the level of the state pension. Saving £3bn would provide enough to give each of the UK’s 12m over-65s another £250 a year – and this does not allow for savings on other benefits and additional receipts from pensioners paying tax.

The single-tier pension rightly aims to simplify the system and improve incentives to save towards additional retirement income. But the picture remains complicated because of government regulation: notably benefits and tax (see Chapter 4).

**Recommendation:** The new government should make rationalisation of pensioner benefits a priority. Other than the state pension, set at a level that lifts many households out of means-tested income support, pensioner specific benefits should be scrapped.
The importance of wage rises

To provide a favourable backdrop for the increase in individuals’ pension contributions from 1% to 4%, a key factor is wage rises. After a squeeze in real terms since 2010, wage rises have exceeded inflation (zero in early 2015) since late last year and this looks likely to be sustained. The EY ITEM Club of economists has predicted an increase of 1.9% for 2015.

In February, the Low Pay Commission recommended to the Government that the national minimum wage, which applies to workers aged 21 and over, should rise by 3% to £6.70 per hour from October 2015. In the Budget on 8 July 2015, George Osborne, Chancellor of the Exchequer, announced a new national living wage (NLW), starting at £7.20 per hour in April 2016, with a target of £9.00 per hour by 2020. This endorsed the trend to narrow the gap between the lowest levels of pay and the “living wage” – £7.85 per hour at the time of writing, about 60% of the 2014 median wage.

The implied increases of 4-5% a year in the NLW are likely to influence the rate of pay growth more broadly. This rate of increase would more than offset the impact of higher AE pension contributions over the next three years.

Another factor mitigating the impact on take-home pay is the rapid rise in the income tax threshold. Mr Osborne confirmed in the Budget a goal to increase the threshold for income tax to £12,500 during this parliament. The additional £500 that this would give people, compared with the 2014-15 threshold of £10,000, will cover the pension contributions of someone earning £18,000.

Recommendations:

- Because for some people it would make more sense to pay off debt, it is better to stick to auto-enrolment rather than compulsion, at least for the employee’s contribution. This means relying on incentives to save for retirement – the employer’s contribution and tax rebates – to encourage low opt-out rates.

- The new government will need to factor in wage trends in considering capacity to save for a pension. Creating a national living wage of £7.20 per hour narrows the gap between the lowest levels of pay and other, higher, measures of a “living wage”. Linking the state pension to the NLW would further the broad policy aim of lifting more households out of benefits.
Chapter 4: Incentives to save for retirement

The latest Personal Pension Statistics (February 2015) from HM Revenue & Customs show £34.3bn in tax relief on contributions to pension schemes and on investment income earned within them for 2013-14. But Michael Johnson, of the Centre for Policy Studies, believes that the total cost of tax relief for that year was more than £52bn, comprised as follows:

- Income tax relief on contributions: £27bn
- NIC rebates on employer contributions to pension schemes: £14bn
- Tax-exempt investment income in pensions schemes: £7.3bn
- Tax-free lump sums: £4bn

This neatly sets out the options for curbing the overall cost of tax relief for retirement saving.

Tax relief for individuals

Tax rebate rate

Steve Webb, Liberal Democrat MP and pensions minister in the 2010-15 coalition government, said this about tax incentives in his speech to the Liberal Democrats’ autumn conference in 2014:

“We also need to tackle the inequity – or should I say iniquity – of the current system of tax relief on pensions. If I want to put £1 into my pension it only costs me 60p – the taxpayer contributes the other 40p through higher rate tax relief. But if someone on an average wage wants to put £1 into their pension it costs them 80p – the taxpayer only contributes 20p. That cannot be right.”

The Liberal Democrat manifesto advocated a single rate of tax relief above the basic rate of 20%. Mr Webb expressed support for a 33% flat rate, which would mean the government contributing 50p for every £1 saved, double the current level for basic rate taxpayers. It would cut the amount received by 40% taxpayers by 26%, with a reduction of 40% for 45% taxpayers.
Mark Hoban, a former Conservative MP and financial secretary to the Treasury, has also expressed support for a single 30-33% rate. At 30%, the basic-rate taxpayer would receive about 70% more in rebates, while the 40% cohort would lose about 36%. An alternative would be to limit tax relief for all to the standard rate.

The Pensions Policy Institute’s report, “Tax relief for pension saving in the UK” (July 2013), set out the following on both the overall cost and the disproportionate benefit to higher earners:

“The projected cost of pension tax relief, after the introduction of auto-enrolment, is £34.9 billion per year. While basic rate taxpayers make 50% total pension contributions, they benefit from 30% of pension tax relief. In contrast, 50% pension tax relief goes to higher rate taxpayers and 20% goes to additional rate taxpayers; these groups make 40% and 10% of the total contributions respectively.”

Having pension tax relief at a different level to employees’ actual tax rates creates some difficulties for payroll administration and tax code calculation. But the need for some IT investment by employers and HMRC should not stand in the way of a more equitable regime. The PPI estimated that restricting tax relief to the basic rate would save £13bn-£16bn. Equalising rebates at 30% would at worst be neutral and may save £1bn.

Recommendation: A flat rate for tax rebates of 30% would increase the incentive for most workers to save for retirement. This move alone would add nearly 10% to the amount being put into AE schemes, taking total contributions to 8.7%.
Level of tax-privileged contributions

In the run-up to the 2015 General Election, attention was focused on potential cuts in the amounts eligible for tax relief. The first target was the annual £40,000 contribution allowance and whether to reduce that to £30,000, or even £10,000 for those earning over £150,000. The latter cap was confirmed (with a taper) in the July Budget, the former was left unchanged. It is worth remembering that the annual allowance was £255,000 as recently as 2010-11. The allowance covers all contributions, including the employer’s.

A reduction in the annual allowance to £30,000 looks an easy target since that amount is higher than median pay. Much smaller annual contributions will lead to a pension pot big enough to provide an income that, added to the state pension, will be better than the “living wage” – even after taking out a tax-free lump sum. For instance, saving £2,000 a year (£3,500 after the employer’s contribution on an AE basis) for 40 years would provide a pot of £284,000, according to the NEST calculator, which factors in tax relief at the basic rate.

The advantage of an allowance that is much higher than typical annual saving capacity is that the individual can choose a much shorter contribution period and/or make lumpy contributions. David Blake, Professor of Pension Economics at Cass Business School and Director of the Pensions Institute, is concerned about the spending squeeze on younger adults caused by mortgage and family obligations. He told a CSFI round-table that a rational person would not contribute to a pension fund in the early years of their career, when income is low. They would start later and then save much more. For some individuals, this approach might also coincide with inheritance or other inter-generational transfers that could be added to pension pots.

The desirability of allowing some flexibility in the way retirement savings are built up argues for an annual allowance that is much higher than would be feasible for regular annual contributions. In that light, £30,000 looks generous enough, even without the current ability to carry forward unused elements of the allowance for three years.

The policy needs to be set in the context of a progressive tax system that does not reach punitive rates. Let’s assume that 40% is not high enough to motivate staff and employers to shelter a significant portion of annual salary in a pension fund. It is, however, arguable, that imposing an effective tax rate of 60% on those earning £100,000-£120,000, by removing the personal allowance, provides an incentive for pensions-based tax avoidance.

Another factor to bear in mind is that a pension fund is just one destination for surplus income. The ISA limit has been raised to £15,240 a year and there are a variety of schemes that offer tax rebates in return for investment in start-up companies, also a worthy public policy goal.

**Recommendation:** £30,000 is generous enough as an annual contribution allowance. Proposing a different rate for those earning more than £150,000 is an unnecessary complication. The new government should monitor incentives to shelter income from tax in pension funds.
The life-time allowance

The lifetime allowance for 2015-16 is £1.25m, but is set to fall to £1m from April 2016 (it was £1.8m in 2010-12). For DB schemes, the valuation formula for tax allowance purposes is not the same as the transfer value if the person wanted to take money out. According to the government’s Money Advice Service, the value is calculated by multiplying the annual pension by 20, plus any lump sum that has been taken out. So a £1.25m limit affects those with DB pension income above £62,500 a year (assuming no lump sum taken); a £1m limit has an impact above £50,000. These schemes typically offer some protection against inflation and to surviving spouses. A 65-year-old with a £1m DC pot might get a bit more than £50,000 initially, but with no inflation protection or other benefits.

The different treatment of DB and DC pots for the purpose of the calculation is just one of the problems with the LTA. Merryn Somerset Webb, writing in the FT’s Money section (19 March 2015), under the headline “Osborne’s lifetime allowance plans are a mess in the making”, said:

“While you can keep track of how much you put into your pension you can have no possible idea of what it will be worth in 10, 20 or even 30 years. That will depend on the returns you make on the money…

Let’s say that you are 35, have £350,000 in your pension scheme and plan to contribute £500 a month until you are 55. Given that you are £650,000 shy of a million quid, you probably aren’t remotely worried about the LTA. You should be. If your pot grows at 5% (in real terms) a year, the magic of compounding means that you’ll have £1.13m when you retire. Whoops.”

Recommendation: Tax allowance limits should focus on annual contributions, with a possible life-time cap on those but not on the overall fund size. To do the latter defeats the logic of retirement saving being tax-exempt for both contributions and investment gains, but taxed when withdrawn.

Tax relief for employers

Employers face a tricky few years as AE is phased in (and, for those with DB schemes, NICs relief related to contracting out of the second state pension is withdrawn). But since pension contributions are salary, there is a case for curtailing their exemption from NICs. With corporation tax reduced from 28% to 20% during the 2010-15 parliament, and a drop to 18% planned, this should provide scope for additional NIC payments. The counter-argument is that the UK should not endanger its reputation as a business-friendly environment.
The impact on pay is a tricky issue. Employees might resent the deduction of pension contributions from take-home pay and put pressure on the employer to raise pay to offset the effect. Calls for higher pay from staff would chime with a public policy concern about the rising level of benefit payments to people in work.

More specifically, in the context of the AE regime, a future government might prefer to raise the employer’s contribution from 3% to at least match the employee’s 4% rate. If total contributions are to rise to, say, 12% then 5% from each side, plus 2% in tax rebates (equalised at 30%) for the employees would be a simple formula.

Recommendation: The first priority is to bed down the AE regime, which will cost both employees and employers money. Then employers should be required to match the employees’ contributions. The shelter from NICs on employer contributions should also be reviewed.

Underlying principle – EET or TEE

Michael Johnson is critical of the UK’s current approach to the taxation of savings because of the contrasting treatment of ISAs and pension funds. The former, which are popular with savers because of instant access and simplicity, are built up from taxed income. Annual investment gains and the accumulated funds are, however, exempt from tax. So the model is TEE (taxed, exempt, exempt). Pension saving is the reverse: contributions and accumulated gains are exempt, most of the ultimate fund is subject to tax on withdrawal: so, EET.

According to Johnson, in “Time for TEE: the unification of pensions and ISAs” (April 2015), moving the whole savings arena onto a TEE basis would be “The Great Trade to do” from a Treasury perspective. Stemming the current cash outflow would make a significant reduction in the deficit. The outflow would effectively be moved back a generation, “as upfront tax relief, paid out to today’s workers, would be replaced by Income Tax foregone from today’s workers, once they had retired”.

What this overlooks is the intrinsic difference between saving “for a rainy day” or near-term expenses, such as a holiday, and locking money away regularly in an investment fund that will help cover the cost of old age. The latter needs more incentives than the former. Johnson points out that employer contributions could be directed into ISAs. This report argues, however, that tax rebates remain a crucial “nudge”. The state has an interest in encouraging people to defer consumption in order to support themselves in later life and minimise future benefit claims. It is also well placed to counter behavioral biases towards instant gratification and under-estimation of life expectancy.

This report supports the EET system for pension saving, but this calls into question the tax-free lump sum that can be taken from the age of 55 (rising to 57 in 2028). At 25% it significantly reduces the amount left to support the individual in later life. Effectively this means the current pension regime is EET(partially E).
In absolute terms the benefit is stacked towards the better off. The PPI, in its 2013 report, found that “while 2% of lump sums are worth £150,000 or more, they attract 32% of tax relief on lump sums”. A cap of £36,000 on the amount that could be taken tax-free would leave three-quarters of lump sums unaffected but halve the £4bn cost of the relief.

One argument for allowing access to some of the savings tax-free is that it helps people reduce their debts as they face a reduction in earning capacity. This echoes the finding of the Social Market Foundation that “making it easier to access invested money in an emergency” was top of the list of actions that might encourage a switch from short-term savings to longer-term investment. But this not only cuts across the crucial difference between short-term and long-term saving, it greatly reduces the benefit of compounding gains in the fund’s value. Capacity to pay off debt in the 10 years before state pension age is already provided by freedom of access to the funds.

**Recommendation:** The tax-free lump sum should first be capped at an absolute amount and then phased out.

Money saved by following the above recommendations could be used to improve the state pension (see box). The most radical approach would be to cut the full £52bn of benefits and increase the state pension by well over 50%. This would take it above the income tax threshold and to about 80% of the NLW. But the cost of providing it would escalate as the pensioner population mounts to more than 16m by 2040, making it more likely that means-testing would be re-introduced. This would reverse the current policy of simplifying the system and removing disincentives to save long-term.
Proposals to increase the state pension make it essential to calculate the net cost, after cuts in pensioner benefits and the increased tax take from pensioners’ income. On the former, using the IFS’s 2015-16 breakdown of benefits, pensions credit is £6.5bn, and then there is the pensioners’ share of £21.6bn spent on disability and attendance allowances and £26bn in housing benefit. However, the increasing cost of the elderly to health and social services should also be borne in mind.

Recommendation: There is clearly a case to rationalise tax breaks for both retirement saving and pensioners, building on the simplified platform of the single-tier pension. The aim should be to have a fairer, simpler system that preserves incentives for the bulk of the workforce to save for retirement, while limiting tax relief for the better-off and mitigating benefit costs. The new government should use independent sources of evidence and research on the potential net effect, taking in taxation, benefits and other welfare costs.

**Potential savings* on pensioner benefits and tax allowances**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Winter fuel payments, free bus passes and TV licences</td>
<td>£3bn</td>
</tr>
<tr>
<td>Pension credit, as the state pension rises, it would fall from</td>
<td>£6.5bn</td>
</tr>
<tr>
<td>Tax free lump sum:</td>
<td>£4bn</td>
</tr>
<tr>
<td>Either income tax relief equalised at 30%</td>
<td>£0 - £1bn</td>
</tr>
<tr>
<td>Or restricted to the basic rate of 20%</td>
<td>£13bn-£16bn</td>
</tr>
<tr>
<td>NICs imposed on employer contributions</td>
<td>£14bn</td>
</tr>
<tr>
<td><strong>Range using the above:</strong></td>
<td><strong>£27.5bn-£43.5bn</strong></td>
</tr>
</tbody>
</table>

* Author’s calculations using numbers from the different sources and fiscal years cited in this report.

Adding £10 a week to the state pension would cost £6.2bn for the current 12 million pensioners and £8.3bn for the 16 million forecast by 2040, if the SPA is not raised more quickly than planned. The net cost would be lower because not all pensioners have sufficient NICs or care credits to qualify for the full amount, and some money would be clawed back in tax paid by pensioners.

Even a saving of £7bn, removing benefits and tax allowances that are not part of the “simplification” and EET logic, would pay for an additional £10 a week on the state pension. This, in turn, would reduce spending on pension credits, mitigating the cost of the rising number of pensioners over the next 25 years. This report supports tax relief on contributions, while restricting the level of contributions (which in itself reduces the cost of tax relief), and so would not advocate all £43.5bn savings being made. Bear in mind that the single-tier pension is already set to be about £40 higher than the 2015 basic state pension of £115.95, and that a couple with full qualification records would each receive it.

The transfer of any of the above savings to the state pension will further the goal of providing a non-means-tested platform on which private savings can be built.
Chapter 5: Who manages the money?

The new, AE-fuelled mass market has a number of features that distinguish it from the old model of employer-based DB schemes, born in an age of “jobs for life” at big industrial concerns, often with a history of state ownership. Modern members of work-based schemes are more likely to switch between smaller employers (which are more likely to fail or experience changes of ownership) and/or have periods of unemployment and self-employment.

This fragmentation of employment – alongside the withdrawal of private sector DB schemes – has led to big variations in pension contributions and to the creation of small pots with different pension providers. Apart from the administrative challenges, such a fragmented base makes the economies of scale enjoyed by the big Dutch, industry-wide schemes difficult to emulate.

In the 2014 PPI report, “How will AE affect Pension Saving”, it was estimated that 57% of private sector savers would be members of AE multi-employer schemes in 2018. While some employers, especially larger ones, might choose to keep their own schemes, the more likely route in a DC world is to offer membership of a scheme run by a third party.

### Different categories of workplace pension schemes

<table>
<thead>
<tr>
<th>Pension Type</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trust-based Pension</td>
<td>A pension scheme taking the form of trust arrangement, which means that a board of trustees is set up to govern the scheme. Benefits can be either defined contribution or defined benefit.</td>
</tr>
<tr>
<td>Contract-based Pension</td>
<td>A defined contribution pension scheme purchased by an individual, either through their employer or individually, from a pension provider. It is owned entirely by the individual with the contact existing between the individual and the pension provider.</td>
</tr>
<tr>
<td>Defined Benefit (DB) scheme</td>
<td>A trust-based pension scheme that provides benefits based on a formula involving how much a person is paid at retirement (or how much a person has been paid on average during their membership of the scheme) and the length of time they have been in the pension scheme.</td>
</tr>
<tr>
<td>Defined Contribution (DC) scheme</td>
<td>A trust-based or contract-based pension scheme that provides pension scheme benefits based on the contributions invested, the returns received on that investment (minus any charges incurred) and the rate at which the final pension fund is annuitised.</td>
</tr>
<tr>
<td>Hybrid scheme</td>
<td>A private pension scheme which is neither pure defined benefit nor defined contribution arrangement. Typically a hybrid scheme is a defined benefit scheme, which includes elements of defined contribution pension design.</td>
</tr>
<tr>
<td>Group Personal Pension (GPP)</td>
<td>An arrangement made for the employees of a particular employer, or for a group of self-employed individuals, to participate in a personal pension (DC) scheme on a grouped basis.</td>
</tr>
</tbody>
</table>
A personal pension (DC) that was required to meet certain legislative conditions including an Annual Management Charge (AMC) of no more than 1.5 per cent. Prior to the workplace pension reforms, employers with five or more employees who did not already offer a pension scheme were required to offer a GSHP.

Source: PPI; Pensions Regulator; DWP

The advent of AE has provided a boost for the multi-employer model in the UK. Three trust-based, multi-employer schemes that have entered the AE market are:

- NEST (National Employment Savings Trust), backed by the UK government. It ensures that every employer has somewhere to go for AE pension provision. It announced on 25 March 2015 that it had enrolled 2m members.

- The People’s Pension, from B&CE, which first established itself as a stakeholder pension provider to employers with transient workers – its roots are in the building and construction industry. Operated on a not-for-profit basis, it had over 1.2 million people auto-enrolled by February 2015.

- NOW: Pensions, launched by ATP, one of Europe’s largest pension providers, which manages Denmark’s national supplementary pension, giving it experience of mass market provision.

**Different DC scheme structures**

**Trust-based**
These schemes are run by a board of trustees, who oversee scheme administration and investment of the money, typically hiring external fund managers. They have a duty to get the best value for members.

**Contract-based**
The employer appoints a pension provider, such as an insurance company, to run the scheme. Although sometimes called “group personal pensions”, the contract is not between employee and employer, but between the individual and the pension provider.

**The challenge of extending AE to micro-employers**

Pulling together members from thousands of employers is not easy, however. NEST’s 2015 Insight report, “Taking the temperature of auto enrolment”, points to the challenge as the number of employers joining the AE system ramps up:

“There are approximately 1.3 million employers with fewer than 50 workers likely to stage over the next few years. 84% of these businesses employ fewer than ten workers and in fact 64% employ fewer than five workers.”

According to its survey evidence, only 18% of small and micro employers “feel they completely understand what it means for their business”. Many will use an accountant or IFA to help them through the process.
However, because NEST was launched by the government, with a loan from taxpayers, it has had restrictions placed upon it to avoid it being seen as having an unfair advantage over the competition. The need to repay the loan – £299m at the end of March, 2014 – is reflected in its fee structure, which includes a 1.8% upfront charge on contributions. The charge on assets under management is relatively low at 0.3%, so it claims an effective blended rate of 0.5%. Restrictions on transfers of pension savings from other schemes to NEST and the cap on contributions to NEST – £4,600 in 2014-15 – are set to be lifted by April 2017.

**Recommendation:** The loan should also be forgiven to enable NEST to remove the high upfront charge and simplify its fee structure.

Baroness Altmann, when “older workers business champion”, spelt out the drawbacks of the restrictions in this way:

“It is not financially sustainable for NEST to only be there to take the pension contributions that nobody else wants. It has a public service obligation to serve all employers who want to find an auto-enrolment scheme, but if it ends up only having the worst employers, with mostly low-paid short-stayers, it will have insufficient assets to function with the necessary economies of scale.”

For Morten Nilsson, CEO of NOW: Pensions, the main issues are the exclusion of about five million workers from AE because they earn less than £10,000 (many of them could opt in). He is also concerned about the size of contributions, lobbying for the 8% to apply to all earnings, not just those above £5,772, and for the minimum
contribution rate to be raised to between 12% and 15%. In Denmark, the average contribution is 15% with a typical split of two-thirds employer, one-third employee.

Darren Philp, head of policy at B&CE, provider of The People's Pension, has focused on the issue of pot aggregation. He told Pensions Expert in January, following the government’s limited proposals for “pot follows member”, that: “An automatic transfer without the automatic element seems to be a half-baked idea.” He advocates a pensions register to bring pension information online in one place.

The insurers

Established players in the market for contract-based workplace pensions include Aviva and Friends Life, which are merging, Aegon, Legal & General, Prudential, Scottish Life, Standard Life and Zurich. All were involved in working groups set up by the DWP to consider how best to consolidate pension pots. Standard Life, for instance, added 340,000 AE pension savers in 2014, taking its total workplace customers to 1.8m.

Aggregation: pot follows member

In a perfect world, lifetime saving would start with the individual, not with the serendipity of who his or her early-career employer might be. From the saver’s point of view, there are clear advantages in being able to see all pots of money in one place and to consolidate pension savings by transferring funds to the preferred one(s). Lower costs should flow from easier administration of fewer, larger pots and there is less risk of mistakes such as losing sight of dormant pots.

Outside the experience of long-serving members of well-run large DB funds, the UK has a way to go to achieve this ideal. Not only do people have both DB and DC schemes, but the latter take several forms – personal as well as workplace-based. For example, stakeholder pensions were introduced in 2001 and heralded some reforms that have been picked up under AE: a charge cap, a default investment option and the ability to transfer the pot.

As a workplace-based scheme, AE could aggravate the problem. Steve Webb, pensions minister, said in “Automatic transfers: A framework for consolidating pension savings” (DWP, February 2015): “We expect 50 million dormant pots by 2050 if nothing is done.”

How can this fragmented scene be rationalised? A 2013 report for the Centre for Policy Studies, by Michael Johnson, said it all in the title: “Aggregation is the key”. Johnson
proposes a central clearing house and database to enable individuals to pool their pension pots and see their total savings in one place. He cites the Netherlands Pensions Registry as a model. The Dutch created a Uniform Pension Overview, which shows each pot and the income that could be expected. The information is derived from a pensions register, which requires pension schemes to send details of members’ pots to it.

In the UK, the individual’s preferred or default aggregator would appear on his or her P45, so that a new employer would automatically know where to direct contributions. The self-employed and others with SIPP should be able to plug in, making it easier to transfer pension savings from one provider to another.

This would suit not only savers but employers, whose main business is not pensions administration. They could simply direct contributions to employees’ pots held within a third-party aggregator. This would enable them to shut workplace schemes. Staff pensions would become a routine collection service, as with NICs (unless the employer makes a conscious decision to run its own scheme as part of its staff incentive package or corporate culture). This report supports Johnson’s vision.

Resistance has come from the financial services industry, which makes money out of inertia by keeping legacy pots and would incur additional costs by having to administer more frequent transfers. The industry also needs to invest in IT systems, security protocols etc so that actual or virtual aggregation can be achieved at an acceptable level of cost and risk.

**Government’s “pot follows member” plan lacks ambition**

The DWP’s proposals for a system of automatic transfer of small pension pots when a member changes jobs is set out in “Automatic transfers: A framework for consolidating pension savings”. The “preferred approach” is for a “federated” model: a network of interoperable registers that will hold information about pension pots eligible to be automatically transferred.

The (unconvincing) arguments given for preferring a network to a central register include:

- A centralised register would risk there being a single point of failure.

- A federated model allows for registers to operate in different ways according to the different needs of sections of the pension market.

- A single register may not keep up to date with technological advances.
The network will comprise approved schemes (charge-capped default funds), so the cost of performing due diligence on the receiving scheme will be removed. Other costs will be saved through standardised processing and electronic transfer of funds.

Pots will only be eligible for transfer if:

- the first contributions were received on or after July 2012 (start of AE);
- the pot is worth £10,000 or less;
- the pot is invested in a charge-capped default arrangement.

Phase One of implementation will involve the 20 largest third-party administrators. In Phase Two, the search for eligible dormant pots will take place automatically and the transfer will happen automatically unless the member chooses to cancel it.

This is a missed opportunity to aggregate all an individual’s pension savings since there are so many exclusions. The good thing is that it requires both the saver and the pot to be identified and recorded on an electronic database, which lays the foundations for a central database.

The same identification requirements should be extended to all pension pots, including the small self-administered schemes and self-invested personal pensions commonly used by the self-employed. Each one could be incorporated into the database along with state pension entitlement. This would enable savers to access a comprehensive “pension dashboard”.

Eventually the UK might catch up with New Zealand, where the Commission for Financial Literacy and Retirement Income runs a website called Sorted. This allows the user to plug in his or her debt as well as savings, promoting the use of the latter to pay off high-interest consumer debt.

Pension Tracing Service

The Pension Tracing Service, a free government service that helps people find lost pension funds, trebled its staff in early 2015 (to fewer than 50 people). The PTS aims “to put customers back in touch with their lost pension provider”, so it is only a first step and in more than 1 in 10 cases it does not succeed. The individual still has to contact the provider, establish what is in the pot and decide what to do with it.
Recommendations:

- **The new government should revisit the DWP’s current plans for “pot follows member”**. The arguments against a central database do not look convincing, unless the proposed network can effectively become one through standardisation.

- **The new network and the PTS need to work together to identify all pension savings and create access to a comprehensive pensions dashboard for savers, to which other elements – ISAs, debt – could be added.**

- **Restrictions on transfer of pots should be lifted, other than that money has to be transferred to a regulated pension fund.**

- **Ways should be explored to encourage the industry to make the necessary investment to upgrade technology.**

**A better way?**

It is worth asking whether the employer should be further removed from the individual’s choice of retirement savings manager. Some people have funds (a legacy, for instance) that could be invested before they start work; others go straight into self-employment. They could choose from a list of schemes that meet The Pension Regulator’s qualifying criteria for AE.

NEST could formally be the default fund. After all, it was born out of a Pensions Commission recommendation, in 2005, that a National Pension Savings Scheme be created, into which employees would be automatically enrolled. An alternative, developed in Chile as a mechanism to cut costs, is for the regulator to run a rolling auction process.

A trusted party other than the employer might also choose, or be chosen as, the fund administrator. More stable, or relevant, relationships than the employer for this purpose might be professional organisations, or favourite brands such as John Lewis; or the individual could go directly to an insurer or investment manager. Since the financial crisis, regulation to protect savers has been tightened, and it is worth remembering that insurers are more tightly regulated than corporate pension schemes.

Anything that facilitates individual choice fits better with a world where people not only change employer regularly but switch between different types of employer, and mix employment and self-employment.
Chapter 6: Charges and investment issues

Investment returns come net of fees and that is where attention has focused in the past few years. The reasoning is that in a low inflation/low interest rate world, with both bond and equity prices at relatively high levels (at the time of writing), nominal returns are likely to be lower than they have typically been since the Second World War. A charge of, say, 1.5% a year on assets under management consumes a noticeable chunk of single-digit returns. Just as investment returns compound over the years, so does the amount eaten away by charges.

Downward pressure on charges

John C. Bogle, founder of the Vanguard Group, tackled “The Arithmetic of ‘all-in’ investment expenses” in an article for the Financial Analysts’ Journal (Volume 70, Number 1, January/February 2014). Not surprisingly, since Vanguard is a passive fund manager, he compared costs for active versus passive management. He estimated the former at 2.27%, with about half being the annual expense ratio and the rest made up of transaction costs, intermediary sales fees and “cash drag” – missed returns on the amount kept in cash. He put the cost of an index fund at less than 0.1%.

He takes as an example a 30-year-old investor, earning $30,000 at the outset, with 3% annual pay growth, and saving 10% of her salary a year over 40 years. The gross annual returns (based on equity investment) are assumed at 7%. After 20 years, her actively managed fund would be $130,000, some $34,000 less than in an index fund. After 40 years, $561,000 pales beside $927,000. The outcome is nearly 40% less.

In the UK, an OFT study of the DC workplace pension market (September 2013) identified several other problems. These included that charges were often too high in older schemes and for those with deferred pensions. This has triggered a regulatory clampdown on differential charges, as well as a focus on the annual management charges for DC default funds.

The upshot is a government-imposed annual charge cap of 0.75% on workplace DC pension schemes. To implement this and other reforms from April 6 2015, the Financial Conduct Authority (FCA) has published the following measures (“Final rules for charges in workplace personal pension schemes and feedback on CP14/24”, March 2015):
- a cap on charges within default funds equivalent to 0.75% per year of funds under management;
- preventing firms from paying or receiving consultancy charges;
- preventing firms from paying commission or other charges for advice that are not initiated by scheme members;
- preventing firms from using differential charges based on whether the member is currently contributing or not.

The cap excludes transaction costs and non-standard services. With NEST and the other low-cost AE players using 0.5% as their effective annual charge, some of the insurers that have established themselves in the group and stakeholder pensions markets, including Legal & General and Aviva, have already moved to a similar level. There is also scope for a challenge to the model of charging a percentage of assets under management via a flat-rate charge for annual fund management, with variations determined by the level of service required.

EU regulation requires, in key investor information documents, disclosure of: ongoing (annual management) charges; performance fees; entry and exit charges; and transaction costs.

The UK-based Investment Association (formerly the IMA) recommends further explanations and breakdowns of the charges, and that stock lending fees should not be used to offset management charges.

The Pensions Institute, in “VfM: Assessing value for money in defined contribution default funds” (January 2014), while pointing out that cheapest is not necessarily best, said the total expense ratio (TER) “is a key determinant of the default fund’s outcome” in terms of providing replacement income. “As a rough rule of thumb, each percentage point increase in the TER leads to a fall in the expected replacement ratio at retirement of about 20%”.

The downward pressure on asset management charges for AE default funds will continue because 0.75% remains much higher than the charges paid either by large institutional funds or by individuals using popular passively managed funds. There is no need to legislate for this, since it can be achieved by competition now that disclosure has improved; and there is scope for different charging models.
How will the growing pile of DC funds be invested?

Other aspects of value for money identified by the Pensions Institute included a multi-asset default fund, expert independent governance and effective member communication. This report takes it as read that long-term saving funds should be expertly run in savers’ best interests and that communication with them should be good. Asset allocation models are worth a closer look.

In following a multi-asset approach (with equities and bonds as the main components), the AE pension providers are joining a bandwagon that seeks to limit risk and volatility through diversification. Over the long term, returns look adequate for AE purposes. A recently published book “Global Asset Allocation” by Mebane Faber, of Cambria Asset Management, examined several popular models, including those of Mohamad El-Erian, Mark Faber and Rob Arnott. Over a period of 30 years to 2013 the annual real return averaged between 5% and 6%, although it was a bumpy ride. The most successful, El-Erian, experienced the worst temporary drop in value – 46.5% during the financial crisis. Others generally limited the fall to 23-29%.

John Authers, in an article for the Financial Times (4 March 2015), concludes: “The remarkable fact jumping out of this exercise is that all these apparently diverse strategies ended up delivering startlingly clustered results by the end of 30 years.” The other significant message is the importance of fees: the performances are close enough together – less than a percentage point apart – to suggest that a significant difference in charging levels could wipe out any superior returns.

AE is expected to drive rapid growth in the amount of assets in DC workplace pension schemes, as the number of members mounts and contribution rates increase. According to the Towers Watson “Global Pension Assets Study 2015”, the UK – the world’s second biggest pension fund market after the US – had $3.3 trillion (£2.2 trillion) assets under management (AUM) at the end of 2014. The split between those in DB or DC funds (of all types) was 71% to 29%; and the asset split was 44% equities, 37% bonds, 15% other and 3% cash. Ten years earlier the equity and bond proportions were 67% and 24%.

Source: Towers Watson
Narrowing it down to workplace schemes, on the DB side just over 6,000 funds covered by the Pension Protection Fund had £1.14 trillion assets AUM at the end of March 2014, according to the regulator’s Purple Book. This report also shows the swing away from equities: “Between 2006 and 2013, there was a marked fall in the share of equities in total assets (from 61.1 per cent to 35.1 per cent) and a marked rise in the share of gilts and fixed interest (from 28.3 per cent to 44.8 per cent).” And within the falling equity portion, the share of UK equities declined for six straight years to 28.9% in 2014.

The Purple Book points out that these DB schemes are “mature”, with only 13% taking new members and, as it comments, “more mature schemes tend to invest more heavily in gilts and fixed interest and less in equities”. Workplace DC schemes are set to multiply AUM from less than £300bn and overtake DB schemes in the 2020s. One forecast is for AUM to amount to £1.7trillion by 2030.

How will these funds be deployed? Not only are these schemes “immature” – growing and with plenty of young members – but the new “pension freedoms” mean that many will leave funds invested in a wide range of assets after what is now regarded as retirement age. This long-term investment horizon should favour the allocation of funds to riskier assets, such as equities, and to illiquid assets, such as infrastructure.

But NEST has found, through surveys, that many new members of AE DC schemes are not comfortable with the idea of “investment”. They are nervous about taking risks: “some of our members associate putting their money into the stock markets with a high chance of losing it,” as its “Looking after members’ money” document says. It has to square this with the belief that “taking investment risk is usually rewarded in the long term”.

NEST uses retirement date funds, based on people wanting to take a retirement income from their private DC pension fund at state pension age. This looks like a rearview mirror approach, but at least it assumes a relatively long investment period for the younger half of its target membership.
NEST believes that people will be nervous about losing money in the early years. Later, as they approach their target retirement date, their reduced earning potential gives them less opportunity to counter market downturns. For these reasons it divides its investment approach into three. In the first, five-year “foundation” phase, it aims to keep pace with inflation while preserving capital, and to limit volatility. In the second, “growth” phase, it targets returns (net of charges) of inflation plus 3% through a diversified portfolio. The third “consolidation” phase typically begins 10 years before the scheme member’s retirement date fund matures. Investments are gradually switched out of higher-risk assets, with the objective of outperforming CPI after charges, while aiming progressively to dampen volatility.

Only the younger members will have time to fit in these three phases, so the approach for more mature investors will be more conservative.

The aim is to build trust and to avoid prompting nervous savers to opt out. This points to the disadvantage of voluntary contributions, compared with the mandatory arrangements in some other countries (eg Australia and Chile). It also means that there is a big communications challenge in explaining to people that the best long-term outcome may entail short-term losses.

### Long-term investment issues

In some ways, the target-date approach to investment echoes the trend towards liability-driven investment in the DB world. Both also share the one disadvantage of transparency: short-term gyrations in asset values are highly visible. Combined with fund managers’ focus on relative performance, these factors are a distraction from thinking about long-term investment returns and fundamental value.

Ashok Gupta, chairman of AA Insurance Services and vice-chair of the Bank of England working party on procyclicality, in an article for Financial World magazine...
(April/May 2015), talks of “fundamental misreadings of the risks to which long-term investors are exposed”. They stem from the failure to distinguish between investment risk (of permanent loss in value) and market risk (volatile prices). The result is too much emphasis on avoiding volatility: “It is often a good time to buy after prices have fallen significantly – when the investment risk is relatively low even if the absolute amount of price volatility is high.”

In “The Market for Lemmings: Is the Investment Behavior of Pension Funds Stabilizing or Destabilizing?” (Sept 2014), the Pensions Institute pointed out that when institutions behave in the same way, it has an impact on prices. Pension funds tend to herd because of their similar investment approaches: the short-term objective of sticking to a pre-ordained asset allocation mix leads to mechanical rebalancing in response to market price movements. The long-term objective is also mechanical (or unthinking as some analysts have described it): to switch from equities to bonds.

Like Paul Woolley, at the London School of Economics (see “Long-term battle to drive out short-term risk”, Financial Times, 13 March 2013), who extends the argument to momentum investing and index-tracking, the Pensions Institute’s concern is that pension funds are failing to form a view on whether prices have moved away from fundamental value. The impact of herding is to exacerbate swings in asset prices, even though it smooths the relative performance of one fund manager compared with another. Refocusing on real returns, plus compensation for risk, over the long term should have the best chance of achieving what the pension saver wants in the new world: a pot that, by the time their version of old age approaches, is significantly bigger than the amounts put in.

With individuals, pension fund trustees, sponsoring companies and fund managers tending to focus on current asset prices, how can patience be restored – and nerves calmed among AE scheme members?

The first approach is to remember two important points about workplace pension saving: a) funds are locked in until a person reaches at least 55 (57 by 2028) and b) contributions from employers and tax rebates cushion losses.

The second is also two-pronged and relates to explanation and presentation: a) far more courage is needed in explaining the risk-reward equation, including that aiming to buy low and sell high means being willing to take a contrarian position. When people buy houses, they do not panic and sell when prices fall or take profits when they rise. A pension fund is like a house: part of long-term asset accumulation; b) returns should be presented as income and capital gains/losses. While the latter may be dictated by market prices at the start and end of the period, other perspectives on value could be presented eg amortised cost (impairment tested) for assets that will be held to maturity – like a bank’s loans; or a discounted cash-flow (net present value) model for illiquid assets, similar to “level 3” accounting for bank assets with no ready market price comparisons.
The residual problem is that if people stick unthinkingly to their target retirement dates, they risk crystallising investment losses. According to Peter Morris and Alasdair Palmer, in “You’re on your own” (Civitas 2011): “An employee who happened to retire in March 2009 could easily end up receiving a pension only half that of a colleague who had saved the same amount and invested it the same way but who retired in October 2007.” Recent liberalisation has ensured that no-one is compelled to buy a poor-value annuity at any particular date. But because the outcome of DC saving is inevitably uncertain, the message should be that flexibility is needed over when, and how much, to draw on funds to supplement the state pension.

The common response in the current world is for NEST and other “target date” pension saving providers to move savers out of equities and other “return-seeking” – but riskier and more volatile – assets as they approach retirement. Is this appropriate in the new world of continued earning, an investment horizon of two to three decades and a move to income drawdown from invested funds?

All these communication challenges are just as great as the one addressing the early opt-out issue.
Chapter 7: Retirement Income

If auto-enrolment is the big idea for the “accumulation” – or saving – phase of retirement planning, then freedom of choice in using those savings post-55 is the big idea for the “decumulation” – or income – phase. What links the two policy changes is the pressing need to make saving for later life more attractive. Lack of freedom in how pension savings could be used and disappointing levels of annuity income had become serious deterrents.

The key changes made by the 2010-15 coalition government to liberalise access to pension savings are:

- Allowing the whole fund to be taken out in cash, with any amount over 25% treated as income for the year, which might push the individual on to a higher rate.

- Detaching access to a 25% tax-free lump sum from the need to use the rest to buy a secure retirement income. This greatly expands access to flexible income drawdown, which was already available to people with pension funds worth £100,000 or more.

- By breaking the link between access to cash and purchasing an annuity, a range of options has been opened up, including delaying taking an income, taking sums out on an ad hoc basis and leaving funds invested in riskier assets.

- Unused pension fund money can be passed on to heirs without the punitive 55% tax rate that used to apply. It can be passed on tax-free if death occurs before the age of 75.

- Money can be taken out of a DB fund and transferred to a DC arrangement (albeit with advice and other safeguards). This cements the new view of pension savings as belonging to the individual, rather than being part of a collective fund that pools longevity, investment and other risks.

Individual choice

Since this has opened the door to individuals taking out funds in different ways once they reach 55, much of the literature has focused on the diversity of options, although the main categories remain annuities, drawdown and cash. In this product comparison world, “shopping around” is keenly encouraged by the regulator as a means of enhancing both competition and value for money for consumers. However, because this approach remains predicated on “retirement” and on how well the market for products is working, it misses other important aspects of the individual’s decision.
The first is that the abolition of the default retirement age of 65 has not only pushed back perceived limits on working life, but also allows a lengthy transition period between full-time work and ceasing to work.

The second is the individualisation of the process. The idea that one pattern is appropriate for everyone is highly questionable. Variables include: earning capacity, level of debt, family obligations, housing and other sources of private wealth, entitlement to benefits, care needs and tax rates. In the decumulation phase, the only unifying element is the state pension.

From an individual’s point of view, several factors must be considered before deciding what type of retirement income product to plump for and at what point in time. Some of this is captured by the Government’s new guidance service, Pension Wise, in its “6 steps you need to take”. Notably:

“Plan how long your money needs to last: Your costs and financial needs are likely to change during retirement. You need to think about when you’ll start taking money from your pension pot and how much you’ll need at different times.”

Perhaps unwittingly, this also captures the difficulty of planning for the last two to three decades of life because those “likely” changes are unpredictable.

The ABI Code of Conduct on Retirement Choices focuses on the “retirement process”, triggered by the customer’s “selected retirement date” (SRD). This target date is likely to have been chosen many years ago, when there was a default retirement age of 65, early retirement was more common and life expectancy was less, and before the state pension age had started to rise.

The “wake-up” and “follow-up” packs that arrive in the run-up to the SRD focus on retirement options and decisions that must be made. Actually, as Baroness Altmann has stressed, there are significant benefits to doing nothing. If a person continues to work, the only “decision” to be considered at 55 is whether to take out a lump sum. A key point here will be whether it makes sense to use it to pay down debt, notably the mortgage.

People take important financial decisions throughout their lives relating to work, family, home ownership, buying on credit, balancing the weekly budget and what to do with any surplus. So the “customer journey” should start where it always has done – with income and outgoings. The older a person gets, the bigger the question mark over their income, but their outgoings may shrink – as the children leave home and the mortgage is paid off. In investment terms, their risk appetite might actually rise because they have fewer obligations.
The retirement date fades

Because the connection is broken between taking a lump sum and taking retirement income, the idea of a “glide-path” approach to a pre-selected retirement date becomes questionable. Exhortations to shop around have already encouraged people at least to consider a break between the firm(s) that has managed the savings and the one(s) that provide income in retirement. This, in turn, suggests a break with the conventional view about the investment approach for people deemed to be approaching retirement. Why switch investments into government bonds and other low-risk fixed-income assets if a) no income is needed and b) the investment horizon at 55 is three decades?

Target retirement dates will still be fed into models to illustrate what size of pot is needed to secure a certain retirement income or annuity. As that idea fades, however, the focus must shift away from a selected retirement date and towards simply building up the savings pot. The savings manager will need to accommodate the different risk appetites of its customers, dictated by personal circumstances (including, but not driven by, age). This profiling, which involves cross-checks against the household budget, is increasingly being automated. To supplement it, savers in AE schemes might benefit from earlier access to the sort of interview service now being offered by Pension Wise to the 55-pluses.

Recommendation: Policy-making and communication with the public needs to shift away from a stereotypical view of people retiring at the state pension age, and towards helping them make rational financial decisions based on their individual circumstances. The government-backed Pension Wise and Money Advice Service should work together on this.

The end of annuities?

Ask people what they want from their retirement saving funds and most will say a guaranteed income for as long as they live. In January 2015, a survey of 5,000 people by the International Longevity Centre found almost 70% of respondents, aged 55-70, favoured guaranteed income over one that rises and falls with the markets.

In the past three decades or so, however, three things have happened to mar the practical implementation of that wish in the private sector. The first is increased longevity: the income has to be spread over more years and the level of disappointment is exacerbated by people’s tendency to under-estimate their life expectancy. The second is falling interest rates, particularly on long-term bonds offered by governments and other low risk borrowers. These fixed-income instruments are the best matches for the cash payouts required by annuitants.
The third is regulation designed to ensure that pension promises are always delivered, with no ability to flex the outcome. It may sound obvious, but a guaranteed income – as with traditional annuities – is much more expensive to provide than a target income with inherent flexibility. The much-admired Dutch system offers the latter. It is worth noting that members of its large collective DC schemes suffered, on average, a cut of about 2% in income after the financial crisis. However, the system overall (also benefiting from economies of scale, investment flexibility and low charges) has delivered pensions about 50% higher than those achieved in the past by members of UK individual DC schemes, according to David Pitt-Watson, in his work as leader of the “Tomorrow’s Investor Project” for the Royal Society of Arts (the pros and cons of collective DC are discussed in Chapter 8.)

The upshot is that annuities for individual savers in the UK are perceived as very poor value for money. Alan Brown, when a senior adviser at Schroders, pointed out in the FT in 2012 that the yield on a UK equity income fund was higher than a 65-year-old man would get for an inflation-linked annuity, with some protection for his spouse; and he would retain ownership of his capital in the equity income fund. At a CSFI round-table on annuities in 2014, it was pointed out that a 65-year-old with £100,000 to spend on an inflation-proofed annuity would receive an initial income of only £3,600. He would have to live to 93 just to get his money back in real terms.

The consultant Ned Cazalet, in a report entitled “When I’m Sixty-Four” (September 2014), summarised the squeeze on annuity rates as follows:

“A combination of increasing life expectancy and reducing nominal interest rates has squeezed the life out of annuities, as measured by the nominal return

$$\text{Government bond yields (%)}$$

Source: Thomson Reuters Datastream
IRR [internal rate of return] to assumed life expectancy, which was as high as 13% for a new male annuitant in 1981 and is close to 0% today meaning that, if the 65 year old dies ‘on cue’ having attained his life expectancy, he would do not much better than simply get back from the insurer what he paid in, but with no interest and no ‘illiquidity’ compensation for suffering permanent lack of access to his funds.”

Source: Cazalet Consulting

Work by the FCA on the annuities market initially focused on encouraging people to shop around, rather than simply purchasing an annuity from their pension saving provider. But a decade of monitoring showed that, by 2014, a stubborn one-third of DC pension savers still failed to do so. On average they could have achieved an income nearly 7% higher on the open market; for people with health problems, shopping around for an enhanced annuity would have delivered an income 8.3% better, on average.

Table 1: Estimated annual income gains by consumers from purchasing an annuity on the open market

<table>
<thead>
<tr>
<th></th>
<th>Standard</th>
<th>Enhanced</th>
<th>All annuitants</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average fund size used for annuity purchase</td>
<td>£17,000</td>
<td>£26,800</td>
<td>£17,700</td>
</tr>
<tr>
<td>Average annual income achieved from existing pension provider</td>
<td>£1,000</td>
<td>£1,630</td>
<td>£1,030</td>
</tr>
<tr>
<td>Average amount of annual increase in income</td>
<td>£67</td>
<td>£135</td>
<td>£71</td>
</tr>
<tr>
<td>Average proportion annual income could be increased by</td>
<td>6.7%</td>
<td>8.3%</td>
<td>6.8%</td>
</tr>
</tbody>
</table>

Source: Financial Conduct Authority; Thematic review of Annuities
This table illustrates another key part of the problem: the sum available to purchase an annuity is typically small (and the smaller the pot, the worse the deal). According to the ABI, the average amount used to purchase an annuity in 2013 was £35,600, with the median at only £20,000.

By the time of the Budget in March 2015, so unpopular were annuities that the government expanded its previous decision to abolish the requirement to buy them. George Osborne, Chancellor of the Exchequer, announced a plan (being consulted on at the time of writing) that would give about 5m pensioners the option to sell their annuities for cash. A survey by the advisory firm, Portal Financial, of 1,000 retired and non-retired respondents found that 569 would consider selling their annuity. Of those, 50% would do so because the value of their annuity was too small.

The chart below shows the drop in the number and value of annuities sold since liberalisation of access to funds was announced. The numbers continued to fall in the latter half of 2014. In the fourth quarter, only 28,712 annuity contracts were total premiums sinking to £1,204 million.

_number and value (£m) of annuities sold, 2010 Q1 to 2014 Q2_

![](chart.png)

Source: ABI
Longevity insurance

The debate about annuities has bundled together a number of issues related to ageing. The first is longevity insurance. Jason S. Scott, in the Financial Analysts Journal (2015 71(1)), explains that insurance gets more expensive the more likely the payout, so a guaranteed income stream for a 65-year-old is bound to be costly. His suggestion is to buy income provision to provide cover for very old age: applying, say, from age 100 backwards. One thing is certain: the market for deferred annuities is set to grow.

If longevity insurance is combined with an annual income guarantee, then the customer is buying investment management and a risk-free income over a potentially long period. Edmund Cannon, at the University of Bristol, defended this traditional annuity product in an article for Financial World (April/May 2015). He emphasised the risk of living beyond average life expectancy of 22 years for a man of 65. “The key point is the uncertainty: there is a 25% chance that a male will live beyond the age of 92.” The insurance works by redistributing from the short-lived (25% chance of dying before 81) to the long-lived.

He raised two questions about the policy of having no compulsory purchase of annuities. The first concerns tax relief: if compulsion is a quid pro quo for generous tax relief on pension saving, why should the state continue to be so generous if the risk to the taxpayer is increased by allowing those savings to be exhausted earlier? The answer to that, as explored in Chapter 4, is to be less generous with tax breaks and to raise the state pension to a level that lifts more pensioners out of benefits.

The second, related, question is how this increased risk interacts with benefit claims: has the pensioner deliberately run out of savings early, or suffered bad luck? This risk is discussed in a DWP factsheet published in March 2015: “If you spend, transfer or give away any money that you take from your pension pot, DWP will consider whether you have deliberately deprived yourself of that money in order to secure (or increase) your entitlement to benefits.” The DWP’s rules for assessment of capital regard it as reasonable, for instance, to pay off a debt or buy a new car, but not to give away money to someone else.

The need to review this complex interaction and to simplify it is also covered in chapter 4.
Income requirements

There is much debate over patterns of spending among older people. Do they spend less because they earn less, or more because they have greater leisure time? Does the pattern have a V-shape: starting high to maintain living standards, dipping as capacity/wants taper and then rising to cover care expenses? Whatever the pattern, continuing to earn will help, hence the welcome abolition of a default retirement age of 65. Baroness Altmann, in a report to the government entitled “A new Vision for Older Workers: retain, retrain, recruit” (March 2015), advocates flexible working, apprenticeships for older workers and action against age discrimination.

Since earning and spending patterns vary, so does the need for a supplementary income. Annuities can still have a place here, but perhaps for shorter, fixed terms. One of the commentators at the CSFI round-table on this subject pointed out that annuities were typically designed for up to 15 years, not the much longer periods that have resulted from increased longevity. Apart from giving the purchaser a better deal, this approach would work more flexibly with other funds that might become available, including legacies or releasing equity from a house, as well as income from work.

It is also easier for people to understand how a fixed-term annuity works. An income offered over ten years in return for a £50,000 upfront payment can be compared with a back-of-the envelope calculation: £5,000 a year plus an expected annual return on an average £25,000 of savings. The difference between a guaranteed annuity income and leaving the funds invested – but at risk – can then be weighed up.

There is also scope for the government to enter the annuity market via its Debt Management Office, with sales to individuals made through NS&I or the Post Office. This would expand direct sales of government bonds, which offer a yield and a capital asset, to 100% income provision in return for the upfront sum, with a variety of durations available and an index-linked option.

Recommendation: the direct sale of annuities to individuals via the government’s Debt Management Office should be seriously considered.

If evidence accumulates that early exhaustion of funds is hitting the benefits system, then remedies could include raising the age at which access can be gained to private pension pots. It is already due to rise to 57 in 2028, keeping it a decade ahead of the state pension age. This gap could be closed, but it has the advantage of giving people access to their own money in the period before the state pension can be claimed. While employment among 50-65 year-olds is rising, some will still be made redundant and have difficulty finding alternative work. Reducing outgoings through debt reduction might be one way to cope.

Allowing flexible access from 10 years before the state pension age is in line with covering a long transition from full-time work to ceasing to work, and with accommodating a wide range of individual circumstances.
**Drawdown and other products**

*Income drawdown*
The income drawdown product is also known as “flexi” or flexible. Savings stay invested and the individual decides how much to draw down monthly, annually, in lump sums, or not at all. There will be initial and ongoing charges. Excluding the tax-free tranche, withdrawals are taxed as income. The saver continues to run the risk of the underlying assets falling in value. Drawdown funds can be passed on at death, untaxed if that occurs before 75.

If the individual does not want to “crystallise” savings by buying a drawdown product, an alternative is to take an “uncrystallised funds pension lump sum”. This mechanism can also be used if the provider does not offer drawdown.

Hybrid products are available that use part of the pension pot to buy an annuity-style guaranteed income and leave the rest as an accessible investment; or a variable annuity may be bought where income is linked to investment performance. Bundled products may incur additional charges.

*Equity release*
Since most people’s homes are worth more than their savings, an obvious option is to convert the asset into income. With a lifetime mortgage, the loan – usually up to 60% of the property’s value – and accrued interest are repaid when the customer dies or sells the house. Home reversion is where the house, or a portion of it, is sold to a company in return for a lump sum or regular income. The percentage of market value offered varies widely.

*Cash*
Whether it’s Steve Webb’s Lamborghini comment or the popularity of the buy-to-let market, freedom means having access to the cash. But beyond the tax-free lump sum, withdrawals are taxed and could tip a person into a higher tax band. That, combined with trust that people will want to use their “retirement” fund to top up the state pension, is regarded as sufficient incentive not to “blow the lot”. The worst case scenario is that the withdrawn cash gets sucked into some investment scam. The FCA is keeping a close eye on this.
Chapter 8: What ever happened to “Defined Ambition”?

When the CSFI pensions programme was launched, the then pensions minister, Steve Webb, had started a debate about “defined ambition”. It tackled the issue of employers and employees being caught between a rock and a hard place over saving for pensions. The defined benefit version, where decades of regulation have hardened promises, is regarded as unaffordable for employers; the lack of certainty over retirement income from defined contribution schemes is seen as scary for employees.

Employers are solving the first problem by closing DB schemes. While in the Netherlands many DB plans were converted into “collective defined contribution” (CDC) schemes, this has not happened in the UK. Indeed, the UK government examined but rejected the option for “flexible DB” in 2014 (following the DWP’s consultation, “Reshaping Workplace Pensions for Future Generations”). Even though some “flexibility” has been allowed over DB liabilities, the main sticking point is:

“to make enough of a difference to employers, the suggested changes would need to apply to accrued pension rights. We are absolutely clear that we will not be making changes that affect past accruals that could reduce the pension benefits that individuals have already built up with their employer.”

UK employers have a bitter experience of the way targeting a retirement income can metamorphose into hard promises, with a heavy burden in costs and balance sheet stretch. Few believe employers will ever again enter into new obligations to “share risks” with employees. For the vast majority, their contribution will stop literally at their contributions.

Pros and cons of collective saving

This leaves the second problem, uncertainty of retirement income for individuals. Peter Morris and Alasdair Palmer set out the issues starkly in a 2011 paper for Civitas, entitled “You’re on your own”. It compared outcomes for twins, Brian and Colin, who both work for private sector companies for 40 years. Brian joins his employer’s DB pension scheme (which pays out two thirds of final salary at retirement age) while Colin is in a DC scheme. The result is that Colin’s pension may be only a quarter of Brian’s. Here’s how:
Four factors reducing DC pensions

<table>
<thead>
<tr>
<th>Factor</th>
<th>Percentage reduction in pension</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lower saving</td>
<td>58%</td>
</tr>
<tr>
<td>Excessive charges</td>
<td>20%</td>
</tr>
<tr>
<td>Stopping and starting ('low persistency')</td>
<td>15%</td>
</tr>
<tr>
<td>Statistics (annuities are expensive for individuals)</td>
<td>10%</td>
</tr>
<tr>
<td>Combined effect</td>
<td>74%</td>
</tr>
</tbody>
</table>

Source: Murthi, Orszag; Orszag; Morris, Palmer

The biggest impact comes from the different average contribution rates to DB and DC schemes, which in 2010 were 21.6% versus 9% of salary, respectively. Both employees and employers were putting more than 60% less into DC schemes than the DB average, with employers dropping from 16.6% to 6.1%. This can be remedied by raising DC contribution rates, as is happening for employees through AE – and it points to scope for employers to provide more than 3%.

On charges, Morris and Palmer assume 1.5% for DC schemes – twice the charge cap for AE schemes and three times the new norm. Persistency is a matter for the individual – Colin benefited from a higher take-home salary when he took savings breaks. Brian effectively experienced compulsory saving in his DB scheme.

The annuities problem has been half solved by removing requirements to buy, but other issues remain:

- Timing: if you need to secure an income through either an annuity or drawdown, market conditions at the time will affect the outcome.

- Longevity risk: a better deal can be obtained if the individual is part of a large pool of would-be pensioners than he or she could obtain alone.

Other advocates of CDC include David Pitt-Watson, whose 2012 report for the RSA, co-authored by Harinder Mann, concluded:

“If a typical young Dutch person and a typical young British person were both to save the same amount for their pension; if they were to retire on the same day, and die at the same age, the Dutch person is likely to get a pension which is at least 50% higher than the British one.”

Kevin Wesbroom, at Aon Hewitt, has argued strongly for a “target pension”, paid from a CDC fund. His model, using data going back 55 years, showed CDC delivering an outcome that was, on average, a third higher than that delivered by individual DC, and one that was more stable. But again, one of the main reasons for the difference has been tackled: required annuity purchase, which has delivered poor value in recent years.
The government’s modelling also showed CDC outperforming DC, but the crucial point made in a parliamentary briefing in September 2014, is: “This was primarily driven by lower costs and remaining for longer in risk-seeking assets, factors not necessarily inherent to CDC” [emphasis added]. It did, however, conclude that sharing risks led to more stable outcomes.

Risk-sharing can be achieved through insurance. The continuing – and developing – annuity market will help deliver stability and certainty to those who want it. Not surprisingly, however, bearing in mind the expense of an open-ended guarantee, demand is shifting away from lifetime annuities bought at a set retirement date and towards deferred, fixed-term and investment-linked annuities.

Recommendation: The new government should focus on the points made in the parliamentary briefing: reducing costs, eg through economies of scale and automation, and encouraging continued investment of funds in return-seeking assets.

The two are linked. Large funds can spread the cost of in-house investment expertise, cutting out some of the other layers (see chart). The big insurers and fund managers are well placed to do this. Funds can also club together to share the cost of expertise and to improve bargaining power, as in the Pensions Infrastructure Platform (PIP) offered by the National Association of Pensions Funds.

Source: Aon Hewitt
It is possible the AE savings providers, or master trusts, will offer a collective DC option. Steve Webb signalled his support for this idea at a Trades Union Congress conference in January 2015. Such a mutual would need not only to build scale rapidly but also to retain its attraction to successive generations of savers – and persuade them all to keep their money in the fund.

For those who are attracted to join a CDC scheme, it must be clear that:

- The target income is neither guaranteed nor certain.
- If the target looks likely to be missed, contributions will increase and/or benefits will decrease.
- It is possible that the distribution of income and calls for contributions will not be fair between generations; and it is difficult to get the investment balance right between assets that help pay current pensions and those that will grow to pay future ones.

- The scheme relies on keeping savings in the pool. It is not designed for people to take cash out at 55 or to pass on unused pots to heirs.

In the end, every step towards certainty – from guarantees to annuities backed by risk-free assets – exerts a cost that eats into potential returns. A DC regime does not offer a “pension”. It aims to build up a pot of wealth that, along with other assets, can be used to fund later life. The only meaningful pension in the UK is the one provided by the state, which is becoming more generous and more universally available – but from a later age.

The government’s pension reforms rightly remove legal obstacles to CDC formation, although the tax issues are thornier. But every other move – from access to the pot at 55 to the abolition of compulsory annuitisation – has raised practical barriers to risk-sharing between members. Indeed, the ability to transfer out of DB into DC, which entails placing a value on the individual’s portion, has extended the UK’s individualistic approach to retirement saving.
Conclusion

This report is entitled “the death of retirement” not because everyone will keep working until they drop, but because the idea of a universal retirement age followed by a lengthy period of economic inactivity is dead. Rapid increases in longevity have seen to that, so have stretched public finances.

Instead of retirement as a one-off event, we have a long transition from full-time work to ceasing to work. The later stages of life are easier if debts are paid off and some wealth has been accumulated. But the mix and timing of changes in earnings, financial obligations and wealth vary widely. So while public policy provides a safety net, beyond that it is increasingly focused on helping individuals to help themselves.

The principle of providing a non-means-tested state pension as a firm foundation for saving is a sound one. But the transition is bound to be costly as baby boomers age and legacy costs of earnings-related state pensions slowly run off. That cost can, however, be mitigated by targeting tax incentives at lower earners and rationalising pensioner benefits.

This report covers the introduction of auto-enrolment (AE) as the new approach to work-based long-term saving. The term “work-based” is preferred to “workplace” because the world has moved away from the employer backing its own scheme. At this stage, the employer is providing a conduit to a savings fund, either in the form of NEST (which must accept any business) or to another qualifying provider. Increasingly, individuals will direct contributions towards their preferred provider, with transfers made easy and all savings and debts visible in an online “dashboard”. This will suit the self-employed as well as the employed and will finally exonerate employers from doing anything other than pay their contributions.

AE has all the elements in place to improve outcomes for the mass of savers; contribution levels can be raised and tax rebates equalised in favour of basic rate payers. On the investment side, the aim of “defined contribution” funds should be clear: help the saver to accumulate as much as possible over the long term. The easy part of this is downward pressure on charges. It is more of a challenge to question the stereotypical “lifestyle” approach to investment, which switches people into very-low-risk assets in the glidepath to a set retirement date. This ignores the fact that their investment horizon is three decades and they remain interested in the value of their funds.

Since people need incentives to lock money away, the principle of contributions and investment gains being tax-exempt and withdrawals taxed – EET – should be applied without exception. Tax allowances for contributions should focus on those who need the incentives most, ie the less well paid.
The issue of motivating people to save cannot be divorced from capacity constraints, notably debt (but also wage levels), and access to benefits. Joined-up thinking is needed between government departments and regulators on this, but one area that clearly needs rationalising is the 20-plus benefits that pensioners may be able to claim. If the state pension is high enough to lift recipients out of means-tested income supplements, they do not need other pensioner-specific hand-outs.

Accessing savings will no longer be seen as one decision to secure a “retirement income”. Annuities will retain a place as longevity insurance or for fixed terms of income, with scope for the government to enter this market. Individual needs for lump sums or income, at different times and from different stores of wealth, are so varied that a one-size-fits-all approach cannot be prescribed. The only clear default option is for the government to provide and encourage independent guidance on a series of decisions, with the aim of maintaining independence. Beyond that, it clearly needs to manage the other pressing issues of old age: healthcare and social services.

The individual approach to saving for later life and to accessing those savings is now embedded in the UK system. With an adequate state pension, people will be much better supported than they were before the 20th century, despite the increase in longevity. But they will revert towards individual (or family) responsibility for supporting themselves beyond that, with help from employers and tax rebates. Enabling people to be as independent as possible for as long as possible is a much worthier aim than encouraging them to believe the impossible: that they can retire and do nothing for three decades.
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