IPPR

REPORT

DEFINING AMBITIONS

SHAPING PENSION REFORM AROUND PUBLIC ATTITUDES

Imogen Parker

December 2013
© IPPR 2013

Institute for Public Policy Research

ABOUT THE AUTHORS

Imogen Parker is a research fellow at IPPR.

ACKNOWLEDGMENTS

The qualitative analysis that forms the heart of this report was carried out by the author and Sian Eliot, a research intern at IPPR. I am grateful for her efforts, research assistance and analysis throughout this project.

I would like to thank Prudential for supporting the work, and particularly Giles Wade and Timothy Fassam for their input and help with the financial modelling. I would also like to thank some of the experts who offered excellent guidance and feedback: Baroness Drake, Nick Barr, Craig Berry, Harinder Mann, David Pitt-Watson, Tim Gosling, Liz Griffin and David White.

Finally I would like to thank my colleagues at IPPR for their valuable input and support throughout the project. In particular, my thanks go to Graeme Cooke and Tony Dolphin.

ABOUT IPPR

IPPR, the Institute for Public Policy Research, is the UK's leading progressive thinktank. We are an independent charitable organisation with more than 40 staff members, paid interns and visiting fellows. Our main office is in London, with IPPR North, IPPR's dedicated thinktank for the North of England, operating out of offices in Newcastle and Manchester.

The purpose of our work is to assist all those who want to create a society where every citizen lives a decent and fulfilled life, in reciprocal relationships with the people they care about. We believe that a society of this sort cannot be legislated for or guaranteed by the state. And it certainly won't be achieved by markets alone. It requires people to act together and take responsibility for themselves and each other.

IPPR
4th Floor
14 Buckingham Street
London WC2N 6DF
T: +44 (0)20 7470 6100
E: info@ippr.org
www.ippr.org
Registered charity no. 800065

This paper was first published in December 2013. © 2013
The contents and opinions in this paper are the author's only.

SUPPORTED BY

IDEAS to
CHANGE LIVES

CONTENTS

Executive summary **2**
What's stopping the public from investing in pensions? 2
What do the public want from a pension? 4
1. A target pension income and communication reform 5
2. A 'smoothed pension' as a lead option to protect against accumulation risk 6
3. The introduction of a 'collective defined contribution' (CDC) pension to the UK 7

1. The case for reform **9**
1.1 Why we need reform: rising life expectancy and constrained finances 9
1.2 Auto-enrolment and workplace pensions 10
1.3 Workplace pensions: saving for poverty? 11
1.4 Defined ambition: more attractive pensions? 13

2. What needs to be addressed to encourage pension saving? **15**
2.1 Six barriers to investing in pensions 15
2.2 Conclusion: trust can be increased through planning and communication 20

3. Would defined-ambition models encourage pension saving? **21**
3.1 A guarantee is desirable in principle, but in practice is seen as bad value 21
3.2 Smoothing finances across the accumulation phase, to protect against sudden 'shocks', is popular 23
3.3 The annuity process is universally disliked, and gaining some surety by purchasing a deferred annuity is no panacea 24
3.4 Most prefer inflation-linked to fixed-rate annuities, but might not be able to afford it at the point of retirement 25
3.5 Sharing risk through a collective DC scheme was the most popular idea tested 25
3.6 Conclusion 28

4. Conclusions **30**
4.1 Eight common principles for better pensions 30
4.2 Broader issues 34

5. Policy recommendations **37**
5.1 A target pension income and communication reform 37
5.2 Offer protection against accumulation risk with a smoothed pension rather than a guarantee 39
5.3 Introduce collective defined-contribution (CDC) pensions 40

References **45**

Glossary **47**

Appendix **49**
Methodology 49
Scheme charges 50

EXECUTIVE SUMMARY

Pensioners have been protected from the worst of the Coalition government's cuts in public spending by the 'triple-lock', which guarantees that the state pension will increase annually by the higher of 2.5 per cent, price inflation or the increase in average earnings. Nevertheless, the state pension alone will not provide people with the standard of living that they may hope for in retirement – and unless they make additional provisions for when they finish work they are likely to suffer disappointment, and possibly hardship, in their later lives. Yet less than half the adult population are currently making adequate provision for their retirement: two in five of those in employment have never held any type of private pension, and one in five have no resources of any kind (beyond the state pension) for their later lives (Scottish Widows 2013, PPI 2013, MacLeod et al 2012).

This growing problem is caused by a number of factors, but of these the two most important are that people are living longer in retirement, and are saving less.

Reform is already underway to encourage people to work for longer (by increasing the state pension age and scrapping enforceable retirement ages), and to increase the number of people saving into a pension, through auto-enrolment. However, even if employees contribute into a pension across their whole working lives, at the contribution rate required by the government when they are auto-enrolled into a workplace pension scheme, they will still have only a one-in-two chance of a decent income in retirement.[1]

It is clear, then, that reform is urgently needed to protect future living standards. People in work need to be encouraged to save more for their retirement (by offering them more attractive products or better incentives), and the conversion rate from savings to retirement income needs to be improved through reducing the charges and fees levied by pension providers and annuity insurers. Better pensions will encourage higher trust and saving levels – and higher saving levels should allow for economies of scale and better rates.

The government's 'defined ambition' agenda aims to devise more attractive pensions by protecting savers from some of the risks associated with accumulating a large pot of money over many years and then converting it into a stream of income (DWP 2012). Pensions minister Steve Webb hopes that offering a new form of pension, which neither places the full burden of risk on the employer (as in 'defined benefit' pensions) nor on the member (as in 'defined contribution' pensions) could encourage savers to invest more and make up the savings shortfall.[2]

For the defined-ambition pension agenda to be successful, new pension models need to reflect what the public want from a pension. This paper brings new evidence to bear on this issue. Using original qualitative research, we explored the key barriers that are preventing people from engaging with pensions, and the underlying principles that they want from a pensions system, before assessing whether defined-ambition models could address these challenges and priorities.[3]

What's stopping the public from investing in pensions?

Beyond affordability, there is a set of barriers that needs to be overcome before trust in pensions can be restored and members encouraged to make contributions above the minimum required rates. The people we spoke to told us that one of their biggest

1 Based on PPI modelling of target replacement rates (PPI 2013).

2 See glossary for explanations of 'defined benefit' and 'defined contribution' pensions, and section 1.4 for further explanation of the defined-ambition agenda.

3 See full report and appendix for details on methodology and findings.

concerns is about the institutions involved: pension fund providers, insurers and the government. The perception that pensions are a risky business has been heightened by various scandals (such as Maxwell and Equitable Life). Since many people conflate the state pension with a workplace pension, changes to the state pension age have made potential savers worried about government 'changing the goalposts', making some reluctant to opt in to a scheme which may end up being redundant, or only be accessible too far into old age.

Another serious barrier is the need for the public to make decisions regarding pensions. While auto-enrolment will certainly minimise this – sweeping savers into a default fund – fear of making the 'wrong decision' stalls some potential savers into inactivity. Most of our respondents didn't understand how pensions worked (even those who were currently contributing), didn't like thinking about retirement and – despite their importance – were reluctant to opt-in or consider their pension options. Uncertainty about pension outcomes, and the difficulty that people have in picturing themselves, their needs and circumstances in old age, make it very hard for many to engage with the pensions system or plan for their retirement.

Similarly, our respondents felt that there was never a good moment to opt in: young people saw pensions as irrelevant or not a current priority; individuals with young children found their finances already stretched; and individuals approaching retirement felt it was too late to begin saving.

The barriers of reluctance to engage with, and lack of faith in, pensions, and the uncertainty inherent in defined-contribution pensions, is further exacerbated by the fact that understanding is low, and that the case *against* pensions is better known that the case *for* them. People hear about the risks, but don't see enough evidence about the benefits, and therefore find it hard to articulate a reason to opt in.

> **'We've all heard about these risks and people losing their money, but people need to be informed about the other end of the scale, where people did make money or got back what they paid in. There is no positivity about pensions, and we need a bit of that.'**
> Research participant with middle income, 28–44, with young children, Stevenage

What, then, are the implications of these barriers to greater pension investment? Clearly overcoming them will require more than just pension models that protect against financial risk. Better communication and the promotion of clearer understanding of pensions needs to be an important component of reform: members can only be enthusiastic about new products if they understand them. Addressing their lack of trust in institutions and government will be more difficult, but improved governance structures and cross-party commitments to new schemes could help to assuage these fears. Defined-ambition could be presented as a new era of pensions – one which establishes some distance from past pension scandals.

The next question is how to build a set of reforms that better reflect what the public want from a pension. Defined-benefit pensions, even with relaxed regulation, are unlikely to be the norm for private sector employees in the future. A new pension scheme will not be able to look to either employers or the state for promises: it is still likely to expose members to some level of risk and uncertainty, but it should reflect how the public would want these risks to be managed.

What do the public want from a pension?

Of course, potential savers would ideally like a pension which isn't realistically deliverable. But in considering the trade-offs between pension models, and critiquing state, defined-contribution, and options for defined-ambition pensions, our respondents revealed some commonly-held preferences which have implications for product design, communications, regulation and governance.

Respondents want a pension that offers:

1. Protection against sudden falls in the size of their pension pot during accumulation.
2. A clearer estimation of likely outcomes.
3. A retirement income that could be accessed before a member reaches the state pension age, and that also provides some protection against inflation.
4. A retirement income that reflects contributions, and ensures a higher quality of life than those relying solely on benefits.
5. Support for the family. Potential savers wanted a retirement income that could be extended to a partner or dependents on their death; this was particularly important for families where one partner had taken time off from work for childcare or care. The ability to provide for survivors would be one of the biggest motivations for saving into a pension.

These principles all have implications for the type of pension scheme that should be developed under the government's defined-ambition agenda. However, in order to engage with the public, these new products need to be launched in the wider policy context of:

6. Policies that support individuals' best interests in the long term. Contributing to a pension should be heavily encouraged, or even made compulsory, and many respondents felt that this should begin with a first job.
7. Cross-party and long-term government commitments.
8. Pension provision that pursues members' best interests without requiring customer choice. Almost all want a small number of good default pension options, with the ability to choose beyond these for those who want to make more active decisions. Alongside wanting fewer default schemes, most savers don't want to be 'lone rangers': they want to save in a common product, and share the associated risks, particularly at the point of retirement. Members want to be paid an income directly from a group scheme or employer, and don't want to be responsible for the decision of purchasing an annuity.

   Across the pension life-cycle, individuals want their interests to be protected without relying on their ability to shop around, weigh-up options and make decisions. They want expert independent guidance and oversight – closer to a doctor–patient relationship than a customer–supplier one. Respondents ideally want pension providers to operate as non-profit organisations, be strictly regulated, and be independent from the government, with incentives well-aligned and charges limited.

Some of these principles are already reflected in current pension policy (the scrapping of the retirement age, for example), or can be met reasonably easily. Others have implications for government and industry, highlighting where there are gaps in current thinking or where more focus is needed, particularly on supporting family life. The last of the above principles poses a difficult challenge for pensions. Respondents, for the most part, neither want nor feel qualified to make active choices when it comes to their pensions, and the pension system is not straightforward for customers to navigate in a traditional market relationship.

This appears to indicate a bias against a system centred on private provision, even though it might offer other benefits such as greater product innovation.

The big challenge for reformers that these principles present, which is made more urgent by auto-enrolment, is how to ensure that members' interests are protected, given how important it is that individuals have adequate savings – both for their quality of life and to minimise the burden that pensioners place on the state. There is no easy or obvious solution to this challenge, but there are a set of issues, particularly regarding governance and the annuity process, that need further thought (these are discussed in chapter 4).

In light of these conclusions, and responses to various simplified defined-ambition models,[4] our findings have led us to make three recommendations for reform:

1. The creation of an individual pension target, and tailored communications to support planning.
2. The offer of protection against market risk through a 'smoothed pension'.
3. The introduction of a 'collective defined contribution' pension to the UK.

1. A target pension income and communication reform

Currently, the pension process is too opaque. Members may understand their contribution, but have little sense of the benefits of contributing into a pension (compared to other saving vehicles), and see little connection between their contributions and their income in retirement. This is problematic for two reasons:

1. The risks of pensions are better known than their benefits, which means that a lack of understanding may encourage opt-outs.
2. Those who do opt-in presume that contributions made across several decades should translate into a decent income in retirement, and so are disappointed by lower-than-expected returns.

Both of these issues prevent the public from making adequate provisions or plans for retirement. Auto-enrolment strengthens the case for improving public understanding of pensions: it imposes a greater responsibility to inform people about what they have been opted in to, and if the charges and risks involved aren't fully understood then savers may fail to make sufficient provision, and trust in pensions may be further eroded in the long term. Furthermore, relying on inertia for opting-in runs the risks that those who opt out will never re-join a scheme, and that members will be unlikely to contribute above the minimum threshold.

Our research demonstrates that supported consideration of the income that people will need retirement increases their propensity to save. The case for saving into a pension specifically is strengthened by a greater understanding of defined-contribution pensions. Finally, beginning from what the public want (and need) in their retirement and working backwards to set a contribution level and pension age is likely to encourage higher contribution rates and a greater feeling of certainty. Simply giving the public a clearer understanding of pensions, removing some misconceptions, and supporting people to plan for their retirement will go some way to allay fears, even without more radical reform.

4 See chapter 3 for respondents' reactions to defined-ambition pension models.

Encouraging everyone of working age to set themselves a target income in retirement should boost saving levels. However, this will only be effective if the right information is made available. Successful communication will need to:

- Encourage people to think about their retirement by providing the tools they need to make realistic plans (including illustrative examples of costs in old age, inflation, and life expectancy).
- Make the case for pensions using practical scenarios that compare personal contributions across a life-course with total contributions (including employer contributions and tax relief), and that demonstrate the impact of enrolling later in life or contributing more.
- Clearly differentiate the state pension entitlement (and age requirement) from a workplace pension.
- Consider pensions from the perspective of the public, by starting from outcomes rather than inputs. Individuals want to know what they will have, and what they will need, once they have retired.
- Adjust for inflation – all plans and communication need to be translated into today's prices.

What should reform entail?

- Providers should offer learning sessions to firms to dispel myths about pensions and support individuals to make plans for retirement. This would be most effective if done face-to-face, but failing that providers could direct members (and potential members) to online tools to support their planning.
- The government should change the regulations governing annual statements so that they state whether pension performance was 'on track' for a specific target or average replacement rate at a member's salary band. Statements could include a 'traffic light' code, with members invited to discuss their provision and contribution rates if their fund is coded 'amber' or 'red' and so is likely to offer a substantially lower income than was planned.

These initiatives could be supported by an information campaign targeted at the public about the need for higher contributions, and an employer-targeted campaign to encourage participation in schemes like Save More Tomorrow, in which employees commit to raise their contribution levels at future pay-rises.

2. A 'smoothed pension' as a lead option to protect against accumulation risk

People are discouraged from saving into pensions by worries about the volatility of the stock market and the risk of a sudden fall in the value of their pension. Yet guarantees that underwrite the value of a pension, while popular in principle, are seen as unattractive on cost grounds. A 'smoothed pension' overcomes the issue of savers seeing their balance suddenly fall, and would provide more certainty by ensuring a less volatile trajectory (see section 3.2 for further details). A smoothed pension was one of the most positively received models among those we tested with members of the public, in part because the associated charge was judged to be reasonable. Offering a smoothed pension therefore could – if it was well governed and the costs were kept low – boost saving levels and provide increased certainty without substantially diminishing future incomes.

What should reform entail?

Members' interests would need to be represented – particularly regarding decisions about pay-outs across the accumulation process, and on crystallisation (the point of retirement or death). Increased transparency and better communication would be required in order to explain the circumstances under which money would be held back or paid out. These aims could be met in a number of ways:

- Smoothed schemes should only be offered where there are independent trustees – acting at the provider/product level, rather than the employer level – to oversee decisions. To further strengthen governance, a requirement could be made to licence trustees on an individual or scheme basis.
- The Financial Conduct Authority should regulate for improved transparency by including information about the amount retained or fees charged (in cash value) on annual statements. This information could be presented to savers as the amount that is in their fund, and the amounts being paid into or out from their 'reserve fund'.
- Depending on the type of smoothed pension, providers should explain the circumstances under which they would pay out funds, and under which they would withhold them, based on a formula. This would not require a guarantee (which our respondents deemed too expensive), but would be contingent on fund performance.

3. The introduction of a 'collective defined contribution' (CDC) pension to the UK

Collective pensions are likely to offer better returns and lower risks to members than standard defined-contribution pensions, because of lower fees through economies of scale, keeping funds invested in higher yield options, and self-annuitisation. Recent modelling by Aon Hewitt for the Department for Work and Pensions showed that on the best like-for-like comparison:

- A collective pension would on average have outperformed an individual pension by 33 per cent, based on historic data.
- A collective pension would have outperformed an individual pension in 37 of the past 57 years.
- Variability (and therefore the risk the saver takes on) would be lower with a collective rather than an individual pension (Pitt-Watson 2013).

More stable outcomes would make the need for costly guarantees less likely, and make it easier for members to plan for the future.

Our research suggests that there would be strong public support for a collective pension: a collective scheme was the most popular of the ideas we tested, and it appealed across different income levels, life-stages and ages. This is partly, but not solely, because of the desire for a higher average income in retirement. CDC pensions also reflected many of the principles that the public wanted from a pension: respondents liked the 'solidarity' of a collective scheme, and envisioned it as a large-scale default option for savers which minimised individual responsibility for decision-making. Cutting out the annuity process was very well received. In all, respondents believed a collective scheme would give them more confidence to save than a traditional defined-contribution scheme. Alongside auto-enrolment, CDC pensions could signal a new type of pension, one that would be far removed from pension scandals of the past.

What should reform entail?

Both the government and leading academics are engaging with the introduction of some form of CDC pensions as a realistic possibility. However, there are some big questions that need to be answered satisfactorily before adopting a collective scheme.

- How could a CDC pension scheme operate in the UK?
- Could a such a scheme operate without relying on direct government intervention? If government involvement were needed, what form would it take?
- How could a CDC pension scheme protect against intergenerational unfairness?
- Could a collective scheme cope with increased longevity without compulsory (or semi-compulsory) enrolment?

The government could create a new pension commission to explore these questions, and consider how CDC pensions could work in the UK. If these questions could be answered satisfactorily, four steps would then need to be taken to make this a reality:

1. Remove any legal barriers. To introduce new legislation, cross-party backing is needed to ensure that a bill is successful and that support for it continues into the next government. This would give fund providers and members confidence in its longevity.
2. Ensure that any CDC scheme works in its members' interests by requiring strong governance structures, such as independent trustee governance.
3. A collective fund should be piloted by the trustees of a large organisation (possibly run on a non-profit basis like the National Employment Savings Trust). It should set out the terms of the collective pension, being clear about what actions would be taken in response to poor performance, low participation, and exposure to risk across the life-course.
4. Clear communications would need to be set up around collective pensions, incorporating the targeted approach outlined above. Members would need to understand that there would be a possibility of a fluctuating income in retirement, and, using historic data, the likelihood that this will happen.

While further work is needed to create a workable blueprint for the UK, and while there are several issues on which members would need reassurance, we would argue that this could be the next big move in pensions, and that CDC should be part of the defined-ambition agenda. Government, providers, employers and members should recognise its appeal and potential, and engage in exploring how CDC could become part of the pension landscape.

1. THE CASE FOR REFORM

We have a pension crisis on the horizon. The combination of declining numbers of people enrolled in pensions, fewer secure pension schemes, lower average contributions and increasing life-expectancy means that, without major reform, the majority of working-age adults won't have a decent standard of living in retirement.

This looming crisis is partly hidden by the fact that today's pensioners are better off than ever before: pension incomes are rising faster than the incomes of those in work, and pensioner poverty is at its lowest level since records began (IFS 2013). This comparative affluence is skewing the expectations of subsequent generations: there is a growing mismatch between the retirement aspirations of working-age adults and their actual prospects (Scottish Widows 2013).

To address this problem, we need reform. Options are constrained by the state of the government's finances, which are already under increasing pension-related pressure due to rises in life expectancy. The shortfall, therefore, must be met by workplace pension provision rather than by rises in the state pension.

This chapter unpicks the reasons why we are heading for a pension crisis, and makes the case for reform in light of the decline of 'defined benefit' pensions, and the drawbacks of 'defined contribution' pensions.[5] Finally we outline the government's reform agenda, which is seeking to usher in a new era of 'defined ambition' pension products.

1.1 Why we need reform: rising life expectancy and constrained finances

Part of the problem is rising life expectancy. People who are now 65 years old are expected to live for another 19–21 years (ONS 2013c). One in three babies born in 2013 will live to the age of 100 – the same proportion as could be expected to reach 65 when the contributory state pension was first introduced in 1926 (ONS 2012a). While desirable in itself, rising life expectancy puts financial pressure on individual and state pension funds. Furthermore, medical advancements mean that people are living with chronic conditions for longer, and so are relying on ongoing care with ongoing costs.

The rise in life-expectancy combined with a decrease in family size has shifted the balance between those in work and retirees. At the start of the last century the working-to-retired ratio was 10:1 – that is, there were 10 people working and paying in to the system for every one person receiving support from it. By 2010 this ratio had fallen to just over 3:1 – a trend that is set to continue, with a quarter of the population projected to be over 65 by 2050 (ONS 2012a).

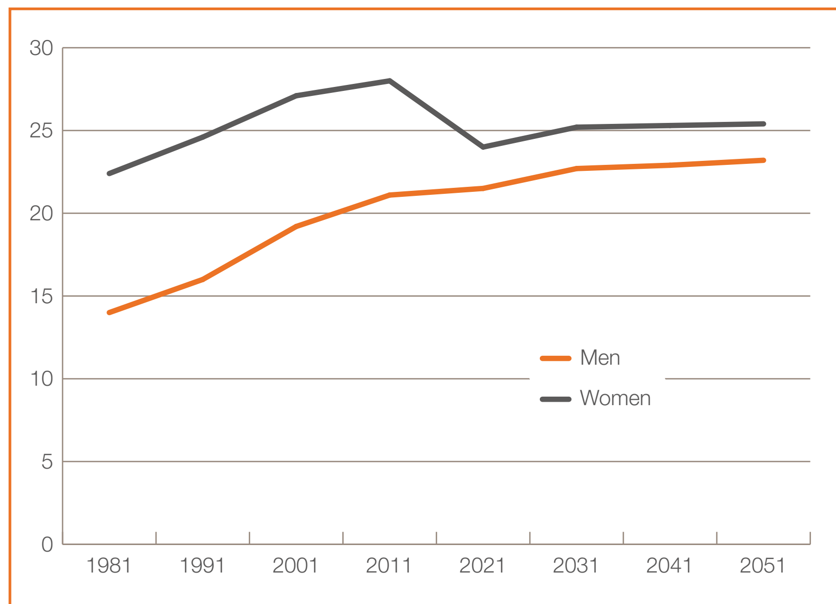
This problem can't be fixed by simply upping the state pension. In the short term, the government's broader agenda is to cut public spending to control the deficit, and within this they have a political agenda of reducing welfare spending. Despite this aim, just maintaining current levels of spending on pensioners will require a net rise of £27 billion between 2010/11 and 2017/18 (Cooke 2013). This increase builds on an already substantial hike in recent years – pensioner spending more than trebled over the last three decades, from £38 billion in 1978/79 to £117 billion in 2012/13 (in today's prices) (ibid).

In response, the government is raising the state pension age and has scrapped the enforceable retirement age to encourage those who are able to do so to continue

5 See glossary for further explanation.

working.[6] Increasing the pension age will slow the pace of the problem, but will not solve it: even taking account of the increase, it is predicted that the working-to-retired ratio will continue to dwindle, as life expectancy in retirement continues to rise.

Figure 1.1
Life expectancy at state pension age (years), 1981–2051



Source: ONS 2012b
Note: The drop in female life expectancy at state pension age between 2011 and 2021 is because of the rise in the female state pension age, from 60 to 65, bringing it in line with male state pension age.

In short, part of the problem is that rising life expectancy has shifted the balance between the working population and the non-working population, and put government finances under increasing pressure.

A second issue is that fewer people are saving into workplace pensions. The number of people contributing to a workplace pension has fallen from almost 11 million at the start of the 1990s to 8.2 million in 2011. The fall is much steeper when looking only at the private sector, in which active pension membership has more than halved over the same period (ONS 2013a). In 2012 just under half of employees were contributing into an employer pension scheme, two in five of those in employment had never held any type of private pension, and one in five had no private pension or any other resources for later life (MacLeod et al 2012).

1.2 Auto-enrolment and workplace pensions

The fall in pension membership led the government to introduce 'auto-enrolment'. By 2018, all employers will have a duty to enrol their employees into a pension scheme unless the employee opts out. This is likely to substantially increase the number of people saving: the government is aiming for at least eight million individuals to be either newly saving or saving

6 The state pension age is currently 65 for men and between 60 and 65 for women, depending on date of birth. By 2020 the state pension age for both women and men will reach 66, and it is due to rise again to 67 in 2026–28. A further increase to 68 was to be implemented by 2046, but the chancellor's announcement in the 2013 Autumn statement that, in future, the pension age will be linked to life expectancy will mean that this date is brought forward. The default retirement age (previously 65) was phased out in 2011, meaning that employers now cannot force employees into retirement without objective cause.

more by the time the scheme is fully rolled out. Uptake has been strong so far, with just 9 per cent of eligible employees choosing to opt out (DWP 2013a).

However, while auto-enrolment may increase the number of people saving, it won't necessarily mean that those savings will be adequate to secure a decent standard of living in retirement. This is partly because of the shift from 'defined benefit' pensions to 'defined contribution' schemes.[7]

'Defined benefit' (DB) pensions were the norm for workplace pensions for several decades. They offered a good deal for members, with generous contributions from employers as well as employees, and a guaranteed retirement income which would hold its value, regardless of how their investment had performed. However, because of the unexpected increase in life expectancy, employers who offered them found themselves under an increasing burden. From its peak in the 1960s of 8 million, there has been a sharp decrease in DB private membership, to less than 2 million in 2013. Furthermore, the majority of DB schemes which remain in operation won't accept new members: the proportion of those still open to new joiners fell from 30 per cent in 2008 to just 14 per cent in 2013 (Pensions Regulator 2013).

The decline of DB pensions means that the vast majority of people who are opted in to a pension scheme under auto-enrolment will join a 'defined contribution' (DC) scheme. These are more attractive to employers, as they shift all the pension risk to the member (employee) and only guarantee a contribution rate rather than a benefit. While preferable for employers, they represent a substantially worse deal for employees. Instead of having a guaranteed income (which would increase) in retirement, the majority of savers now take on both the risk of their pension investment performance (while they are working), and uncertainty as to what that pension 'pot' can be converted into in terms of a retirement income.

1.3 Workplace pensions: saving for poverty?

DC pension schemes offer a worse deal for members for several reasons:

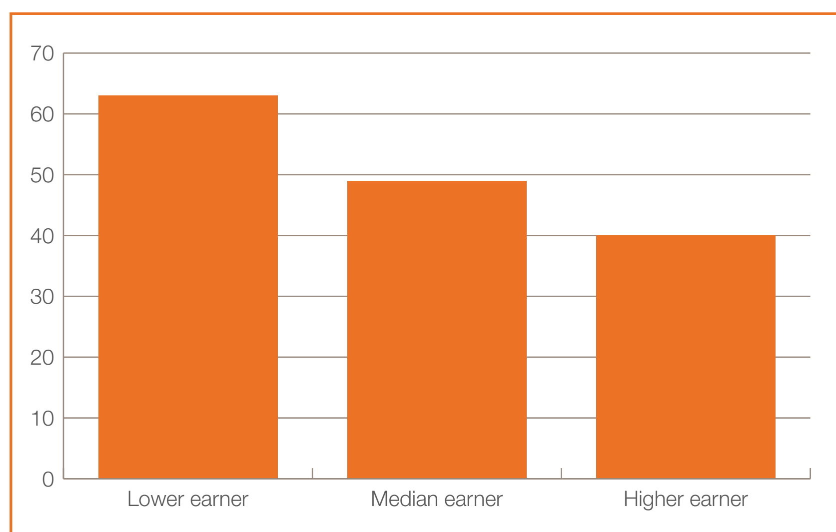
- Individual savers take on all the risk associated with pensions, meaning that pensions are less attractive to members, and their futures less certain than under DB schemes.
- Contribution amounts are lower: those in DC schemes have average total contributions of 9.4 per cent of employee salary, less than half the average DB contribution of 19 per cent.
- Charges levied when savers convert their fund into an annuity income can substantially reduce their pension savings – the incomes that can be bought with the same size of pension pot vary between different providers by as much as 30 per cent.[8]
- The average value of annuities has fallen by 19 per cent since 2003, and by 60 per cent since 1990 (DWP 2012). In less than four years, the cost of annuities for men has jumped by almost 30 per cent: a guaranteed lifelong £5,000 annual income for a man reaching state retirement age at the end of 2009 would cost £118,000; by early 2013, the same annuity would cost £152,800 (ONS 2013b). This rise has been driven by life expectancy and lower interest rates – the same issues are also affecting DB schemes but, since the responsibility sits with the employer, members are protected.

7 See glossary for explanations of defined-benefit and defined-contribution pension schemes and annuities.
8 Based on highest and lowest Association of British Insurers annuity rates (Grote 2013).

- Annuities aren't automatically protected against inflation, so their value can fall with time – despite the fact that people's living costs are likely to rise in old age because of greater care needs.
- Pensions do not automatically cover spouses.

The need to address these drawbacks is increasing daily, as contributing into a DC pension at the rate required under the government's auto-enrolment legislation (8 per cent of banded earnings by 2018) is unlikely to provide this generation of savers with an adequate retirement income. Somebody on a median income contributing across their working life would have only a 49 per cent probability of receiving a decent replacement rate in retirement,[9] as is illustrated in figure 1.2 below.

Figure 1.2
Probability (%) of achieving target replacement income for individuals in different earnings brackets, with income from both private and state pensions, if they save throughout their working lives



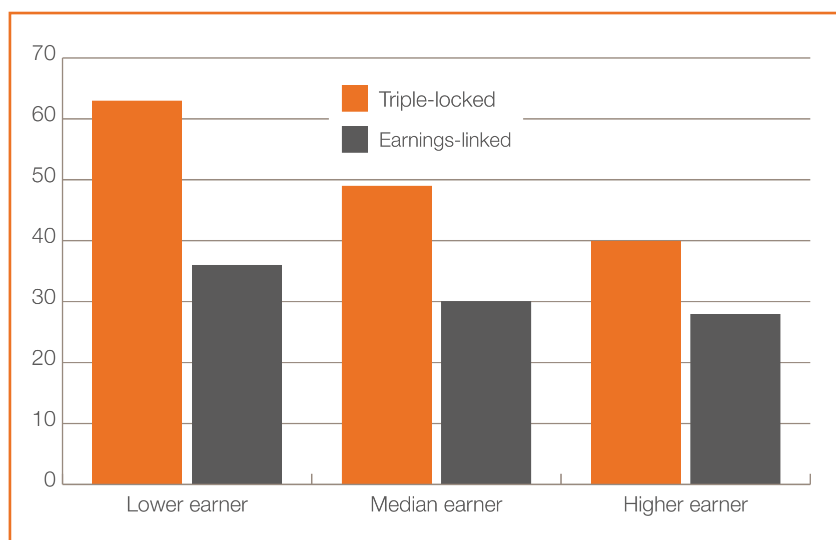
Source: PPI 2013
Note: Model is based on individuals saving from the age of 22 to the state pension age, at 8 per cent of earnings between £5,668 and £41,450 (in 2013/14 terms) contribution into a DC pension with a traditional lifestyle investment approach. 'Low', 'median' and 'high' earner brackets are defined as the 30th, 50th and 70th percentiles of economy-wide age-specific earnings levels in each year that they are in the work (PPI 2013).

The probabilities above are calculated under the assumption that the state pension will increase under the generous 'triple lock' guarantee, which will protect the value of that income by guaranteeing that it will rise at the rate of whatever is highest among changes in average earnings, the consumer prices index or 2.5 per cent. However, the triple lock is only guaranteed until 2016 and, while dropping it would be politically difficult, it may prove unaffordable in the long term. If the triple-lock were relaxed, and the state pension to increase only at the rate of average earnings, this would significantly exacerbate the replacement rate problem.

If the state pension grows only at the rate of average earnings, the predicted proportion of future pensioners who will have a decent standard of living (if they opt-in at the government minimum) drops by almost half. Less than a third of people who opted into a workplace pension across their whole working life would have a decent chance of maintaining a comparable lifestyle in their retirement (PPI 2013).

9 Target replacement rates are bands used to assess whether pensioners will be able to maintain the same living standards as they had in their working lives. Throughout the report we refer to the rates set out in PPI 2013, which are included in the glossary.

Figure 1.3
Probability (%) of achieving target replacement income for individuals in different earnings brackets with income from private and state pensions if they save across their working life, depending on different state pension indexation (triple lock or earnings-linked)



Source: PPI 2013
Note: Model is based on individuals saving from 22 to state pension age, at 8 per cent of band earnings contribution into a DC pension with a traditional lifestyle investment approach.

In either scenario, the Pensions Policy Institute have estimated that, based on current pension models, there needs to be a substantial increase in minimum contributions if future generations are not to experience a sharp drop in their standard of living at retirement. To secure a two-in-three chance of this replacement income, the minimum contribution would need to be either between 10 and 14 per cent if the triple-lock remained in place, or between 14 and 17 per cent if it was replaced by earnings-linked indexation (PPI 2013).

However, raising the minimum contribution would be a tough ask in the near future, particularly given stagnating wages: doing so would run the risk that more people will opt out altogether. That being the case, this shortfall needs to be addressed by encouraging savers to invest more by offering more attractive products or better incentives. Improving the conversion rate from saving to retirement income by reducing the charges and fees levied by pension providers and annuity insurers would also help. Ideally, a reform agenda should pursue both these goals – in fact, the two are mutually-reinforcing. Better pensions will encourage higher trust and saving levels, and higher saving levels will allow for economies of scale and better rates.

1.4 Defined ambition: more attractive pensions?

Pensions minister Steve Webb wants to find a middle ground between defined-benefit and defined-contribution pensions. In 2012 he proposed a new set of pension schemes, under the heading 'defined ambition' (DA), based on the understanding that current DC pension schemes aren't always attractive to members, and DB schemes overburden employers. The hope is that if a middle ground can be found, these new products might be more attractive to members, and so lead to increased contributions to help address the savings shortfall.

The models proposed under the DA heading feature some 'DB-lite' options, which explore ways to relax some of the existing DB regulation in the hope of encouraging employers to maintain them. Other ideas build from a DC baseline: these 'DC-plus' options try to improve standard DC pensions by offering protections or minimising risks without additionally burdening employers. Various DC-plus models protect against the

financial risk that members are exposed to at various points in the pension process: during accumulation (the contribution period), at crystallisation (the point of retirement or death) and in retirement (receiving an annuity).

One of the aims of the DA initiative is to help restore public faith, and increase confidence and members' engagement, in pensions. In this report we explore how the general public respond to the defined-ambition agenda in order to assess its likely success in increasing the public appetite for saving. Our research focuses on 'DC-plus' ideas, as they are likely to affect the majority of future pensioners – most commentators agree that relaxing DB regulation might slow their decline, but are unlikely to restore their popularity.

In the following chapters we identify the barriers that need to be overcome if faith in pensions is to be restored, before exploring whether DA models can address these adequately. As we will show, the research identifies some clear 'winners' among the DA proposals, but it also highlights some broader challenges to successful reform that are not fully addressed by the DA proposition. There is a good case – even an urgent need – for wide-reaching pension reform, and modifying pension products should certainly be a component of this. However, to regain public trust in pensions and, more importantly, to increase future retirement incomes, we will need a reform agenda that encompasses providers as well as products. We will return to these conclusions and recommendations in our final chapter.

We now turn to the reasons why potential savers are reluctant to invest in pensions. Before we drill down to specific DA options, we need to clarify exactly what the challenges are that the defined-ambition project seeks to overcome.

2. WHAT NEEDS TO BE ADDRESSED TO ENCOURAGE PENSION SAVING?

In the first stage of our research we sought to clarify exactly which concerns were preventing people from enrolling in or engaging with pensions. We identified six common barriers, which fell under the broad headings of 'risk', 'uncertainty', 'irrelevance' and 'misunderstanding'. To overcome these barriers, reform will need to encompass communication and engagement, strengthen the governance of pension funds, and, where possible, offer cross-party and long-term political commitments.

This report draws on findings from our original qualitative research conducted with working adults of different incomes across the UK between August and November 2013. We explored potential savers' attitudes to risk, their trust in pensions and the barriers preventing them from saving, before testing their responses to some of the DC-plus models proposed in *Reinvigorating workplace pensions* (DWP 2012). The appendix has full details of this research's methodology, recruitment specification and approach.[10]

2.1 Six barriers to investing in pensions

The defined-ambition agenda seeks to minimise the three elements of financial risk that members are exposed to in DC pensions: investment performance during accumulation, annuity rates at retirement, and whether the value of the annuity keeps pace with inflation. While some of our participants identified the 'risk' of pensions as a barrier to saving, this was not just a concern about these financial risks, which are the core focus of the defined-ambition proposition. In fact, only a minority of participants had a sufficient understanding of pensions to appreciate that a pension was an investment rather than savings product, and therefore were aware that they faced the associated risks. Only a small minority, even among current members, knew about the annuity process, for example.

In order to address the public's concerns, a broader interpretation of the perceived risks associated with pensions is needed.

2.1.1 Risk associated with pension institutions

> **'I think everybody knows someone that's lost money in pensions.'**
> Middle income, 28–44, with young children, Stevenage

> **'I think that the bad press that pensions and finances have had the last 10 years have changed everybody's attitude. Years ago, it was rock solid. [There was an advert with] a man on a tower, and he's got a safe guard around him – that's how you thought pensions were, but so much has happened over the last 10 years.'**
> Middle income, 42+, 'empty-nester', Coventry

Pension funds were not seen as trustworthy by participants in our research. This distrust was particularly pronounced among older respondents, but was evident across all

10 We do not argue that our research is predictive of behaviour. There is extensive scholarship demonstrating the difficulties of considering primary research to be indicative of likely action, particularly when dealing with questions relating to long-term decisions about the future. This chapter captures initial attitudes to pension savings, and the following chapter presents findings from a highly deliberative process. Respondents were introduced to information about pensions, savings, life expectancy, inflation and other relevant issues to allow them to make informed decisions about various pension models. We know both from this research and other studies that pensions understanding is low, and that without this deliberative phase respondents would not necessarily have been able to distinguish between the various models. While these latter findings do not, therefore, reflect what respondents' attitudes would be to various pension options 'cold', we think that the approach taken is valuable in terms of ensuring that policy reflects what the public *would* want from pensions if they had greater understanding of them.

generations. Potential savers were worried about losing money in pensions, and many had an acquaintance who had 'lost everything' in 'pensions'.

Rather than a specific concern about investments performing poorly, or low annuity rates (neither of which were understood by the majority of the respondents), the major risk that they associated with pensions was that institutions were untrustworthy. Common worries concerned pension schemes folding (with no savings being returned to members), pension funds being illegally or immorally raided by investors, or losing everything through irresponsible decisions by 'whizz-kids in the City'.

> **'You're putting this money into the faith of… a whizz-kid up in the City, you know, he's living on his £100,000 bonuses and salaries and whatnot, but it is not physical, it is all paper transactions. There is nothing there.'**
> High income, 22–32, with no children, London

It appears that scandals like Maxwell and Equitable Life have undermined trust. Since knowledge of pensions among non-participators is largely based on a combination of family attitudes (particularly parental advice) and news headlines, savers need to be reassured about the institution as much as the investment.

2.1.2 Government changing the goalposts

> **'With all the changes [made by] the new government it's definitely more of a risk, and you do get the feeling that one day pensions won't exist anyway.'**
> Middle income, 22–32, with no children, Newcastle

Most people conflate the state pension with a workplace pension. Recent changes to the state pension age have made some reluctant to save in a workplace pension. The explicit fear is that the retirement age will continue to increase, meaning that they will never be able to access their funds. An undercurrent of this apprehension is the general worry that the government will 'change the goalposts', rendering their decision to opt in to a pension redundant or misguided.

Savings attitudes are also interlinked with government policy on inheritance taxes, care costs and welfare. A major barrier to any form of saving is the possibility that any payout will be 'eaten up' by inheritance tax. Several of our respondents were worried about the government 'raiding' pensions, or that because they had saved they would be penalised by having to pay for social care. There was also concern, particularly in lower-income groups, that people on benefits would receive just as much as those with a workplace pension – in which case they would have been better off spending their money rather than saving.

> **'I think you work hard all your life and you're just worried that the government will bring in a scheme that robs you of that money that you've worked bloody hard and saved for.'**
> Middle income, 42+, empty-nester, Coventry

Pension policy is an area in which people want cross-governmental, long-term commitments to be made, given that savers themselves are being asked to make long-term decisions.

2.1.3 Making a bad decision

> **'That's the [problem] – we just don't understand it, so you're a bit frightened to pay all this money into something.'**
> Low income, 42+, empty-nester, London

Most people don't understand pensions. In a recent Department for Work and Pensions (DWP) survey, only one in five disagreed with the statement, 'sometimes pensions seem so complicated that I cannot really understand the best thing to do'; one in three admitted 'dealing with pensions scares me' (MacLeod et al 2012). Our research found that many of those who had gone through auto-enrolment, or had attended work presentations, still didn't have a clear sense of the benefits or risks they were exposed to by opting in to a pension. This is reflected in other, quantitative studies: for instance, it has been found that 60 per cent of current pension savers do not understand (or do not know whether they understand) the risks they face with DC pensions (Altmann 2013).

Low levels of understanding, the complexity of pension products, the lack of certainty about outcomes inherent in DC, and esoteric communications have the combined effect of making potential savers disengage from their options. While auto-enrolment will partially deal with this issue – and indeed is predicated on member inertia – a sizeable proportion of our respondents had been flummoxed into inactivity: several had failed to opt in to a workplace pension scheme because they worried they might be making a bad decision. Behavioural literature shows that too much choice can lead to paralysis, and this tendency is exacerbated when the choices are complex (OFT 2010).

A majority of respondents believed that property was a better investment vehicle than a pension, partly because it was more straightforward, comprehensible and visible.

> **'I think you need to invest your money in things that you understand, and I don't understand pensions and stocks and maths and things, and I get property, I understand that… I would feel more comfortable putting my money into something that I [get] rather than just trusting a man who I've never met before to look after my money for 35, 40 years. To me that is just alien… Whereas property is there, you can see it, you can walk in and out of it, you can knock a brick out, it's yours.'**
> High income, 22–32, with no children, London

2.1.4 Uncertainty of future needs and income

Research has shown that people are reluctant to think about old age, and struggle psychologically to picture themselves in any position that is substantially different to their own current one (Hershfield et al 2011). The difficulty of engaging with old age, combined with the uncertainty of pension outcomes, makes it difficult for people to plan ahead.

Some of our respondents held an unexamined belief that they would retire with an income similar to that of their older relatives, without having to take any practical steps to ensure that this happens.

> **‘I’ve never really thought about it. I know that’s stupid, but I know my nan gets well over £400 a week with, like, a war widow’s pension, a state pension, a private pension. She’s doing alright, so I’m just thinking, “It’s going to be alright”.’**
>
> Low income, 22–32, with no children, Erdington

As respondents’ understanding of pensions was partly informed by their older relatives, the impact of policy changes around state pensions (particularly for women), changes in life expectancy and the shift from DB to DC pensions mean that they lacked a realistic vision of their future needs and likely income.

As well as obstacles to do with risk or uncertainty, there are broader barriers to investing in a pension which require that a stronger case is made for workplace pensions, combined with better, clearer information and planning tools.

2.1.5 There’s no ‘good moment’ to opt in to a pension

Opting in to a pension can seem unaffordable at any age. With the increase in living costs outstripping wage inflation, many of our respondents struggled to absorb the salary cut required to opt in to a pension scheme. This was most pronounced in the lower income groups, and was also closely tied to life-stage.

Across our respondents, it was evident that there was never felt to be a ‘good moment’ to start saving for a pension. Younger respondents did not think of pensions as a current priority, which is reflected nationally in the high proportion of young people who have no savings at all (Scottish Widows 2013). They presumed that as they got older their salaries would rise, making it easier to cover savings costs.

> **‘You do think about your pension life being way, way off… It is pretty far away, and it’s quite difficult to make those choices when you’ve got a daily lifestyle choice.’**
>
> High income, 22–32, with no children, London

> **‘It’s not an urgent thing I need to do.’**
>
> Middle income, 22–32, with no children, Newcastle

Having children was felt to substantially reduce disposable income and stretch finances thin; this was true across the income spectrum. While several respondents had good intentions regarding saving, they had more immediate demands on their wages. Those who had young children, even those with higher salaries, found that they had substantially less disposable income and greater immediate claims on their finances from both family and housing expenditure. They hoped that once their children were older they would have more money to put towards their own futures. Yet older participants, whose children were beginning to become financially independent, felt they had ‘missed the boat’ on saving for a pension.

> **‘It’s always one of those things you push further and further back, I think, the older you get. Worry about it then – you may not be alive by that time… there’s always something more immediate to spend your money on than thinking about your future, something 15 or 20 years down the road.’**
>
> High income, 28–44, with young children, Newcastle

> **'"Wait a wee minute here," [you think,] … "what do you have to get rid of to put that money away?… How do I find the money to put aside?"… It's kind of like a dream: you'd like to do that, but then reality sets in. I've got three kids, and with all the technology they bring out, they want everything… You think about [opting in], and you think, "No, because I can't afford it anyway, so what's the point in thinking about it?" It kind of goes [to the] back of the mind.'**
>
> Low income, 28–44, with young children, Stirling

Participants argued that people should be encouraged to contribute to a pension as young as possible, to get them into a 'saving habit', like paying national insurance. Many older participants wished they had had the benefits of a pension explained to them when they had begun working. From across all ages there was a belief that if pensions were heavily encouraged at the start of a working career then the money wouldn't be missed, making opting-out less likely.

While auto-enrolment will help with this issue by sweeping savers into pensions, opt-outs should be re-approached regularly before they reach a point at which they consider it 'too late to save'. Some questioned auto-enrolment's age minimum of 22, pointing out that – despite salary rises – disposable income was felt to *de*crease with age, and that at the age of 22 some will already have been employed for several years.

Several respondents had the baseline attitude that pension contributions were currently unaffordable to them because they prioritised their current lifestyle above future savings. Importantly, most of these people rethought their position once they were given more information about pensions, particularly about the impact of starting contributions later. In only a small number of cases, among low-income participants, did affordability present an insuperable barrier – for these people, making pension contributions would not have been manageable without failing to meet rent or bills.

2.1.6 The case for pensions is less well-known than the case against

> **'We've all heard about these risks and people losing their money, but people need to be informed about the other end of the scale, where people did make money or got back what they paid in. There is no positivity about pensions, and we need a bit of that.'**
>
> Middle income, 28–44 with young children, Stevenage

The majority of respondents knew there was some type of risk (in a broad sense) associated with pensions, but few could articulate any positives about saving in a pension. The majority view was that saving in property (if you could afford to), or in an ISA if not, might be a better decision.

By participating in this research, respondents gained understanding of how pensions worked, their benefits and their risks, and were helped to plan for what income they might need in retirement. This experience substantially increased respondents' appetite for saving, and for saving into a pension specifically. Our demonstrations of the 'pot size' of personal contributions alone compared to personal and employer contributions with tax relief proved particularly effective in shifting attitudes.

2.2 Conclusion: trust can be increased through planning and communication

While financial risk is a concern for some respondents, other barriers were more pertinent. The good news for government and industry is that even without more radical reform, simply giving the public a clearer understanding of how DC pensions work – removing some misconceptions and distinguishing the state pension from workplace pensions – goes some way to allaying the public's fears.

Communications that take as their starting point the income that individuals might need in retirement, and that support potential members to think through their likely expenses and how these could best be met (including the state pension and other sources of income), could help make the case for opting in to a workplace pension. In other words, an approach that starts from the outcome and works backwards is more likely to engage the public, and reinforce the idea that contribution today will provide for a better lifestyle in the future.

Practical scenarios, which compare personal contributions across a life-course with total contributions (including employer and tax relief), have been shown to make a compelling case for saving into a pension, despite the element of financial risk involved, rather than another savings vehicle. Seeing the potential loss in value of a total pension pot in the context of the member's contributions was reassuring: in many scenarios savers lost some 'unearned profit' but not their personal 'savings'.[11] Demonstrating the relative impact of starting a pension later in life, and the effect that contributing more into a pension has on a likely retirement income, both make a compelling case for opting-in early and increasing contribution rates.

Addressing the public's lack of trust in pension institutions and the government is a more difficult issue. Improved governance structures and cross-party policy commitments could help to assuage these fears. In particular, defined-ambition could be presented as a new era of pensions, one which creates some distance from the negative associations of past schemes.

In summary, a policy response that aims to boost trust solely by offering protections against the specific risks of investment performance, annuity rates and income value would not be as effective as one that also pursues complementary reform in communication and governance.

We now explore the appetite for various forms of defined-ambition pension models, and gauge their potential effectiveness at overcoming the 'barriers' that currently prevent the public from engaging with pensions.

11 Although this finding should be treated cautiously: attitudes towards hypothetical losses are likely to be different to actual ones.

3. WOULD DEFINED-AMBITION MODELS ENCOURAGE PENSION SAVING?

This chapter summarises the findings from our primary research.[12] We tested four different 'DC-plus' pension ideas which would offer some protection from an aspect of DC pension risk:

- A insurance product or guarantee to protect against investment risk during accumulation.
- 'Smoothing' some profit accrued in good years to cushion losses in other years to mitigate volatility risk during accumulation.
- Purchasing deferred annuities across several years to give some certainty of annuity value.
- Inflation-linked annuities to protect against devaluation of income in retirement.

We also tested attitudes to a collective form of DC to see whether there was appetite for risk-sharing between members. It is important to note that we tested simplified versions of pension models (outlined below) to make them comprehensible for respondents; this may have increased their attraction in some cases.

Overall, while there was appetite among our respondents for protection against risk, it was not desired at any cost. In fact, sharing risk with others through a collective pension is preferred to formal protections like guarantees or insurance products, given their cost. Smoothing, guarantees and inflation-linked annuities were seen to offer protection against risk, and are therefore attractive in theory – but in practice, the cumulative costs of guarantees were felt to be too expensive to offer good value. Deferred annuities were not believed to offer any improvement; in fact, the annuity aspect of DC pensions was by far the most disliked element associated with workplace pensions, and put some people off enrolling altogether.

3.1 A guarantee is desirable in principle, but in practice is seen as bad value

DA model 1: Capital guarantees

A capital guarantee would offer the member some security by guaranteeing a pot size. The guarantee could be offered throughout accumulation (meaning that the value of the pension pot will never drop below a certain level) or at crystallisation (the point of retirement or death).

We focused on the latter option, as while both will diminish a fund's value, protection offered at retirement is substantially cheaper. We proposed that the guarantees would protect a minimum pot size, with the possibility that the pot will grow larger.

We tested three types of guarantees, which progressively increase in terms of both cost and the level of protection they provide:[13]

A. *Guarantees personal contribution at the point of retirement, charged at a reduction of 0.1 per cent of annual growth.*

12 These findings are based on qualitative research, the full details of which can be found in the appendix. They reflect the opinions of a cross-section of employees, following explanations of pensions, inflation, investment, retirement and life expectancy. The findings should be treated as indicative of what an informed potential saver thinks about pensions. While our findings were coherent across the groups, and while respondents had clear opinions and preferences, we don't claim that these findings are predictive of behaviour. However, they should be considered in the policy debate.

13 Full details of models and explanation of the costs can be found in the appendix.

B. *Guarantees total contribution (including employer and government contributions) at the point of retirement, charged at an annual growth reduction of between 0.3 and 0.8 per cent (with the charge decreasing in line with the longevity of the investment).*

C. *Guarantees total contribution plus 2 per cent growth per year, at the point of retirement (charged at an annual growth reduction of between 1.3 and 1.8 per cent, decreasing with the longevity of the investment).*

The *principle* of guaranteeing a certain portion of a 'pension pot' or retirement income was popular, with the latter more strongly preferred. Guaranteeing at least individual and employer contributions immediately made pensions more attractive than a bank account as a saving vehicle. A guarantee also minimised the concern that savers could be making a bad choice in investing in a pension.

By contrast, on considering various guarantee options and the cumulative impact of their costs, almost all participants concluded that guarantees weren't an attractive option.

One of the reasons why respondents disliked guarantees was their surprise at how small an annuity would be if it was solely based on their contributions, even without considering inflation. Respondents presumed that if contributions were protected and made over several years, this would guarantee a pot which could translate to a reasonable retirement income. Faced with scenarios (at 40, 30 and 20 years of contributions at £40 or £100 per month) respondents were extremely disappointed to see how low their likely annuity would be. Because of the small amount that was guaranteed, most people thought it unlikely that they would need to rely on the guaranteed portion.

Each of the three guarantee scenarios presented (A, B and C) were felt to protect *too small a proportion* of the predicted pot (based on 6 per cent annual growth) to be worth paying for.

> **'If you pay in that amount of money to the company over 40 years, and you came out with that, you'd be disgusted. So you're better off with the risk, because the fail-safe just isn't enough to make it worth [it].'**
>
> Middle income, 42+, empty-nester, Coventry

> **'The way I see it, if it's all just on today's prices, £80 is not going to get you two weeks' food, so what are you going to do for the rest of your retirement? I wouldn't even bother with it.'**
>
> Middle income, 22–32, with no children, Newcastle

Similarly, while the charges associated with the various guarantees sounded reasonable (between 0.1 and 1.8 per cent reduction in annual growth),[14] upon seeing the impact of these charges across several years (and particularly their impact on the final pot size) respondents considered them far too expensive to commit to. A very small minority of participants said that they would consider subscribing to the cheapest guarantee (guarantee 'A', protecting personal contributions only), while acknowledging that that option was 'psychologically appealing' rather than necessarily 'financially sensible'.

14 See appendix for details

> **'I can see the theory behind it as a good theory, because if you're investing in something and you're not sure what you're going to get back, at least you know you're going to get something. But the amount guaranteed isn't worth it.'**
>
> Middle income, 22–32, with no children, Newcastle

Respondents disliked the fact that the guarantee only extended to the 'pot' rather than an actual income. What's more, those with little confidence in pension providers (particularly those in the older age groups) did not trust that guarantees would be honoured in any case.

The very small minority who said that they might consider a guarantee also said they would want to know the likelihood of needing to rely on it, even if such an analysis used only historic data.

> **'I would like to have the knowledge behind the percentage of current pensions that would only ever come out as [below the guaranteed amount]. I would have to make an educated decision on it that way, because I don't think anyone who's invested in a pension for that amount of time would ever come out of it with that kind of money, so I think it's a bad deal personally.'**
>
> Middle income, 22–32, with no children, Newcastle

3.2 Smoothing finances across the accumulation phase, to protect against sudden 'shocks', is popular

DA model 2: 'Smoothing' during accumulation

Smoothing would protect members against some of the volatility associated with pension investment. Some of the profit made in good years would be held back, to be paid out in under-performing years. At retirement, the member would be eligible for a bonus pay-out.

We tested this both by itself as a low-cost option (charged as a fixed management fee of 0.05 per cent reduced annual growth), and at a higher cost in combination with guarantee 'B' (at 0.5 per cent reduced growth).

A smoothed pension fund was one of the most positively received models that we tested. Respondents preferred protection from sudden falls in value – cushioning the impact of 'another 2008' – to a baseline guarantee. They also liked the fact that it would protect them against market performance at the point at which they decide to retire. Some thought that protection against volatility would make it easier for them to plan for their old age:

> **'[It makes pensions] a little bit more reliable… it allowed people to forward-plan better from a financial perspective, [the fact] that there was an indication of how steady it was going to be… I felt it was a steady way forward for individuals, that they weren't going to take the big hit that they could potentially have taken.'**
>
> Middle income, 42+, empty-nester, Coventry

Most respondents did not see investment gains as money they had personally 'earned': minimising potential losses was more of a preoccupation than maximising potential gains. Smoothing was therefore seen as logical, particularly if the fund performed well enough to be continually increasing in value. This is backed up by risk studies, which have demonstrated that the public fear loss more than they appreciate gain (NEST 2010).

'I prefer that idea [smoothing] to being a big winner, but I wouldn't want to be a big loser either, so I like the idea of having a wee bit level of protection, even if it's not guaranteed.'
High income, 42+, empty-nester, Edinburgh

A smoothed fund would be more likely to reflect how respondents assumed pension funds performed during accumulation, with slow but steady growth (NEST 2010). The associated costs of smoothing (0.05 per cent reduction in annual growth) to protect against volatility was thought to be reasonable for the protection offered. However, smoothing combined with a guarantee was deemed too expensive.

3.3 The annuity process is universally disliked, and gaining some surety by purchasing a deferred annuity is no panacea

DA model 3: Purchasing a deferred annuity
This would allow savers to part-purchase an annuity in advance of retirement, in order to provide surety about a portion of their future retirement income.

The responsibility involved in the annuity process was universally disliked: respondents felt they had to make a decision they weren't adequately equipped to make, which would be time-consuming and troublesome, and would have a big impact on the rest of their lives. There was a great fear of 'getting it wrong', and concern about the administration involved in making a decision.

While a sizeable minority of participants knew something about the accumulation process in pensions, hardly anybody knew about annuitisation – almost all respondents presumed they would receive an income directly from their employer or fund.[15] Picking an annuity seemed more challenging than enrolling in a pension, and it was a decision participants felt even less qualified to make.

Feeling was so strong that a few respondents were put off investing in a pension at all:

'That puts me off a pension right away… [I] thought I would just retire and the company would just work my pension out for me, and I'd get my cheque every month, no hassle. I wouldn't have a clue how to go and take my money and go and discuss it with, you know, somebody else and understand what they're talking about and stuff like that.'
High income, 42+, empty-nester, Edinburgh

The fact that the value of their annuity would depend on a number of factors that were out of their control was seen to make it difficult for them to manage the risk, even with advice. The fear of making 'the wrong decision' was heightened at the point of annuity, as it would affect the rest of their lives and was not a decision they could reverse.

Several also disliked the fact that some annuities could 'reward' unhealthy lifestyles – for example, by offering smokers a higher retirement income. Some of the respondents in Scotland were aware of their statistically lower life expectancy compared to other parts of the UK, and argued for some tailoring for factors that were out of their control (region and age), but less for lifestyle factors (alcohol and cigarettes).[16]

15 None of our participants expected to retire within five years, so were unlikely to have considered annuities.
16 This finding should be treated with caution: we didn't dwell on the impact of manual labour, for example, on life expectancy, which respondents could have been more positive about.

No participants liked the option of purchasing deferred annuities. They felt that this wouldn't necessarily improve their finances, would involve greater administration, and would increase the emotional pressure of making several decisions about annuities rather than just one. The question of whether they would be better off by leaving their funds invested or buying an earlier annuity was felt to present a decision they were unqualified to make – and one which left them vulnerable to losing a substantial amount of money.

To be clear, the issue was not necessarily the concept of a deferred annuity (or of having an annuity rather than managing savings across retirement), but rather the responsibility of the decision and the process of the purchase.

3.4 Most prefer inflation-linked to fixed-rate annuities, but might not be able to afford it at the point of retirement

DA model 4: Index-linked annuities

Purchasing an inflation-linked annuity protects the value of that annuity. Doing so results in an initial retirement income that is substantially lower than that offered by a flat-rate annuity, but which rises over time.

In principle a substantial majority of participants preferred inflation-linked annuities to fixed rate ones. While this opinion was partly informed by a group discussion about inflation (and should therefore be treated cautiously), the fact that energy prices were dominating the news and bills had been rising visibly meant that hikes in living costs were at the front of respondents' minds.

> **'I think that the… cost of living has gone up, you know, everything: fuel, fuel bills, fuel for the vehicles.'**
> Low income, 28–44, with young children, Stirling

Yet the initial drop in income that resulted from adopting an inflation-linked rather than flat-rate annuity was seen by many as too great. This reaction was equally pronounced across the income spectrum: the issue wasn't just the lower income, but the proportion of the decrease.

While most agreed that index-linked annuities were the 'right choice to make', participants didn't know if they would be able to afford to make it when it came to the moment of decision. This attitude was linked to concerns about life-expectancy: several people were worried that they wouldn't survive long enough to 'make up the difference'.

Some respondents suggested a compromise option of an annuity which increased year-on-year (at below inflation), but which required a smaller initial fall in income.

3.5 Sharing risk through a collective DC scheme was the most popular idea tested

DA model 5: Collective defined-contribution (CDC)

Collective pensions are a fundamental part of provision in the Netherlands and Denmark. The employer and employee both pay a fixed contribution (as in standard DC), but accumulation and decumulation risks are shared between members. Members have a predicted retirement income, which reflects retirement age and contributions, but this is not guaranteed. Retirement income is paid directly from the collective fund, and aims to increase to reflect inflation, although indexation is conditional on fund performance. The

model we tested with our participants was a simple version, though one in which the possibility remained of pension income fluctuating in retirement.

A form of collective pension was the most popular model among those tested in our research, even if risks were only shared between members (rather than with employers). Part of the popularity of the scheme can be attributed to participants' expectation that a collective pension could lead to a higher average retirement income (because funds remain invested in retirement, reduced need to 'de-risk' investments, and economies of scale), therefore providing better value to savers. Based on evidence from the Royal Society for the encouragement of Arts, Manufactures and Commerce (RSA) and the DWP, respondents thought that the collective pension model gave a good chance of a higher average income (Pitt-Watson and Mann 2013, Pitt-Watson 2013, DWP 2013c).

However, a higher income was not the only reason why a collective pension was preferred to other DA options: collective pensions were also thought to be 'fairer' than individual pension schemes. Given the complexity of pensions, respondents believed that members should neither reap all the rewards of a high-performing pension, nor have to face all of the downsides of a low-performing pension:

> **'If you put in the same money as me, but they've risked your money on something different and [so] you did worse and I did better, that's not fair because you haven't decided that you're going to risk it on that.'**
> Middle income, 22–32, with no children, Newcastle

> **'If something major happens [to his pension], it's only going to affect him, and he's going to lose all his pension but we're all okay. That's not fair on him. Whereas if something were to happen and we all share in that, we'll all only lose a little bit. He's not made that investment. Someone else has made that investment on his behalf, why should he lose out? It's just not fair. If everybody is going to lose just a little bit, it just seems fairer really.'**
> Middle income, 28–44 with younger children, Stevenage

> **'It's providing for your old age – you just want to provide a way of living. Security is more important than making some big killing.'**
> Low income, 42+, empty-nester, London

A collective pension was thought to strike a good balance between rewarding contribution (and responsible behaviour) and offering the same rewards for all. Several respondents said that they liked the solidarity of a collective scheme – meaning they didn't face the fear of making the 'right' decision alone. Respondents felt protected against responsibility for their individual pensions, and several voiced the idea that pensions should be a 'social policy', and that a collective scheme was a more appropriate vehicle for it:

> **'I like the thought of it – all in it together, rather than out there on your own.'**
> Low income, 22–32, with no children, Erdington

> **'It's less of a financial thing for me, it's more of a social policy… I like the social aspect of it… I'd be willing to pay more for that, I think.'**
> High income, 22–32, with no children, London

Related to this idea of pensions as a 'social policy', respondents were enthused about how a collective scheme would 'cut out the middle man', and about having a few larger default schemes with reduced fees and complexity. The fact that in the Netherlands collective pensions are run by non-profit organisations was particularly appealing:

> **'I think it's much safer… you can't profiteer as much as you could, but then you haven't got all these pension companies making loads of money out of it either.'**
>
> High income, 28–44, with young children, Newcastle

> **'[The government should take pensions] away from big business and make it more of a social element. The fact that it's the government's responsibility to get people to contribute towards their wellbeing [in old age means that they should] take [the responsibility] away from the people who are making money out of it. Therefore any profit will be ploughed back into [the system], rather than going [to] corporate men who are making fortunes out of it.'**
>
> Middle income, 42+, empty-nester, Coventry

Another element that our respondents particularly liked about a collective pension option was that they would not have to shop around for an annuity. Having to convert the pensions pot into an annuity was little known-about and, once explained, heavily disliked. The process was seen as difficult, and another instance in which individuals would have to live with the potentially negative consequences of a decision they did not feel capable of making. Some respondents also didn't like the way in which different annuity rates were offered according to health – they felt that this rewarded unhealthy behaviour, and that life-expectancy predictions were too abstract to be fair.

> **'Nobody's to know that the less healthy one is gonna get hit by a bus… I don't think it's right that you get more money if you're less healthy just because you're [not] going to live longer – it's not your fault half the time if you're unhealthy or if you are healthy.'**
>
> Middle income, 22–32, with no children, Newcastle

The fact that retirement income could fluctuate in a collective scheme was cause for concern. However, if the scheme was run by a non-profit organisation with proper governance arrangements, respondents felt that falls of 5 (or even 10) per cent could be manageable – particularly if the fall was being faced by all members. Because of the assumption that, on average, CDC would provide a higher income in retirement in the first place, the possibility of an annual fall was felt to be worth accepting.[17] That said, our respondents said that they would feel more confident as savers if there was an indication (ideally a guarantee) of the maximum fall they would be likely to face on a year-to-year basis. Being shown historic data on good and bad years would give them more certainty and confidence on this point, even without minimising the risks.

Respondents' most significant reservation about enrolling in a CDC was how to ensure that there would be a large enough number of members (both now and in the future) to safeguard its continuing success. A sizeable minority of respondents supported the idea

17 Participants struggled to think about the cumulative impact of falls, so this finding should be seen as a willingness to accept a few years with a slightly smaller income, rather than the long-term implications of 5 or 10 per cent falls.

of compulsory contributions to a collective scheme, as long as funds were protected and the minimum contribution was very low. This finding is reflected in quantitative analysis by Capita, in which 52 per cent of the sample supported the idea of a compulsory pension, regardless of income – including a third of those who were not then in a pension scheme (Hames 2013).

Collective defined-contribution pensions in the Netherlands

Occupational pensions in the Netherlands are made up of:

- industry-wide pension funds (for a whole sector such as the civil service, construction industry, hospitality industry or the retail sector)
- company-specific pension funds (for a single company or corporation, though these can be linked to one or more companies, and
- pension funds for independent professionals such as medical specialists and dentists.

These pension schemes can be mandatory or voluntary. If the social partners (employers and trade unions) decide to provide a pension scheme for their employees, the minister of social affairs and employment can make participation mandatory for an entire sector or profession. The quasi-mandatory nature of the system has ensured that over 90 per cent of employees have a pension scheme with their employer.

A collective defined-contribution 'hybrid' pension scheme has been developed in the Netherlands. It operates in a similar way to a DB scheme, but crucially the investment and longevity risk, which was previously borne by the employer, is transferred to employees and retirees, who share it as a group. The contributions of the employer and the employee (plus tax relief) are pooled and invested collectively, which enables a more ambitious investment strategy than in an individual DC scheme. Because of economies of scale, fees and other costs are also significantly reduced. The plans are intended to provide a similar replacement income as in a DB scheme – the 'career average' benefit formula is retained, and retirement income is index-linked.

A fixed percentage of wage contributions (employer and employee) are designed to ensure that the scheme is well funded, with a target cushion of 30 per cent overfunding. However, in the event that a fund makes losses on its investments and the scheme is consequently underfunded, the pension scheme's governing body (which includes representatives of employers, employees and retirees) decides what adjustments need to be made. This can involve an increase in contributions by employees (but not employers), the elimination of index-linking or, in extreme cases, the reduction of retirement income in future years. If the scheme becomes overfunded, employees and retirees benefit rather than employers.

3.6 Conclusion

The most popular option for pensions reform is the creation of a collective form of DC. All respondents felt that government reform should focus on developing a collective pension, believing that this could boost public engagement. This finding bucks the commonly-held belief that the public is becoming more individualistic in its attitude towards welfare. In

fact, there are strongly-held pockets of support for collective institutions in the forms of the NHS, education and the state pension (NatCen 2013). As well as stimulating the public's appetite for member saving, a collective pension could offer a better return for savers than pure DC, through risk-sharing, economies of scale and self-annuitisation. Our findings strengthen the case for policymakers and the industry establishing a form of CDC in the UK pension market.

Some form of 'smoothed' pension during the accumulation phase also proved popular. It was felt to better reflect how a pension 'should' perform – slow and steady – and the charge (a 0.05 per cent reduction in annual growth) was considered acceptable. A smoothed product was preferred to some form of guarantee (or a combination of a guarantee with smoothing) because of the higher charges involved. Ideally, our respondents wanted smoothing combined with a collective pension, and some form of planning and communication session (as mentioned in the previous chapter). The final chapter of this report provides some practical suggestions for how this could work.

Our respondents felt that these three reforms could help build trust and engagement in pensions, better manage pension-related risks, and increase the public's appetite for saving.

4. CONCLUSIONS

There is public appetite for a form of defined-ambition pension that minimises some of the risks associated with DC. In particular, participants in our research preferred a Dutch-style collective scheme that shares the risk among all members and removes the need for an annuity, and that incorporates some form of smoothing into the accumulation phase.

However, reform will need to go further than simply offering new products if it wants to rebuild trust, encourage saving and ensure a good deal for members. Just as many individuals are reluctant to invest in a pension because of concerns broader than exposure to investment risk, reforming workplace pensions to reflect public priorities will require more significant reform than just the introduction of a DA pension product.

To inform this broader reform agenda, this chapter sets out what the public want from a workplace pension.

Of course, potential savers would like a pension which isn't realistically deliverable: one with low contribution amounts, high reward, no risk, and a guaranteed income that rises with inflation and provides them with enough disposable income to enjoy retirement. But having considered the trade-offs between different pension models, and critiqued state and DC pensions, respondents revealed some commonly-held preferences which have implications for product design, communication, regulation and governance.

This chapter distils those trade-offs, priorities and criticisms voiced by our respondents into a set of set of common principles for pension reform which would resonate with the public. These principles should provide a foundation for action by government and industry.

4.1 Eight common principles for better pensions

Our respondents wanted a pension that offers:

1. Protection against sudden falls during accumulation
Savers want to be protected against sudden unexpected falls in the value of their pension pot. Unless guarantees could be offered at a lower charge and give greater protection than seems likely, savers would prefer to have some form of smoothing mechanism to protect against sudden shocks.

2. A clearer estimation of likely outcomes
While savers accept that it is not possible to guarantee a fixed income (without undesirably large charges), they want a clearer indication of how their contributions will translate in terms of income and living standards in retirement (taking inflation into account), so that they can plan accordingly. They accept that estimations could change, but would like a 'best guess' indication of income. They also wanted to know how much old age itself usually costs – they did not feel they had a sense of what they would need in retirement. Savers want a clearer explanation of the potential risks and benefits of their pension scheme, and an account of how their type of pension fund has fared historically.

3. A retirement income that is available when needed and provides some protection against inflation
People want to be able to access their pension fund earlier or later than the state pension age without penalty (apart from the inevitable impact that this has on their annuity). They don't want a fixed retirement age, but want to be able to make decisions about work based on their personal circumstances.

Pensioners want a retirement income that holds its value against inflation, but doesn't start so low as to be unaffordable. Some savers would accept a compromise between a higher fixed income and a lower inflation-linked one; this could be delivered in a variety of ways.

4. A retirement income that reflects contributions and rewards 'good behaviour'
Members want a retirement income that reflects their contributions and matches those of others in the same circumstances. Respondents did not think it fair to receive a different income than somebody else who has contributed the same amount over the same number of years. They felt that pensions should reward contributions equally: 'If you've invested the same, for the same amount of time… you should get the same amount of money.'

A pension should also reward people for having made positive choices, and this should be manifested in two ways. First, those who have invested in a workplace pension should be able to afford a better quality of life than those relying solely on benefits. Those who have built up a retirement income don't want to be penalised by having to pay for social care, or be exposed to higher income or inheritance taxes because they 'did the right thing.' Second, people who smoke or who drink excessively should not be 'rewarded' with a higher annuity, despite their shorter average life expectancy. Instead, pensions should incentivise healthy behaviour.

5. Support for the family
Workplace pensions should provide better support to a member's family as a default. Savers want at least a portion of their pension to pass to a close family member (partner or child) in the event of their death. Ideally they would want it to be available for transfer at any point, but they considered it more of a priority that their partner receives a pay-out when he or she reaches retirement (when family finances are likely to be lower) rather than during employment.

> **'My [priority is] the dependents getting looked after, to make sure… if somebody's contributed for 40 years into a pension, that if they die, their widow or whoever, partner, is getting the money, and the other way round.'**
> High income, 42+, empty-nester, Edinburgh

Pensions should also take account of families in which time has been taken off work either for childcare (until children are of school age), or to care for a partner or relative:

> **'I just brought my children up, and it was at a time that that's what people did. Like your husband went out to work, and you brought your children up… and then after that, as my children grew up I child-minded, and never even thought about a pension. It never really entered my head, and I don't know why because I think now, "How silly was I?" – I didn't think. I don't think you do… everybody talks now about pension and you need a pension, [but] nobody ever did at that time. So I think it's probably too late now. You know, where do I start?'**
> Middle income, 42+, empty-nester, Coventry.

> **'A lot of people don't work… their husbands are on big salaries, they're not working for 20 years, they're going back into work, they're not getting very good jobs because you're quite happy just pottering along, you know, getting a couple of hundred pounds a month or something like that.'**
>
> High income, 42+, empty-nester, Edinburgh

Ensuring that pensions support the family (both in contribution years and during retirement) is one of the most important issues for savers. A few participants felt that they couldn't afford to contribute to a pension, yet were paying substantial amounts for monthly life insurance because their priority was providing for their family rather than themselves.

With the decline of DB pensions, our respondents were right to worry: the reality is that despite the fact that the basic state pension recognises years spent in care as contributing years, women will still face a triple penalty in retirement without family-focused workplace pensions. They are likely to earn less than their partner, and therefore contribute less into a pension. They are also more likely to take time off work around having a family, and so stop contributing into a pension for a number of years. Finally, because of higher female life expectancy, most will outlive their partners in retirement, and will therefore require more in their pension pot to ensure a decent quality of life. Despite public concern, and this mismatch between women's means to contribute to pensions and their needs later in life, the issue has been largely absent from defined-ambition discussions.

These first five principles all have implications for the type of defined-ambition pension scheme that should be developed. However, to increase public confidence in pensions more generally, these products need to be launched alongside:

6. Policies that support individuals' best interests in the long term
Contributing to a pension should be heavily encouraged, or even compulsory. Many felt that this should begin with a first job. Individuals supported auto-enrolment, but were concerned about the minimum threshold being too high and suggested lower but ramped contribution criteria (provided that this does not result in lower pensions overall). While they wanted the opportunity to access their pension at whatever age they chose to retire, they would not want to have the ability to dip into pension funds before then: several voiced a desire to be 'protected against themselves'.

7. Cross-party and long-term government commitments
Paying into a pension requires members to make decisions that prioritise the long term over the short term. It is important that the policies which affect these decisions are stable. While it may not be possible to commit to policy across many decades, where possible there should be cross-party support for pension policy to at least protect against the political cycle. Furthermore, there should be clear explanations for any change of approach, particularly if the 'goalposts' are moved regarding entitlements: our respondents' dismay at rising retirement ages was tempered by information about rising life expectancy in retirement.

8. Pension provision that supports members' best interests without requiring active customer choice

People want to save for their future without the burden of making a lot of choices. Almost all want a small number (two or three) of good default options for saving into, with the possibility of making more active decisions for those who want to look beyond these defaults.

Alongside having fewer, default schemes, most savers don't want to be 'lone rangers' – they want to save in a common product, and share the associated risks.

At retirement, members don't want to have to go through an annuity process: they would rather be paid an income directly from their scheme or employer. If they do have to convert their pot into an annuity they don't want to be responsible for the decision, or to have to shop around.

Incentives should be better aligned between members, employers, advisers, fund managers and the industry. Respondents said that ideally they would want pensions to be run by specialised non-profit organisations, but in any case they would want some limit on charges. Fee structures should (mainly) rely on positive performance, which savers don't feel they have 'earned', rather than charges that take a proportion of the whole 'pot' and therefore diminish personal contributions. In other words, a reduction of positive growth is in theory more acceptable than an annual management fee, regardless of a fund's performance.

Across the whole pension lifecycle (the investment period through to retirement), individuals want their interests to be protected without relying on their willingness or ability to shop around, weigh-up different options and make choices. They want expert independent guidance and oversight, closer to a doctor–patient relationship than a customer–supplier one. Potential members want to invest their pension savings into a trusted institution that is run by experts who can take decisions on their behalf and represent their interests. Ideally, pension providers should operate as non-profit organisations, and be strictly regulated and independent from the government.

Some of these principles are already reflected in current pension policy – the scrapping of the retirement age, for example. Others can be adopted reasonably easily (or are already being met in a similar form), such as offering a compromise annuity which increases at an under-inflation rate but starts at a level closer to that of a fixed-rate income.

Others among these principles should shape the next steps for the DA agenda. They have specific implications for government and industry which highlight where there are currently gaps in thinking or where more focus is needed, particularly concerning supporting family life as a default.

The final principle poses a difficult challenge for the pension industry. For the most part, respondents neither want nor feel qualified to make active choices when it comes to their pension. Savers don't understand pensions, even in broad terms, and certainly not the details of highly technical products. Even among those of our respondents who were contributing to a pension, almost none had a clear idea of the type of scheme they were enrolled in. As discussed in section 2.1.3, one of the barriers to public engagement with pensions was fear of making a bad decision – and, given the complexity and importance of pension choices, this led some individuals to disengage altogether.

An obvious example of this phenomenon in practice occurs at the point of converting a fund into an annuity. Almost all respondents had concerns about this process, and the evidence on annuity purchasing bears this out: despite the fact that standard annuity rates can vary by 30 per cent between providers, too many members don't shop around to capitalise on the best deals, and instead simply remain with their current provider. Analysis by the Institute for Fiscal Studies found that 78 per cent of annuitants between 2002/03 and 2010/11 remained with their original pension provider (IFS 2012). While more people have been shopping around in recent years, figures from the Association of British Insurers indicate that a third of people do not shop around (ABI 2013).

In many ways the pension system isn't set up for members to act as customers in a traditional market relationship. Most decisions are made by employers, and auto-enrolment relies on member inertia. Even if members were successfully encouraged to be more active, the extreme complexity of products, the uncertainty of outcomes in DC schemes, and the lack of transparency in fees and charges make it extremely difficult for non-experts to make well-informed pension decisions. This either means that money which could be put towards retirement is absorbed in fees for consultation and advice throughout the pension life-cycle, or that pensions will not always lead to the best possible outcomes for members. Even the Office of Fair Trading struggled to interrogate charges levied by many suppliers, and in their recent review of the DC pensions market they concluded that competition alone could not be relied upon to drive value for money: their assessment found that £30 billion is currently held in pension schemes that provide poor value for their members (OFT 2013).

The big challenge for reformers – made more urgent by auto-enrolment – is finding a way to ensure that members' interests are protected. This is vital given the importance of individuals having adequate savings, both in terms of their quality of life and of minimising the burden that pensioners place on the state.

4.2 Broader issues

There is no easy or obvious solution, and working through this challenge in detail is beyond the scope of this paper. However, there are a set of issues which require more consideration and government reform if members are to be better protected.

4.2.1 Governance

Defined-benefit pensions have strong governance structures in place. All DB schemes are governed by a board of trustees whose task is to advance the interests of members. DC schemes, on the other hand, can be trust-based or contract-based. The latter type usually has no formal scheme-level governance, and instead has a contract of service between member and provider (usually an insurance company) (Berry and Stanley 2013).

Contract-based DC schemes implicitly assume that the member or employer is being an effective customer, making an active choice. However, as discussed above, it is difficult for customers to ensure that products act in their best interests. Simply improving products will not, therefore, be effective at driving up the quality of DC schemes, due to buyer asymmetry and the complexity and opacity of the market.

As millions of employees will shortly be opted in to DC schemes, it is important that governance structures are strengthened. One solution might be to require all contract-based schemes to have an independent governance committee which includes member representatives (a proposal that was put forward by the Office of Fair Trading and has been adopted by much of the industry) (OFT 2013).

Another option would be requiring auto-enrolment schemes to be trust-based, or at least make this a requirement for small and micro-organisations (which are less likely to have the resources to assess and negotiate with their providers). Trustees could provide the oversight that the public desires, and be given responsibility for protecting their members' interests. In the strongest form of this governance structure, trustees could be given a duty of care to act in the primary interest of their savers, and the board could be put under obligation to act at the behest of trustees.

It would be legitimate to criticise a reform which advanced or required trust-based schemes on the grounds that not all trustees meet regularly enough, and that some lack sufficient expertise to ensure good outcomes for their members. However, rather than constituting an argument against independent oversight, this criticism makes a case for ensuring better stewardship. Trustees could be required to be licenced, either individually or on a scheme basis. Alternatively, a more radical move would be to task the Pension Regulator with creating a panel of experts from which scheme trustees could be selected.

A solution goes beyond the scope of this research, but the issue remains urgent. Discussion of the best way to protect members' interests should be a priority for industry and government, in order to improve both members' outcomes and the public's faith in pensions.

In summary, reform is needed to put governance structures in place that ensure pension schemes are providing value for money and – if a trust-based solution is chosen – that trustees are both independent and have adequate expertise to protect members' interests.

4.2.2 Annuities

A second challenge is presented by annuities. The process of securing an annuity (as opposed to the product itself) was disliked by our respondents. Even if schemes were to offer better guidance, the burden of responsibility of making an irreversible decision would still lie with the individual (unless they were enrolled in a self-annuitising scheme).

Many members aren't shopping around to secure the best rates, so the annuity market is not functioning effectively. Current differences between annuity rates mean that some pensioners are effectively losing up to £2,000 every year of their retirement (based on a £150,000 pension pot).[18] Over and above pension rates, converting a pension pot into an income stream can also involve associated fees, even when the member remains with the same provider.

Given increasing longevity risks, and customer concerns with annuities, there are two questions that need to be addressed by policymakers and the industry:

1. Are the annuity products provided by insurers still fit for purpose? Is there any way annuity rates can be increased?
2. Can the annuity process be improved for members?

The industry is already responding to the latter question. They have agreed to introduce a compulsory code of conduct which requires fund managers to contact members two years before their retirement with an explanation of the annuity process and various options. This builds on the previous FSA requirement that providers communicate with

18 Based on highest and lowest Association of British Insurers annuity rates for September 2013, assuming a 65-year old with a 150,000 pension pot , level payments and no health problems or guarantee period. https://www.abi.org.uk/Insurance-and-savings/Products/Pensions/Annuity-rates/Example-rates

members between four and six months before their intended retirement date with a 'wake-up pack' on annuitisation.

This is undoubtedly a step in the right direction, and we will need to examine its impact once this new approach has bedded in. However, our research suggests that it may not go far enough. Our respondents were clear that they did not want to take responsibility for the decision of purchasing an annuity, which they felt ill-equipped to make. Ideally they would want a default income that didn't require active choice. However, it is not clear what a 'good default' option would be for the majority of the population. Our findings show appetite for an income in retirement that has some form of indexation (even if it does not fully keep pace with inflation), and income that pays some income out to a partner upon a member's death. Yet even these basic choices won't be right for everyone. In practice, decisions about retirement, or even when to retire, will depend on the individual's circumstances – but to offer independent advice on an individual basis would add significant costs into the process.

4.2.3 A fee cap

A proposal to cap annual management fees at 0.75 or 1 per cent is currently under consultation (DWP 2013b). Scrutiny of fees is to be welcomed, as the impact of a marginal difference in the annual management charge (AMC) translates into a substantial difference in retirement income: bringing fees down from 1.5 per cent to 0.5 per cent, for instance, could boost a savers' pension pot by over £140,000 across their working life (ibid). Based on current annuity rates, that works out as more than £500 of extra income in every month of retirement.[19]

For a fee cap to be effective it needs to be ambitious. In 2012, new contract-based schemes and bundled trust-based schemes in the UK had an average AMC of just 0.5 per cent (OFT 2013). In other countries, pension fees are substantially lower, due to larger schemes benefitting from economies of scale – Dutch collective fees, for instance, stand at just 0.15 per cent on average. Of course there is a balance to be struck: the cap needs to be set as low as possible, but should not restrict decisions which may result in high-performing investments.

On the other hand, a fee cap may become less necessary if governance and oversight were strengthened, so long as fees were made more transparent.

There are no easy or obvious solutions to any of these issues, but taken together they strengthen the case for reform that is more ambitious and covers a broader remit than simply developing new pension products. Without tackling issues of governance, communication and transparency, reform could do more harm than good: offering DC protections with the associated charges (which may be not be fully understood or always necessary) could lead to worse retirement outcomes for many savers and further erosion of public trust in pensions in the long term.

In light of these conclusions, we have three recommendations for the government and industry to build trust in pensions and ultimately boost saving levels.

19 Based on current Prudential modelling, provided by Prudential to IPPR.

5. POLICY RECOMMENDATIONS

Our research was, unavoidably, based on simplified pension models, but we believe that in the context of the wider evidence base our findings have clear implications for the next phase of defined-ambition thinking. Based on public preferences, we have three core policy recommendations for shaping the defined-ambition agenda. These three recommendations are presented in order, from the least to the most ambitious in scope.

1. Ask members to set a target pension income, and tailor communications to support planning.
2. Offer protection against accumulation risk with a smoothed pension.
3. Introduce collective defined-contribution pensions to the UK.

Our recommendations should not be considered mutually exclusive: while each could be beneficial independently, they would be more powerful if enacted together.

5.1 A target pension income and communication reform

5.1.1 The case for reform

There are good reasons for improving savers' and potential savers' understanding of pensions:

1. Those who understand more about workplace pensions (and other interlinked policies) want to save more – this was clearly established in our research. Currently the risks of saving in a workplace pension are better known than the benefits, which means that a lack of understanding may encourage those who are unlikely to have other assets to support them to opt out.
2. In light of auto-enrolment, employers, government and pension providers now have a greater responsibility to inform people of what is happening to their contributions. If charges and risks aren't fully understood, savers may fail to make adequate provision for their retirement, and trust in pensions may be further eroded.
3. While pensions are a jargon-filled, uncertain and complex policy area, our research demonstrates that the general public can understand simplified versions of fairly complex pension models, and hold strong opinions about decisions made about their finances.
4. If workplace pension provision relies on inertia through auto-enrolment, it runs the risk that those who initially opt out will never opt back in, and that the majority of people who contribute at only the minimum level will not have an adequate replacement income (PPI 2013).

With our participants we explored the possibility of employees setting their own target income for retirement and then working backwards to decide how to save, how much to contribute, and when to retire. Although such a process does not offer any formal guarantees or protections from risks, it was popular, particularly if providers were obliged to contact them if their investments were not performing (roughly) in line with their target. The process made respondents feel more confident that a pension was the right way to save, and more certain about their outcomes (while understanding that the target was a 'best guess' rather than a guarantee). Furthermore, our respondents felt empowered by the idea of having the choices of accepting a lower-than-planned income, working longer, or contributing more. This contrasted starkly with their attitudes during earlier discussions which started from the contribution level (and general expectations about the level that would provide a decent retirement income) and led to their being 'let down' by how this translated into a lower-than-expected pension.

We believe that asking potential members to set their own target incomes for retirement and then work backwards from that figure could substantially increase the amounts that individuals are willing to contribute, and their appetite for saving into a pension. However, this will only be effective if potential members are given the right information, tools and examples. Successful communication needs to:

Encourage people to think about and plan for their retirement
Providing illustrative examples of costs in old age, inflation, and life-expectancy forces potential savers to consider their future needs, and gives them the tools they need to make realistic plans.

Make the case for pensions
Seeing the potential impact of modest levels of pension fund growth over a full working life, and comparing pension outcomes to other savings vehicles, substantially boosted our respondents' appetites for saving in a pension. They were shocked by the difference that a few years of contribution delay could make to their likely retirement income – seeing different scenarios with cash values increased their desire to save sooner rather than later. Communication should include various pension scenarios (retirement age, contribution amounts, number of contribution years, fund performance) and historical data, or a likely range of outcomes.

Clearly differentiate the state pension from a workplace pension
The fact that there is no enforced retirement age, and that workplace pensions can be paid out earlier than the state pension age, was a compelling incentive to contribute to a workplace pension. Learning that government changes to the state pension age would not affect a member's access to their workplace pension boosted our respondents' appetites further.

Consider pensions from the perspective of the members – start from outcomes, not inputs
When considering the future, respondents didn't think of 'pensions' per se. They wanted to know what they will have, and what they will need, in retirement. Their attitude to pensions was affected by other potential incomings and outgoings, particularly how a pension income would interact with benefit entitlements, the state pension, social care costs, inheritance taxes and life insurance. To be effective, communication can't take workplace pensions as its starting point: rather, it needs to consider the broader retirement picture, beginning with the individual's needs rather than their pension policy. In particular, the issue of whether saving for a pension could affect benefits (because of means testing) needs to be addressed.

Adjust for inflation
Future target incomes, and the likely outcomes referred to in communications, need to be converted into 'today's prices'. Members won't be able to assess or plan for their needs accurately if inflation isn't taken into account.

In summary, communication needs to primarily engage with the public's interest in pensions ('What will I have to live on in old age?'). This will need to include broader explanations of other income sources (benefits and state pensions), inflation, and (if asked) how pension income would interact with other policy areas – particularly social care and inheritance and income taxes. This should be followed by asking members to set their own target pension incomes, having given them tools to help them arrive at informed decision.

5.1.2 What could reform entail?

The government should work with the pensions industry to improve communications and develop a planning component at enrolment (and potentially at other moments such as a new job or key periods away from retirement). While face-to-face communication in small groups would have the greatest impact, there are a variety of potential ways to boost engagement, understanding and support planning which could be less costly but still improve trust. For example:

- Providers could decide to offer sessions to employees within specific firms, to dispel myths and support individuals to make plans for retirement. This support would probably be most effective if provided face-to-face, but otherwise providers could direct people to online tools to support their planning as part of the enrolment process (similar to financial planning exercises in the mortgage application process). Providers could offer the service of contacting individuals if their scheme was performing significantly under target.
- The government could change the regulation concerning annual statements so that they state whether pension performance was 'on track' for a saver's specific target or target replacement rate at their salary band (see glossary). One straightforward way of communicating this could be through a 'traffic-light' system in which, based on current projections, 'green' would indicate a likely outcome of at least 95 per cent of target income, 'amber' would indicate at least 85 per cent of the target, and 'red' a likely outcome of less than 85 per cent of target income. On receipt of an amber or red statement, the member could be invited to contact their provider or employer to discuss the option of adjusting their target, contributing more or working longer.
- The government could improve auto-enrolment communications so that they offer a clear account of the strengths and weaknesses of pensions compared to other saving vehicles, and clarify the distinction between the state and workplace pensions.
- The Pension Advisory Service or Money Advice Service could play a role in developing materials or tools to support employers who are offering planning sessions.

These initiatives could be supported by an information campaign targeted at the public about the need for higher contributions, and an employer-targeted campaign to encourage participation in schemes like Save More Tomorrow, in which employees commit to raise their contribution levels at future pay-rises.

Several providers have worked to provide better communications during accumulation but, while this is important, good communication at enrolment could have a more profound impact. There are questions to be worked through to ensure that engagement is effective rather than overwhelming, to interrogate costs and practicalities, and to explore issues around advice and independence. However, we feel there are incentives for all stakeholders to engage with these questions.

5.2 Offer protection against accumulation risk with a smoothed pension rather than a guarantee

5.2.1 The case for reform

Savers want more certainty. If it were possible to offer a guaranteed income at a very low cost, it would be a powerful motivator for potential savers. However, the costs of protecting the value of a pension fund at retirement were deemed to be too high by our respondents given the level of protection on offer. Raising income is the main motivation for reform, and our research suggests that the reassurance provided by a guarantee is, for many people, unlikely to outweigh its cost.

If guarantees are offered, it is important that the cumulative impact of the related costs, rather than the low annual percentage fee, is clearly communicated to potential members. Respondents acknowledged that they would have been attracted to guarantees if they hadn't seen the modelled long-term costs of them under various scenarios.

Instead, smoothing is seen as a better protection at a far more acceptable cost. Offering a 'smoothed pension' would overcome the issue of savers seeing their balance suddenly fall (which remains a possibility with a guarantee), and was believed to provide more certainty by ensuring a less volatile trajectory. A charge of 0.05 per cent was felt to be reasonable, and would have only a small impact on pension incomes.

5.2.2 What should reform entail?

While a smoothed product wouldn't need to operate in the same way as a with-profits policy (in fact, a smoothing mechanism with guarantees was thought to be too expensive), it would need to address some of the 'negative characteristics' associated with some with-profits products. The most recent FSA review of with-profits funds agreed that, if they worked effectively and fairly, they could be an attractive option for customers as a low-risk product that aims to deliver mid-range performance. Yet despite their potential, the overwhelming opinion held by consumer stakeholders was that the with-profits sector was not working effectively, resulting in poor outcomes for policyholders. Their main concerns were with the areas of governance and communications (FSA 2010).

If a smoothed pension product were created, the issue of governance would need to be addressed to ensure that members' interests are represented, particularly on decisions about pay-outs across the accumulation process and on crystallisation (the 'inherited estate'). There would also need to be increased transparency and better communication with members or customer stakeholders to explain how the policy would work, and under what circumstances money would be held back or paid out.

These issues could be addressed in a number of ways:

- Smoothed schemes could be offered only on a trust basis, with independent trustees – acting at provider/product level, rather than employer level – to oversee decisions. To further strengthen governance, a requirement could be made to licence trustees either on an individual or scheme basis (see chapter 4 for a discussion of governance).
- The FCA could regulate for improved transparency by including information on amounts retained or fees charged (in cash value) in annual statements. This information could be presented to savers as an annual amount in their fund, with the amounts going into or being paid out from their 'reserve fund'.
- Depending on the type of smoothed pension offered, providers could explain the circumstances under which they would pay out and withhold funds, based on a formula. This wouldn't require a guarantee, but could be contingent on fund performance.

The government should include a 'smoothed pension' as a lead option for the accumulation phase of the pension process. There are also incentives for providers to engage with the smoothed pension option – it could provide a high rate of enrolment and low opt-out rate.

5.3 Introduce collective defined-contribution (CDC) pensions

5.3.1 The case for reform

Collective pensions appear to offer better returns to members than standard DC ones. CDC reflects what people want from a pension: it was the most popular idea among those we tested, it addresses many of the barriers that participants identified as making

them reluctant to contribute into a pension, and reflects many of the common principles for better pensions laid out in our conclusion.

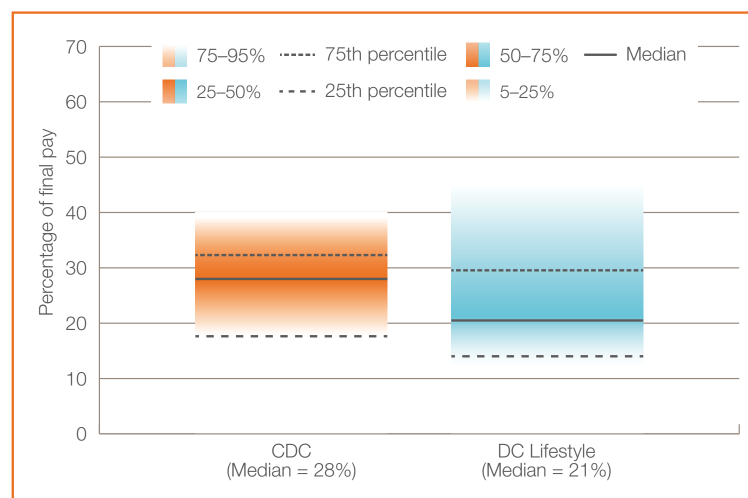
While debate is ongoing, leading academics and government-commissioned modelling suggest that CDC could offer a better pension salary for members than DC pensions, because:

- Fees can be substantially lower in CDC than in DC vehicles. The Dutch average AMC is just 0.15 per cent, which throws the UK's current consultation about capping fees at 0.75 or 1 per cent into sharp relief. Just bringing down AMC's, by creating larger schemes which could reap economies of scale, would substantially boost pension pot size.
- Risks are shared, so investments can be more productive. There is less need for 'de-risking' – moving invested assets into low-risk, low-yield options – in the run-up to retirement.
- Self-annuitisation (as in the Dutch model) could reduce the fees associated with annuities through economies of scale, and allow funds to remain invested throughout retirement. Sharing longevity risks should mean that savers get better rates than they would do on an individual basis.

DWP calculations have found that the cumulative impact of these savings (lower fees through economies of scale, keeping money invested in higher-yield products, and removing the annuitisation process) would result in an average pension income 39 per cent higher than that from a traditional DC pension (DWP 2009). More recent modelling by Aon Hewitt based on historical UK data calculated that on the best like-for-like comparison:

- a collective pension would on average have outperformed an individual pension by 33 per cent
- in 37 of the past 57 years, a collective pension would have outperformed the individual pension, and
- the variability of the pension (and therefore the risk the saver would have taken) would be lower with a collective rather than an individual pension (based on modelling by Aon Hewitt (2013) cited in Pitt-Watson 2013).

Figure 5.1
Historic CDC and DC outcomes expressed as a distribution of the percentage of final pay received by retired members



Source: Pitt-Watson and Mann 2013, based on Aon Hewitt modelling (Aon Hewitt 2013)
Note: the individual DC refers to an inflation-linked annuity, and the CDC reflects the average pension received by a member across the duration of their retirement (expressed in real terms relative to their retirement date).

In other words, if savers had invested in a CDC rather than a DC pension, they could expect a higher retirement income and would be less likely than under a DC pension to receive an income that falls into the highest or lowest spectrum of outcomes. More stable outcomes would also reduce the need for a costly guarantee, and make it easier for members to plan for the future.

Our research demonstrates that there would be public support for a collective pension. This is partly, but not solely, because of the desire for a higher average income – a CDC also reflected many of the principles that the public wanted to be at work in a pension. For example:

A clearer estimation of likely outcomes
The less volatile nature of CDCs means that members' pension investments will perform in a way that is closer to the average. Cutting away the very high and low performing 'tails' (as shown in figure 5.1) reflected the public's desire for a middle ground between the opportunity to save for a decent retirement and the desire for some protection against risk.

A retirement income that is available when needed and offers some protection against inflation
Because a collective pension offers an income which reflects fund performance, the assumption would be that in many years this would grow. However, this does come with the downside that pension income may possibly fall during retirement.

A retirement income which reflects contribution
A CDC pays out the same amount for everyone who has made the same contributions, rather than an annuity based on individual performance and personal factors.

A pension that supports family finances
Because a CDC pension bridges both the accumulation and decumulation stages, the argument for contributing could be bolstered by membership being offered with the promise that a future salary would be paid to the member's dependents or partner in the event of his or her death. In the Dutch system, a member can accrue entitlements to a retirement pension, partner's pension and orphan's pension (MSZW 2008).

Our respondents envisioned a collective pension as a large-scale default option for savers – meaning that they hoped it would overcome the need to make decisions, or the risk of being a 'lone ranger'. Respondents felt that a collective alternative would give them more confidence to save, and would make them more likely to save at a higher rate (if it was affordable) than in a traditional DC scheme. Alongside auto-enrolment, CDC pensions could signal a new type of pension, one that would be far removed from pension scandals of the past.

In this report we have argued that there is an urgent need to secure higher retirement incomes for those currently in work, and suggested that this could be addressed by offering more attractive products to encourage savers to scale-up their contributions or by improving the conversion rate from contributions to final income by reducing fees through new approaches or regulation. A collective pension would represent progress on both of these objectives. Of course, some aspects of a collective pension could be offered through currently existing vehicles as well – this should also be explored.

5.3.2 What should reform entail?

We can't import a Dutch collective pension model wholesale into the UK. Yet both the government and leading academics, backed by industry stakeholders, are engaging with the introduction of some form of CDC as a realistic possibility. However, there are some big questions that need to be properly answered before a collective scheme is adopted. Based on the existing evidence for CDC, and our research demonstrating public support, conducting further research to answer these questions should become a priority. To manage this process we need a new pension commission to assess:

- how a CDC pension model could operate in the UK
- whether a CDC could operate without relying on government intervention, and if government involvement were needed, what form it would take
- how a CDC could protect against intergenerational unfairness
- whether a collective scheme could ensure longevity without compulsory (or semi-compulsory) enrolment.

If these questions could be addressed satisfactorily, four steps would need to be taken to create a collective pension vehicle in the UK:

1. The first step is legalisation. Employers and providers can't seriously engage with the details of how CDC could work in the UK unless it is made a viable option. There is a good case for it – it works well in other countries, and it reflects what the public want in a pension – yet under current legislation it would be illegal to offer it. The introduction of new legislation to allow for collective schemes requires cross-party consensus and support from key stakeholders to ensure both that such a bill is successful, and that support for it will continue into the next parliament. The Confederation of British Industry, Trades Union Congress, National Association of Pension Funds and the Association of Member Nominated Trustees backed the latest report from the RSA that argued for CDC pensions (Pitt-Watson 2013), and both the government and opposition have shown some interest in a collective alternative. For CDC to work well, support needs to rise above party politics and election timescales to offer reassurance about longevity to potential providers and members. A newly created pension commission could be tasked to build cross-party consensus and legislate for CDC.
2. The second step is to ensure that any CDC scheme will work in its members' interests, by creating strong governance structures (see chapter 4 for further discussion). The need for oversight is particularly acute for CDCs given the intergenerational risk-sharing involved.
3. Once these elements are in place, the trustees of a large entity (like the National Employment Savings Trust) could pilot a collective fund. They should set out the terms of the collective pension, being clear about what actions would be taken in response to poor performance (for example, under what scenario pension incomes could be reduced), low participation, and exposure to risk across the life-course.
4. Finally, clear communications need to be built into collective pensions. These should expand upon the target communication approach outlined in our first recommendation. Communication will also need to clearly explain the possibility of a fluctuating income in retirement and, using historic data, the likelihood that this will occur. While our research indicates that members would in principle accept the risk of a fluctuating income in exchange for a well-governed, less volatile collective scheme, in reality cuts to pension income – particularly if they are repeated or substantial – are unlikely to be received

stoically. Holland has demonstrated that in extreme economic circumstances, pension incomes are vulnerable under a CDC pension model. It is therefore of the utmost importance that members understand that income fluctuation is a real possibility, in order to help mitigate negative responses to falls in pension income.

While further work is required to create a blueprint for CDC pensions in the UK, and while there remain serious questions that need to be addressed, we would argue that based on public appetite this should be the next big move in pensions: CDC should be central to the defined-ambition agenda. Government, providers, employers and members should recognise its appeal and potential, and engage in exploring how CDC could become part of the pension landscape.

REFERENCES

Altmann, R (2013) 'Time for change: Make pensions fit for 21st Century retirement', Pensions and savings.com, 14 October 2013. http://pensionsandsavings.com/pensions/time-for-change-make-pensions-fit-for-21st-century-retirement/

Aon Hewitt (2013) *The case for collective DC: A new opportunity for UK pensions*, London

Association of British Insurers [ABI] (2013) 'Insurance industry takes big steps to help customers make the most of their pension savings', press release, 27 March 2013. https://www.abi.org.uk/News/News-releases/2012/03/Insurance-industry-takes-big-steps-to-help-customers-make-the-most-of-their-pension-savings

Berry C and Stanley N (2013) *Third Time Lucky: Building a progressive pensions consensus*, London: Trades Union Congress

Cooke G (2013) *On the front foot: Designing a welfare cap that reforms social security*, London: IPPR. http://www.ippr.org/publication/55/11290/on-the-front-foot-designing-a-welfare-cap-that-reforms-social-security

Department for Work and Pensions [DWP] (2009) *Modelling Collective Defined Contribution Schemes: A summary of The Government Actuary's Department modelling of collective defined contribution schemes*, London

Department for Work and Pensions [DWP] (2012) *Reinvigorating workplace pensions*, London

Department for Work and Pensions [DWP] [2013a] *Automatic enrolment opt out rates: findings from research with large employers*, London

Department for Work and Pensions [DWP] [2013b] *Better workplace pensions: a consultation on charging*, London

Department for Work and Pensions [DWP] [2013c] *Reshaping workplace pensions for future generations – Consultations*, London

Financial Services Authority [FSA] (2010) *With-profits regime review report*, London. http://www.fca.org.uk/your-fca/documents/fsa-with-profits-report

Grote D (2013) 'ABI annuity rate figures show up to 30% disparity between providers', CityWire.co.uk, 21 August 2013. http://citywire.co.uk/new-model-adviser/abi-annuity-rate-figures-show-up-to-30-disparity-between-providers/a698739

Hames R (2013) 'Beginners' page: The people's choice', webpage, *Pensions World* website, August 2013. http://www.pensionsworld.co.uk/pw/article/beginners-page-the-peoples-choice-12326951

Hershfield H E, Goldstein D G, Sharpe W F, Fox J, Yeykelis L, Carstensen L L and Bailenson J N (2011) 'Increasing saving behavior through age-progressed renderings of the future self', *Journal of Marketing Research* 48: S23–S37

Institute for Fiscal Studies [IFS] (2012) *Expectations and experience of retirement in Defined Contribution pensions: a study of older people in England*, London

Institute for Fiscal Studies [IFS] (2013) *Living Standards, poverty and inequality in the UK: 2013*, London. http://www.ifs.org.uk/publications/6759

MacLeod P, Fitzpatrick A, Hamlyn B, Jones A, Kinver A and Page L (2012) *Attitudes to Pensions: The 2012 Survey*, research report no 813, London: Department for Work and Pensions. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/193372/rrep813.pdf

Ministerie van Sociale Zaken en Werkgelegenheid [MSZW] (2008) *The old age pension system in the Netherlands*, the Hague

NatCen Social Research (2013) *British Social Attitudes 30: 2013 edition*, London

National Employment Savings Trust [NEST] (2010) *Understanding reactions to volatility and loss: A report of research carried out by Opinion Leader*, Peterborough

Office for National Statistics [ONS] (2012a) *What are the chances of surviving to age 100?*, Newport. http://www.ons.gov.uk/ons/rel/lifetables/historic-and-projected-mortality-data-from-the-uk-life-tables/2010-based/rpt-surviving-to-100.html

Office for National Statistics [ONS] (2012b) *Pension trends – chapter 3: Life expectancy and healthy ageing (2012 edition)*, Newport

Office for National Statistics [ONS] (2013c) 'Life expectancy at birth and at age 65 by local areas in England and Wales, 2010–12', spreadsheet, Newport. http://www.ons.gov.uk/ons/rel/subnational-health4/life-expectancy-at-birth-and-at-age-65-by-local-areas-in-england-and-wales/2010-12/rft-table-1.xls

Office for National Statistics [ONS] (2013a) *Pension trends – chapter 7: Private pension scheme membership, 2013 edition*, Newport

Office for National Statistics [ONS] (2013b) *Pension trends – chapter 10: Saving for retirement, 2013 edition*, Newport

Office of Fair Trading [OFT] (2010) *What does behavioural economics mean for competition policy?*, London

Office of Fair Trading [OFT] (2013) *Defined contribution workplace pension market study, September 2013*, OFT1505, London

Pensions Policy Institute [PPI] (2012) *Closing the gap: the choices and factors that can affect private pension income in retirement,* London

Pensions Policy Institute [PPI] (2013) *What level of pension contribution is needed to obtain an adequate retirement income?,* London. https://www.pensionspolicyinstitute.org.uk/uploadeddocuments/20131022_AE_Adequacy_FINAL_REPORT.pdf

Pensions Regulator (2013) *The Purple Book: DB pensions universe risk profile 2013*, Brighton

Pitt-Watson D (2013) *Collective pensions in the UK II: Now is the time to act*, London: Royal Society for the encouragement of Arts, Manufactures and Commerce (RSA) Action and Research Centre

Pitt-Watson D and Mann H (2013) *Collective pensions in the UK*, London: Royal Society for the encouragement of Arts, Manufactures and Commerce (RSA)

Scottish Widows (2013) *Ninth Annual Pensions Report: Retirement savings across the nation: Scottish Widows UK Pensions Report June 2013*, Edinburgh. http://reference.scottishwidows.co.uk/docs/46273-2013.pdf

GLOSSARY

Defined-benefit pensions

A defined-benefit pension scheme is run by the employer and promises a pre-agreed income in retirement. The amount is based on either the member's final salary at the point of retirement, or their average salary across their career, as well as their length of service. The employer and employee's contributions, plus tax relief from the government, are invested over the employee's working life to build a common fund. Because the retirement income is guaranteed, the employer takes on all of the investment risk, and is obliged to pay what was promised out of this fund, regardless of its performance. As well as being protected against the performance risk of the pension investments, members of DB pensions are protected against inflation in retirement. This retirement income is either index-linked with inflation or can be capped at 2.5 per cent. DB schemes provide for surviving partners, and have strict regulations on governance.

Defined-contribution pensions

A defined-contribution scheme is run by the employer but does not guarantee a fixed income at retirement. Contributions plus government tax relief are invested over the employee's working life to build an individual fund which is owned by the employee. Instead of a guaranteed income, at retirement the employee uses at least three-quarters of their 'pot' to purchase an annuity, which converts the fund into a stream of regular income payments. The level of pension income depends on size of the fund (which in turn depends on the amount contributed and how well the investment has performed, taking fees and other charges into account) and the annuity rates that are on offer at this point. During the member's working life, they do not know what this amount will be, and they take on all associated risk.

Annuities

An annuity is an income offered by insurers in exchange for a pension 'pot' at the point of retirement. The amount of monthly income offered will largely depend on the size of an individual's pension fund at retirement, but other factors like life expectancy (which takes lifestyle factors into account), fees, and market interest rates for government debt can have a big impact on the size of pension income offered in exchange for the fund. Depending on the annuity purchased, income can increase during retirement or be fixed at a flat rate, and it can either be extended to a partner or be paid solely to the purchaser.

Target replacement rates

Target replacement rates are bands used to assess whether pensioners will be able to maintain the same living standards as they had in their working lives. Throughout this report we refer to the below rates which are set out in PPI 2013, using the Pensions Commission's target replacement rates.

Pensions Commission target replacement rates (in 2012 earnings)		
Earnings	Target replacement rate	Target replacement income
<£12,136	80%	<£9,709
£12,136–£22,354	70%	£8,495–£15,647
£22,355–£31,936	67%	£14,978–£21,397
£31,937–£51,098	60%	£19,162–£30,659
>£51,098	50%	>£25,549

Lapses

Refers to cases in which the customer stops paying into their pension and takes the existing fund value away (by transferring to another pension).

PUPs (paid-up pensions)
Refers to cases in which the customer stops paying into their pension, but leaves the existing fund where it is.

Targeting of 'asset share less cost of guarantee'
'Asset share' is essentially the performance of the underlying fund. Targeting of 'asset share less cost of guarantee' means that the pension provider aims to set final bonuses in such a way that customers receive the full performance of the underlying fund less an amount to cover the cost of providing the MVR-free guarantees (see above).

Market-value-reduction-free guarantees
For with-profits, values shown to customers are 'smoothed' and are not the same as the value of the underlying fund. The with-profits values for customers increase from annual bonuses awarded throughout the time they are with their pension provider, and they may receive a final bonus or a market value reduction when they finish the plan. The annual bonuses can never be negative, so are set prudently. Customers' 'values with annual bonus' do not fall throughout their time with their provider.

If the growth of the underlying fund over the whole time the customer has invested has been better than the prudent annual bonuses, then a final bonus (over and above the annual bonuses) is awarded once the customer finishes their plan. If the underlying fund has performed less well, there may be little or no annual bonus, and potentially a 'market value reduction' (MVR). An MVR means that the value given back to the customer may be below the value plus annual bonuses – potentially even less than the premiums they paid in.

'MVR-Free guarantees' are guarantees that the provider will not apply an MVR, even if the value of the underlying fund is significantly less than the customer's premium plus annual bonuses. Providers generally give these guarantees upon death, and on selected retirement age. (Customers taking their money at other times – to transfer to another provider before retirement, for example – may experience an MVR).

APPENDIX

Methodology

We conducted fieldwork between August and November 2013. During the first stage we conducting nine deliberative focus groups around the country. More than 60 individuals, all of whom were then in employment, were recruited by an independent recruiter.

Location	Income	Age and life-stage
Erdington	Low	22–32, with no children
Newcastle	Middle	
London	High	
Stirling	Low	28– 44, with children who live at home
Stevenage	Middle	
Newcastle	High	
London	Low	42+, but not expecting to retire in the next five years, with older children who do not live at home ('empty-nester')
Coventry	Middle	
Edinburgh	High	

Respondents were recruited based on location, income,[20] age and life-stage. Across the fieldwork we ensured that we recruited a representative mix of:

- Housing tenure
- Relationship status
- Current pension provision (excluding those with DB pensions)
- Nature of employment (part-time, full-time, temporary and permanent)

In the focus groups we explored different sets of issues in four distinct stages.

1. Unprompted:
    a. current saving behaviours
    b. attitudes to saving and trust in pensions
    c. knowledge of state and workplace pensions.
2. Explanation:
    a. the state pension and retirement age
    b. workplace pensions: risks and benefits
    c. inflation, and FTSE 100 performance over the last few decades.
3. Testing:
    a. guarantees (with associated costs)
    b. smoothing (and guarantee), with associated costs
    c. floor pension (with no guarantee)
    d. deferred annuities
    e. escalating versus flat-rate annuities
    f. collective pensions.
4. Attitudes to pension reform more broadly

20 Income was assessed by single or dual household income levels (whichever was more appropriate), and reflected London and non-London averages. Bandings reflected latest income data, and bands were chosen to ensure that everyone in the group had a comparable amount of disposable income. Non-London respondents (based on an individual salary) were recruited into low-income groups if earning £14,200–£18,350, median-income groups if earning £18,351–£23,350, and high-income groups for earnings of £23,351–£30,000. Inside London these bands were adjusted to £17,000–£22,000 (low income); £22,001–£28,000 (median income) and £28,001–£36,000 (high-income).

We also conducted follow-up interviews with a third of our respondents (selected from across all groups). In these we gauged respondents' retention of the stimulus, and explored a different series of costs for smoothing.

A summary of model charges can be found below (based on a contribution of £100 per month). We also tested the same charges with ongoing contributions of £40 per month. Requests for further details about the stimulus or approach should be addressed to i.parker@ippr.org.

Scheme charges

The charges we showed to participants in research indicated the relative cost of each guarantee option, and to aid comparison of the guarantee models. The figures were not firm indications of charge levels. Guarantee costs change depending on market conditions, but the relative cost of each option is less changeable.

For each term, the charges are indicative of the relative cost of each guarantee model. For a particular guarantee model, the way charges change according to the term is also indicative.

		Charge (% per annum)				
Term	Age of member at outset	Guarantee A	Guarantee B	Guarantee C	Smoothing in combination with guarantee B	Smoothing only
10	55	0.1%	1.0%	2.0%	0.5%	0.05%
20	45	0.1%	0.8%	1.8%	0.5%	0.05%
30	35	0.1%	0.5%	1.6%	0.5%	0.05%
40	25	0.1%	0.3%	1.3%	0.5%	0.05%

Guarantee A

Guarantee A guarantees only employee contributions, which make up half of total contributions. For this guarantee to 'bite', fund values would need to fall considerably. The calculated cost of this guarantee is negligible, but was assumed to be 0.1 per cent per annum for illustrative purposes in the research. This charge was so small that it was indicated as the same for all terms.

Guarantee B

The calculated cost for guarantee B for a 10-year term in a fund with around 50 per cent equities, assuming no lapses/PUPs (see glossary), was actually 1.2 per cent per annum. For lapses of 10 per cent, the charge was around 0.5 per cent per annum. PUPs do not alter charges significantly except at longer terms. A charge of 1 per cent was used in our research to reflect the fact that there would be some lapses in DA, but perhaps not as many as 10 per cent per annum.

At longer terms the cost of guarantee is much less than shown – perhaps as low as 0.03 per cent per annum for terms of 40 years where there are PUPs of 10 per cent per annum. However, a higher charge was used in our research to differentiate this guarantee from guarantee A.

Guarantee C

This guarantees a fund value of total contributions plus growth of 2 per cent per annum on each contribution. Providing such a guarantee would involve reducing returns to near cash levels, so the actual guarantee charges would perhaps be higher than those used

in our research. However, it is clear that the charges should be much more than those for guarantee B, as indicated in the table above.

Smoothing

With-profits funds currently offer smoothing and guarantee B in combination. The cost of this guarantee is perhaps 0.5 per cent per annum at most. To demonstrate the pooled nature of this model, the same charge was assumed across all terms. While that could be how a pooled, smoothed DA solution actually charged, today's with-profits funds do charge less for longer terms, through targeting of asset-share less a percentage for the cost of the guarantee (see glossary).

Without guarantees of any form, with-profits is smoothing alone. Fund values could fall, just as fund values for any other non-guaranteed investment could. Smoothing alone would be like today's with-profits funds without any market-value-reduction-free guarantees (see glossary) – it would remove small fluctuations and afford some protection at retirement. It would cost perhaps 0.05 per cent per annum.

In our research, cost models were communicated based on two contribution scenarios:

- Contributions of £100 per month, assuming 6 per cent annual growth and no further charges other than those associated with each pension scheme.
- Contributions of £40 per month, assuming 6 per cent annual growth and no further charges other than those associated with each pension scheme.

The likely costs, based on the £100 per month scenario and an individual retiring at the age of 65, are overleaf.

No. years of contribution	Pension model	Description	Minimum pot	Charges (annual growth reduction)	Predicted pot	Total cost	Monthly annuity[20]	Guaranteed (minimum) annuity based on current rates
40 years	Standard DC	No charges or protections	Any	None	£191,696	None	£799	None
	A	At retirement the fund will not be lower than the personal contributions total	£24,000	0.10%	£186,849	£4,848	£779	£100
	B	At retirement the fund will not be lower than the total contributions total	£48,000	0.30%	£177,554	£14,142	£740	£200
	C	At retirement the fund will not be lower than the total contributions + 2% annual growth protected	£73,265	1.30%	£138,181	£53,515	£576	£305
	Smoothed	Management fee paid to hold back capital in good years to pay out in bad	Any	0.05%	£189,255	£2,441	£789	None
	Smoothed + B	Smoothing management and a guarantee that at retirement the fund value will not be below total contributions	£48,000	0.50%	£168,770	£22,926	£703	£200
30 years	Standard DC	No charges or protections	Any	None	£97,926	None	£408	None
	A	Personal contributions protected	£18,000	0.10%	£96,169	£1,756	£401	£75
	B	Total contributions protected	£36,000	0.50%	£89,491	£8,435	£373	£150
	C	Total contributions + 2% protected	£49,207	1.60%	£73,684	£24,241	£307	£205
	Smoothed	Management fee paid to hold back capital in good years to pay out in bad	Any	0.05%	£97,043	£883	£404	None
	Smoothed + B	Smoothing management + guarantee B	£36,000	0.50%	£89,491	£8,435	£373	£150
20 years	Standard DC	No charges or protections	None	None	£45,565	None	£190	None
	A	Personal contributions protected	£12,000	0.10%	£45,055	£510	£188	£50
	B	Total contributions protected	£24,000	0.80%	£41,661	£3,904	£174	£100
	C	Total contributions + 2% protected	£29,472	1.80%	£37,309	£8,255	£155	£123
	Smoothed	Management fee paid to hold back capital in good years to pay out in bad	Any	0.05%	£45,309	£256	£189	None
	Smoothed + B	Smoothing management + guarantee B	£24,000	0.50%	£43,078	£2,486	£179	£100

20 Annuity was calculated by Prudential based on current rates, with none of the pot taken as a lump sum.