Department for Work and Pensions

Reinvigorating workplace pensions

Presented to Parliament by the Secretary of State for Work and Pensions by Command of Her Majesty
November 2012

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Foreword by the Minister of State for Pensions

2012 has been a major milestone in the development of the UK's pension system. It has seen the introduction of automatic enrolment into workplace pensions, a reform which will result in millions more people saving privately for their retirement. It has also seen the confirmation of our intention to fundamentally reform the State Pension. Single-tier reforms will deliver a simpler State Pension, set above the basic level of means-tested support, helping to ensure that those of working age will be able to save for their retirement with confidence. We will be publishing more details on our plans for the single-tier pension shortly.

Building on these two elements, it is critical that we ensure that people saving privately are doing so into high quality, value for money schemes. It is no secret that people have less confidence in pensions than they used to. But for many people pensions remain the best way of saving for retirement and such savings are crucial if people are to have the level of income in retirement they say they want. We need to restore confidence in the system: so people don't choose to opt-out of automatic enrolment; so people put enough in; so people get the most out of what they put in; so the pensions market provides a good range of products that meets the needs of savers and employers.

This strategy sets out the key elements needed for a future private pensions system that delivers good outcomes for those who save. It does not have all the answers – confidence will not be restored overnight and we will need to work with the industry, employers and consumers to build on the foundations outlined here.

We are clear that we have more to do in a number of areas. We need the right regulatory framework for Defined Contribution schemes to ensure high quality and well-governed schemes without restricting innovation. We need to ensure charges are appropriate and transparent. We need savers to be supported with clear and understandable information throughout the pensions lifecycle and particularly at critical periods, such as on the approach to retirement. And as automatic enrolment settles down, we'll need to think about how we might encourage people to save more than the statutory minimum.

Looking at issues through the lens of the consumer can provide us with powerful insights for improvements. For example, one thing we know people value in pensions is certainty and I am keen to increase the range of products available to savers in order to give them this. Our work on 'Defined Ambition' pensions is a key part of establishing a future pension landscape that meets consumer needs,rebuilds confidence in the system and ensures good outcomes in retirement.

Steve Webb MP
Minister of State for Pensions

Executive summary

1. The UK's pension system is in need of reform. There are two primary reasons for this:

   - the UK has an ageing population. Without reform, supporting the increasing proportion of pensioners in the population will put an increasing financial burden on those of working age; and
   - working age people are not saving enough to meet their expectations of income in retirement.

2. The Government has already begun to set in train a series of reforms to meet these challenges. In particular it has:

   - brought forward plans to increase State Pension age;
   - set out proposals to create a single-tier State Pension to provide a firm foundation for saving for retirement; and
   - introduced automatic enrolment into workplace pensions to increase the numbers of those saving privately for their retirement.

3. However, there is more to do. Critically, we need to ensure that those people saving privately for their retirement are doing so in high quality schemes that meet their needs. Meeting the needs of consumers will help to increase confidence in the pension system and help people to realise their expectations of income in retirement.

4. This strategy sets out the key issues which need to be tackled to reinvigorate workplace pensions and achieve our objectives.

Reinvigoration objectives

- Increase the amount people are saving in pensions.
- Increase the amount people receive for their savings.
- Enable industry innovation and development of new products including those which will give people more certainty about their pensions and encourage more risk-sharing.
- Increase transparency and build trust, confidence and engagement in pension saving as the norm.
- Ensure the sustainability and stability of the UK pension system.

5. **Chapter 1**: this sets out the background to our reinvigoration strategy.

6. **Chapter 2**: this sets out the two primary types of private pension saving, Defined Benefit (DB) and Defined Contribution (DC), and highlights the key factors which impact on outcomes for savers.

7. For DB schemes, the Government has been examining ways to ease the regulatory burden on employers, whilst protecting the benefits of scheme members. For DC schemes, which many people will be saving in through automatic enrolment, we are working to ensure the regulatory framework provides a safe canopy around schemes that sets appropriate parameters and supports good governance, without restricting innovation. The Department for Work and Pensions (DWP) has examined its occupational pensions regulation as part of the Government's Red Tape Challenge initiative: this suggests the legislation is largely fit for purpose, but we are looking at simplification in the disclosure regulations.

8. The chapter also examines a number of key factors which affect outcomes for savers in DC schemes:

   - Contribution level – where the minimum level required by automatic enrolment provides a good starting point, but as things settle down we will wish to consider ways of encouraging people to contribute more, if they can.
   - Charges – where we need to ensure that charge levels are transparent and offer value for money.
   - Investment strategies – where we need schemes to have appropriate default fund options and guidance to encourage good investment decisions.
   - Decumulation - where good guidance can help support people through the process of turning their pension pot into a retirement income.

9. We also examine the potential benefits of a pensions market with a smaller number of larger-scale, multi-employer pension schemes.

10. **Chapter 3**: this chapter examines the case for greater risk-sharing in pension schemes. With risk currently sitting with employers (DB) or employees (DC), the Government is keen to explore the scope for new types of scheme which share risk ('Defined Ambition'). A Defined Ambition pension would seek to give greater certainty for members than a DC pension about the final value of their pension pot and less cost volatility for employers than a DB pension.

11. While risk-sharing is currently possible and occurs to a limited extent within the current pension market, we are keen to examine whether we can encourage greater take-up of these options, or enable greater innovation in this space by amending legislation.

12. There may be a number of different types of Defined Ambition schemes. Some may have elements of current DB schemes, but with greater sharing of risk; others may start from a DC standpoint, but with increased certainty for members. Discussions are ongoing with industry, employers and consumers to explore new ideas and existing options. We will also need to consider the impact on the regulatory regime in developing future proposals.

13. **Chapter 4**: this chapter focuses on how we can help improve people's trust, confidence and engagement in pension saving. Automatic enrolment is built upon the recognition that people are not engaged, but it is still important for them to understand what is happening and feel in control of the situation.

14. A critical part of enabling engagement is to ensure that pensions information is presented appropriately. We have developed a series of principles for pensions information.

Key principles for pension information

- Give people control – they must know they have a choice.
- Focus on the benefits to individuals, not on their responsibilities.
- Make it relevant now – engage with people as they are in their working lives.
- Give real examples to help people understand the context.
- Keep the presentation simple and let the facts speak for themselves.
- Build understanding of basic concepts but tailor the level of information to the individual.

15. There are a number of areas we are focusing on as part of improving pensions information:

- exploring whether messages can be targeted at particular life events;
- promoting the Department's pensions language guide;
- developing best practice guidance with industry, for example on Statutory Money Purchase Illustrations;
- examining how we might help employers and consumers with scheme choice; and
- considering rules of thumb for pension saving.

16. This strategy sets out the key issues which will impact on outcomes for savers. It details steps we will take and the issues that need to be tackled in order to build confidence in the pension system and ensure it helps give people the income they expect in retirement. We do not have all the answers to some of these issues, so we have outlined a number of areas for further discussion with industry, employers and consumers.

17. Working with our partners, we can begin the process of delivering on the future pension landscape we have set out and reinvigorating workplace pensions.

Responding to an ageing society and changing savings behaviour

1

The background to pensions reform

1. Since the introduction of the first Old Age Pension in 1909, successive governments have sought to support people in retirement. This has resulted in an evolving state pension system, with entitlement based on National Insurance contributions, supported by a variety of income-related benefits. People have supplemented this state support by saving privately for their retirement.

2. However, two trends have put the sustainability of the current pension system at risk.

3. Firstly, like many developed countries, the UK has an ageing population. Between 2012 and 2050, the proportion of people aged 65 and over is projected to increase from 17 to 24 per cent. The fastest population increases are in the 'oldest old', with the proportion aged 85 and over projected to increase from 2 to 6 per cent. Since 1981, the number of centenarians (people aged 100 years or more) in the UK has increased more than five fold from 2,600 in 1981 to 14,600 in 2012, and is projected to exceed 300,000 by 2050.[1]

4. This demographic change poses a challenge to the sustainability of the current system of pensions and savings in this country. The support pensioners receive from the state is funded from current taxation and National Insurance contributions. The old age support ratio, which was steady at around 3.3 working age people to each pensioner from the mid-1970s to 2006, reduced to 3.2 between 2007 and 2009 as women born in the post-World War II baby boom reached State Pension age and is projected to reduce below 3 working age people to every pensioner by 2050 (to 2.9), even with the increase in State Pension age.[2]

1 Office for National Statistics, 2012, *What are the Chances of Living to 100?*
2 Office for National Statistics, 2012, *Pensions Trends: Chapter 2 Population Change.* Working age population is defined as individuals aged 16 to SPA.

5. As the ratio of pensioners to working age people increases, there is a need for individuals to save more and work longer to limit the increase in the cost of state support.

6. The second problem is that current working age people are not saving sufficiently to achieve their expected level of income in retirement. Analysis by the Pensions Commission outlined the target level of income people are likely to expect in retirement, expressed as a replacement rate[3] by income band.

Table 1 **Income bands (gross earnings) and replacement rate targets**

Original 2004 income band	Income band in 2012 earnings terms	Target replacement rate
Up to £9,500	Up to £12,000	80%
£9,500 – £17,500	£12,000 – £22,100	70%
£17,500 – £25,000	£22,100 – £31,600	67%
£25,000 – £40,000	£31,600 – £50,000	60%
Over £40,000	Over £50,000	50%

7. Current estimates suggest that of people currently aged between 22 and State Pension age, 11 million (40 per cent) will not save enough to meet these replacement rate targets.[4]

8. The combination of an ageing society and inadequate levels of saving means that, unless action is taken to tackle these issues, either pensioners will become poorer relative to the rest of society; people will need to work longer; or tax and National Insurance will need to be raised to a level that the working age population will be unable to bear. The Government has therefore put in train a series of reforms which, taken together, will create a strong platform for pension savings.

Reforming the State Pension

9. The Government has already restored the earnings link for the Basic State Pension only and introduced the triple guarantee, ensuring the Basic State Pension will increase in line with the highest of prices, earnings or 2.5 per cent. This measure will mean the average person retiring on a full State Pension in 2012 will be around £15,000 better off over their retirement than under the old system.

10. In addition, to ensure the pension system remains sustainable, the Government brought forward the timetable for increasing State Pension age to 66 to 2020 and has announced its intention to bring forward the increase to 67 by 2028. We have also removed the default retirement age to ensure that older people are able to continue to work where they wish to do so.

3 Income in retirement expressed as a percentage of income before retirement.
4 Department for Work and Pensions, 2012, *Estimates of the number of people facing inadequate retirement incomes.*

11. These reforms have done much to protect current and future pensioners from poverty, while ensuring the system remains sustainable. However, bolder reform is required to reduce the complexity, uncertainty and inequality which currently exists and inhibits the private saving which for many people will be a critical component of their income in retirement.

12. The Government has therefore developed proposals to create a single-tier State Pension. This reform will usher in a simpler and fairer system that reduces the need for means testing and rewards saving. The single-tier pension will be set at a level above the standard minimum guarantee in Pension Credit, helping to ensure that those of working age will be able to save for their retirement with confidence. The reforms will be introduced in the next Parliament and the new rules will apply to future pensioners only. We will be publishing more details on our plans for single-tier shortly.

13. The single-tier white paper will also set out proposals for a more structured framework within which to consider changes to State Pension age in the future. This more structured framework will help to ensure the costs of increasing longevity are shared fairly between the generations and provide greater clarity around how State Pension age will change in future.

Increasing savings levels

14. Many measures have been taken over recent years to encourage individuals to save more, including the introduction of stakeholder pensions, communication campaigns and strengthening the regulatory regime. However, saving levels remain low.

15. To increase savings levels and the sense of ownership needed to save for their long-term future, the Department has introduced a legal requirement for individuals to be automatically enrolled into a workplace pension scheme by their employer, with the ability to opt out. Employers will also be compelled to provide a modest level of contributions.

16. Automatic enrolment is intended to work by turning on its head the inertia that currently inhibits saving. The Department expects around two thirds of individuals to remain saving in a workplace pension following automatic enrolment.[5]

17. Automatic enrolment began in October 2012 and will be rolled out gradually, starting with larger employers. The new duties will not apply to small employers (those with fewer than 50 employees) until June 2015 at the earliest. When automatic enrolment has been fully introduced in 2018 there should be a significant increase in the numbers saving for retirement. Departmental estimates suggest that there will be an additional 6-9 million newly saving or saving more into a private pension. This will be a critical mechanism to increasing the numbers saving privately for their retirement.

5 Bourne T, Shaw A and Butt S, 2010, *Individuals' attitudes and likely responses to the workplace pension reforms 2009: Report of a quantitative survey,* DWP research report 669.

18. Reforms to State Pension age and measures the Government is putting in place to support people to work longer could also help to increase the amount people are saving for their retirement. A longer working life means more opportunity in which to save.

Reinvigorating workplace pensions

19. These reforms are vital, but they are likely to only take us so far. To help people to achieve the levels of replacement rate which the Pensions Commission assumed many would seek in later life, further action needs to be taken. In particular, we need to give those coming into pension saving through automatic enrolment the confidence that such saving is worthwhile.

20. We need to put in place the conditions to ensure that in the future:

- people are saving a sufficient amount for their retirement and take responsibility for doing so;
- the regulatory framework for pensions balances protection for members with minimising administrative costs for employers and allowing providers to innovate;
- pension schemes are high quality: well-governed and providing value for money for savers and employers;
- more risk is shared between key parties including employers, savers and the industry to help give members greater certainty about their income in retirement and reduce cost volatility for employers;
- savers and employers are given clear and consistent information that enables them to engage in decision-making about their pension, building their confidence and trust in pensions as a vehicle for retirement saving; and
- the pension system is sustainable and stable over the long term.

21. This future vision can be translated into a set of objectives which clearly articulate what we seek to achieve through our reinvigoration strategy.

Reinvigoration objectives

- Increase the amount people are saving in pensions.
- Increase the amount people receive for their savings.
- Enable industry innovation and development of new products including those which will give people more certainty about their pensions and encourage more risk-sharing.

- Increase transparency and build trust, confidence and engagement in pension saving as the norm.
- Ensure the sustainability and stability of the UK pension system.

22. This strategy sets out the key issues which impact on these objectives and some of the steps we need to take to achieve them. However, we are at the early stages of developing solutions in many places. Our proposals are exploratory and we will need to continue to work closely with employers, the pensions industry and consumers to find the right approach, tackling the issues listed throughout the strategy. All of these parties have significant roles to play in achieving our objectives, as the table below shows:

Table 2 **Roles and responsibilities in reinvigorating workplace pensions**

Government	Employers	Providers	Savers
Providing a foundation to support planning and saving for retirement by delivering a single-tier, flat-rate State Pension	Helping employees achieve their expected level of income in retirement by contributing to their pensions	Providing a range of value for money, well-governed and consumer-focused schemes	Contributing to a pension
Setting the regulatory regime for independent regulators which minimises employer burden, allows innovation, ensures a minimum quality level of pension and provides appropriate member protection	Complying with pensions legislation	Supporting employers and savers to think about retirement saving	Engaging with pension saving and thinking about what they need to save for their retirement
Putting in place incentives to save and providing stability in the pension system	Sharing risk with employees	Enabling and participating in risk-sharing	Sharing risk with employers and insurers
	Supporting employees to think about their retirement saving	For trust-based schemes these roles lie primarily with the Board of Trustees	
	Choosing high quality pension schemes		

23. This document is not a formal consultation. However, the issues raised within it will be the focus of future work by the Government and future discussions with key stakeholders. There may be more formal consultation on elements of the strategy in the future.

Saving privately to meet income expectations in retirement

2

1. Most private pension saving will be in one of two types of scheme:

   - **Defined Benefit (DB)** – this will typically take the form of an occupational pension scheme that promises an income in retirement, or a specific level of pensions savings, based on a formula involving how much a person is paid at the point of retirement (or how much a person has been paid on average during their membership of the scheme) and the length of time they have been in the pension scheme.

   - **Defined Contribution (DC)** – a pension scheme that provides pension scheme benefits based on the contributions invested, the returns received on that investment (minus any charges incurred) and the rate at which the final pension fund is converted into retirement income.

2. One critical difference between the two scheme types is who bears the risk regarding the level of savings or income in retirement. In DB schemes the employer, rather than the individual, bears the risks of longevity (how long the person will live and therefore how long the pension will be paid) as well as investment (how the fund performs over time, which impacts the amount the employer needs to contribute to meet their obligations to the individual) and inflation (at least up to the level specified in scheme rules). In DC schemes, the individual bears the risk as they save in their pension, and can then buy an income product at retirement where the insurer will promise an income for life, and will bear the risk of funding that promise.

3. For many years, companies largely offered DB pension schemes. However, DB scheme membership has been declining since its peak in the late 1960s. In 1997, of 12.7 million jobs with employer pension provision, 10.5 million were DB. By 2011, there were 12 million jobs with employer pension provision, of which 7.8 million were DB.[6] Although membership of DC schemes has increased over that period, it has not been equivalent to the DB decline.

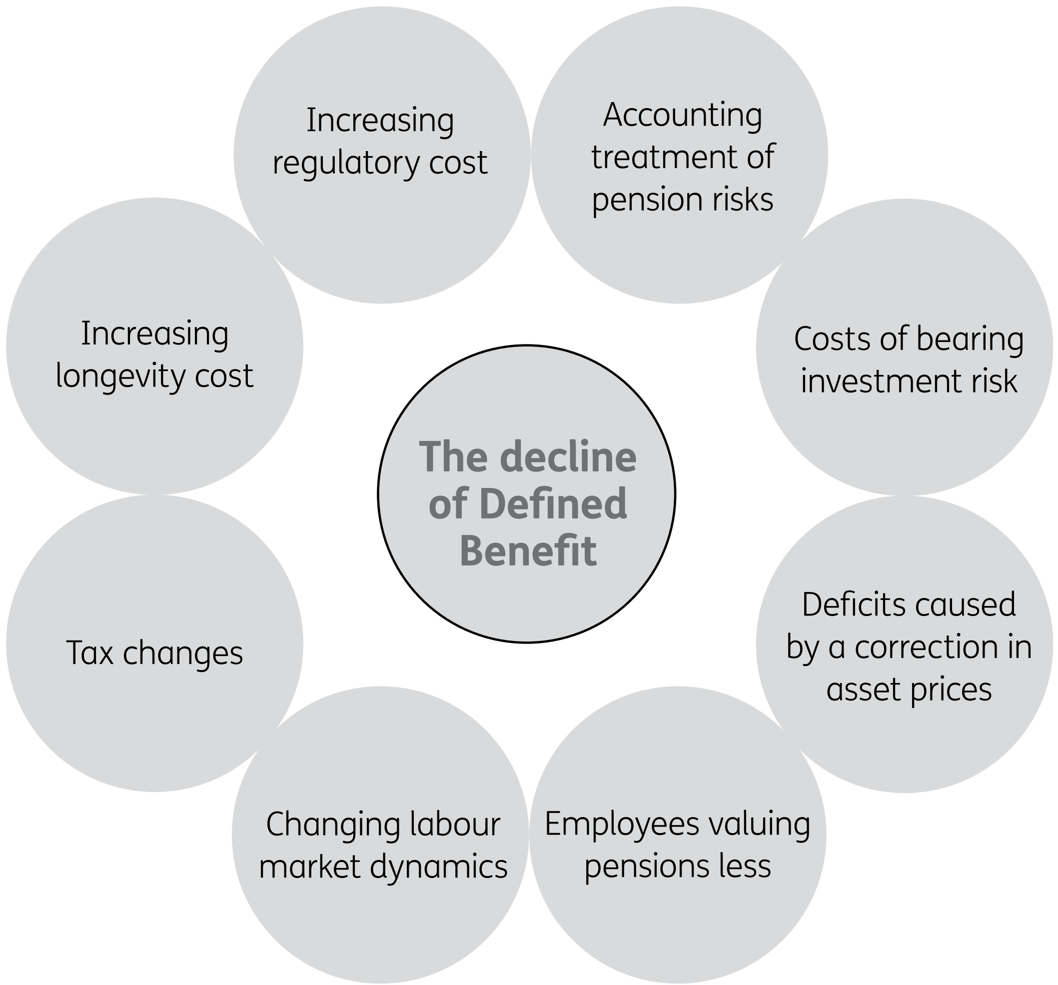
The decline of Defined Benefit

4. Those saving in DB schemes are likely to have a relatively good income in retirement – the vast majority of final salary schemes offer half to two-thirds replacement rate with full service.[7] They also have the benefit of greater certainty regarding their income in retirement. If a qualifying DB scheme does not pay its members their pension due to qualifying employer insolvency or insufficient funds, the Pension Protection Fund ensures that when a person reaches their pension scheme's normal retirement age it pays compensation at a rate of 90 per cent of their former pension entitlement, subject to a cap (currently £34,000 at age 65).

5. The decline of DB schemes has been the subject of much debate. There are a number of complicated factors which have combined to make them more costly and less attractive to employers. Some of these are inherent in the nature of this type of scheme, some result from regulation to increase member protection and some are linked to wider macroeconomic and societal factors.

6 Office for National Statistics, 2012, *2011 Annual Survey of Hours and Earnings.*
7 Office for National Statistics, 2012, *Occupational Pension Schemes Survey, 2011.*

Fig 1 Factors causing the decline of Defined Benefit



6. Given the very different economic and social environment in which workplace pensions now function, there is likely only to be a limited amount that can be done to revive DB schemes, at least in their pure, final salary form.

7. Nevertheless, with 1.9 million[8] people currently paying into private sector DB schemes, 4.9 million pensions in payment and the size of private sector DB schemes' investment portfolio (£1.1 trillion as of September 2012), they will remain an important part of the pensions landscape for many years. As such, it is important to examine any opportunities to help employers manage their DB commitments and the ongoing costs entailed.

8 Office for National Statistics, 2011, *Occupational Pension Schemes Survey.*

Managing the legacy

Reinvigoration objective
Ensuring the sustainability of the UK pension system

8. The impact of the regulatory regime on employers, both in terms of cost and risk, is one area where government may be able to help employers. For the Government, the critical question is one of balancing enough regulation to protect the pension benefits of DB scheme members while trying to reduce the costs and responsibilities that employers face. We have therefore recently examined private pension regulations through the Government's Red Tape Challenge initiative.

The Red Tape Challenge

The Red Tape Challenge (RTC) is a cross-government initiative that seeks to review all government regulations that affect business (http://www.redtapechallenge.cabinetoffice.gov.uk/home/index/). We have used it as an opportunity to re-visit occupational pensions regulation and are grateful for input from our Pensions RTC Stakeholder Group (CBI, ABI, NAPF, Which?, BCC and EEF); the Pensions Regulator; 18 written submissions from stakeholders; and comments from the wider public.

We have looked very carefully at whether there are regulatory burdens that can either be reduced or removed altogether, while protecting accrued rights and without unjustifiably reducing protection for members.

We have identified significant scope for simplification of the disclosure regulations (see chapter 4) as well as a few other discrete areas where regulation could be slimmed down. However, our emerging conclusion is that in relation to the current pensions landscape the legislation is largely fit for purpose. We also believe that the introduction of automatic enrolment necessitates stability in legislation.

However, in considering a future framework for private pensions policy that would enable greater risk-sharing (see chapter 3) we are looking very carefully at the extent and nature of regulation to ensure it balances opportunities for risk-sharing with an appropriate level of consumer protection.

9. We have also been reviewing the legislation governing contracted-out schemes as part of our proposals for a single-tier State Pension.

The rise of Defined Contribution

10. With the move away from DB, the majority of people who begin saving through automatic enrolment will be doing so in a DC scheme. It is imperative therefore, that people have confidence in these schemes and that they provide the best possible outcomes for those saving in them.

11. While DC schemes do not offer guarantees as to the level of pension provided (as DB does), they can offer great flexibility and choice for employer and employee and can be a good way of saving for retirement.

Governance and the regulatory framework

12. There are two types of governance arrangements in DC Pensions:

- trust-based (with a board of trustees set up to govern the scheme in the best interests of the members), with members' interests protected by the Pensions Regulator; or
- contract-based (with a contract set up between the member and pension provider), with regulation principally by the Financial Services Authority (FSA).

13. Although the two types of pension have different frameworks and different regulators they offer broadly comparable levels of member protection. With the advent of automatic enrolment the capability of both regulators to operate in a fast changing environment has been under scrutiny from the National Audit Office as well as the Work and Pensions Select Committee. The Government continues to progress work in respect of the regulators to ensure they remain fit for purpose for the new pensions environment.

Good DC schemes

14. The Government (including HM Treasury, DWP, the Pensions Regulator and the FSA) are working to create the optimum environment in which DC schemes can provide a secure retirement for savers. The fundamental starting point is to ensure a safe canopy around DC schemes that sets appropriate parameters without restricting innovation.

15. Last year, the Pensions Regulator set out six elements needed to achieve the good member outcome of an adequate income in retirement.[9] It built on these with six high-level principles for DC schemes and has now published a more detailed set of features which elaborate what the principles are likely to mean in practice.[10]

9 The Pensions Regulator, 2011, *Enabling good member outcomes in work-based pension provision.*
10 www.thepensionsregulator.gov.uk/docs/draft-key-features-june-2012.pdf

The Pensions Regulator's Six DC Principles

- Schemes are designed to be durable, fair and deliver good outcomes for members.
- A comprehensive scheme governance framework is established at set-up, with clear accountabilities and responsibilities agreed and made transparent.
- Those who are accountable for scheme decisions and activity understand their duties and are fit and proper to carry them out.
- Schemes benefit from effective governance and monitoring through their full lifecycle.
- Schemes are well-administered with timely, accurate and comprehensive processes and records.
- Communication to members is designed and delivered to ensure members are able to make informed decisions about their retirement savings.

Embedding the features that promote good member outcomes

16. The Pensions Regulator and the FSA have been mapping their existing rules and powers against the features underpinning the six principles. The Pensions Regulator intends to translate the features into a Code of Practice and guidance for trust-based DC schemes. This will set out clearly what is expected of those running DC schemes and how schemes can demonstrate how the features described in the Code of Practice apply in their schemes. The new Code and guidance will be backed by an education programme and revised Trustee Toolkit so that trustees have the tools to do the job. Although the Code will not create new legal requirements, it will clarify how existing duties should be addressed in the new world of automatic enrolment.

17. As a risk-based regulator the Pensions Regulator has segmented the existing DC landscape by scheme size and type, and has identified risks associated with each segment. While the nature of many of the risks in each segment are often similar, the impact on member outcomes – should those risks crystallise – may vary significantly. Segmenting the landscape in this way therefore enables the Pensions Regulator to tailor its efforts at embedding the principles according to the risks presented.

18. Ensuring confidence in **Master trusts** (where there are non-associated employers) is particularly important as such schemes have the potential to combine economies of scale with excellent standards. For them to achieve this potential it is important that any conflicts of interest and other risks in this sector are addressed. The Government and the Pensions Regulator are considering how to ensure appropriate governance for such schemes.

19. In the **single employer scheme segment** there is less potential for problematic conflicts of interest and many employers will take an interest in ensuring the scheme meets high standards. For this segment, the Government will be exploring with the Pensions Regulator a lighter-touch approach than that taken with Master Trusts, based on encouraging schemes to report to their members on how they are addressing the Code and guidance.

20. **Contract-based personal pensions** play an important role in the market, potentially combining economies of scale with excellent standards. These schemes are primarily regulated by the FSA. The Government, FSA and Pensions Regulator will work together to ensure that regulation of this segment is also achieving appropriate levels of protection.

Automatic enrolment standards and NEST

21. To ensure people are automatically enrolled in quality schemes, the Government has set minimum requirements for schemes selected for automatic enrolment. It has also established the National Employment Savings Trust (NEST) – a low-cost, trust-based, occupational pension scheme focused on people with low to moderate earnings and employers that the existing pensions industry does not serve well. While employers do not have to use NEST to meet their automatic enrolment obligations, NEST has a public service obligation to accept any employer who wishes to use it to meet their duties. This ensures that all people can be automatically enrolled.

22. Encouragingly, the pension market has already begun to respond to the imminent introduction of automatic enrolment and the likelihood that their potential customer base will increase and change. Providers such as NOW: Pensions and The People's Pension have also come into the UK market with the offer of simple and accessible pension products.

Factors influencing Defined Contribution outcomes

23. Building on the principles outlined above, there are a number of key factors which have an impact on the level of income in retirement that a person receives from their DC pension:

- **Contribution level** – the amount that the individual and the employer put in has the biggest impact on outcomes in retirement, along with the duration and persistency of those contributions.

- **Charges** – how much pension providers charge for services such as the administration of the pension, which is taken out of the individual's pension pot; or a third party's fee for advice to an employer on which pension scheme to use (consultancy charges).

- **Investment strategies and returns** – how the money that is put in is invested and how successful those investments are.

- **Decumulation** – when an individual retires they need to decide how best to use the money they build up in their pension pot to support themselves. Usually they will buy a lifetime annuity, which provides them with an annual income until they die. The level of this income depends on factors such as the value of the fund, the age and health of the individual at the point of purchase and the type of annuity purchased.

Contribution levels

Reinvigoration objective
Increasing the amount people are saving in pensions

24. Research by the Pensions Policy Institute suggests that the level of contributions can be the most significant factor affecting income in retirement for someone saving in a DC scheme.[11] The shift from DB to DC pensions has reduced overall contribution levels as the latter tend to have lower contribution rates. Average member contribution rates to DB schemes in the private sector were 5.1 per cent in 2010, while average employer contribution rates were 15.8 per cent. For DC schemes in 2011, average member contribution rates were 2.8 per cent and average employer contribution rates were 6.6 per cent.[12]

25. Automatic enrolment legislation requires contributions for those enrolled to amount to at least 8 per cent of their gross earnings (including bonuses, overtime and commission) within a band between £5,564 and £42,475:[13] 4 per cent from the individual; 3 per cent from their employer; and 1 per cent from the Government in the form of tax relief (assuming a basic rate taxpayer). This minimum level of contribution will be phased in to help employers and individuals adjust to the additional costs of the reforms.

26. However, for many people, saving privately at the minimum level, building on the foundation provided by a single-tier State Pension, will not be a high enough level of saving to give them the level of income they are likely to expect in retirement.

Going beyond 8 per cent

27. In the public information campaign supporting the launch of automatic enrolment we have been clear that 8 per cent is a minimum amount. For some people, there is little option to save more than the minimum, and the information has been designed so that people in this group are encouraged to take what steps they can.

11 Pensions Policy Institute, 2012, *Closing the gap: the choices and factors that can affect private pension income in retirement.*
12 Office for National Statistics, 2012, *Occupational Pension Schemes Survey, 2011.*
13 Rates current for 2012/13 tax year. The figures are reviewed annually.

28. However, some people and some employers may wish to contribute more. A number already do so, particularly larger employers: 54 per cent of employers with 500+ employees and 51 per cent of employers with 250-499 employees offer schemes with six per cent or more employer contribution rates.[14]

29. We are keen to encourage saving beyond the 8 per cent minimum. However, we recognise the need to balance this with the fact that many individuals will not currently be saving at all and requiring them immediately to save beyond the minimum may increase individuals' perception that saving for retirement is an insurmountable challenge. This could lead them to opt out. Similarly, for employers to increase their contributions would place an additional burden and cost on business.

30. For those reasons we have no plans to alter the statutory minimum beyond 8 per cent at this point. However, it is important to begin thinking about what other mechanisms we might use to encourage an increase in saving beyond that level.

Automatic escalation

31. One option that is worthy of further examination is the use of automatic escalation schemes. These encourage people to commit to increasing their contributions at a future date, often in line with wage increases.

32. Much like automatic enrolment itself, these schemes work by playing on people's inertia and myopia. Once signed up, an individual no longer has to take active decisions to increase their saving – they happen automatically. By synchronising the point of increase in saving with an increase in wages, individuals not only defer to a later date the loss of immediate income that an increase in contributions represents, but also know that when that loss comes, it will be tempered by their overall income increasing anyway.

Case study: Save More Tomorrow™

Save More Tomorrow™ is an automatic escalation scheme popular in the United States, developed by leading behavioural economists Shlomo Benartzi and Richard Thaler. These schemes have resulted in a significant increase in savings levels. At the firm where they first tested Save More Tomorrow™, 78 per cent of those offered the scheme joined with the vast majority of them (80 per cent) remaining in it through to their fourth pay raise. The average saving rates for those signed up to the scheme increased from 3.5 per cent to 13.6 per cent over the course of 40 months.[15] In 2009, 59 per cent of large companies in the United States had some form of automatic escalation scheme.[16]

14 Johnson P, Yeandle D and Boulding A, 2010, *Making automatic enrolment work: a review for the Department for Work and Pensions*, Cm 7954, TSO.

15 Benartzi S and Thaler R, 2004, *Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving*, Journal of Political Economy.

16 Aon Hewitt, 2010, *Hot Topics in Retirement*, 2010.

33. As we move into an automatic enrolment world, these schemes may represent an effective mechanism to increase savings levels. Research suggests that there is an appetite for increasing saving. Of those who said they would be likely to stay in automatic enrolment, nearly half (48 per cent) said that they would be willing to contribute more than four per cent.[17] Of those who said they would definitely or probably stay in a workplace pension scheme, an increase in wages or salary was the most important factor in encouraging them to contribute more.[18]

Issues for further examination

- Is there a demand for automatic escalation schemes among employers and savers?
- Why have these schemes not become common in the UK as they have in the United States?

Charges

Reinvigoration objective

Increasing the amount people receive for their savings

34. Relatively small differences in levels of charges can have a big impact on a member's pension pot over time. An annual management charge of 1.5 per cent reduces a final pension pot by 22 per cent because of the lost compound growth potential, whereas an annual management charge of 0.5 per cent reduces the pot by nine per cent.[19]

35. Given that many of the new savers created by automatic enrolment will not understand the full impact that charges can have on their retirement pot, it is important that people are enrolled into schemes which offer both transparent and value for money charges. This does not always mean comparatively low charge levels – a more actively managed fund that achieves higher returns may warrant a higher charge level and still reflect value for money for individual members. That is why transparency as much as the charge level is critical.

17 Bourne T, Shaw A and Butt S, 2009, *Individuals Attitudes and Likely Reactions to the Workplace Pension Reforms.*

18 Bourne T, Shaw A and Butt S, 2010, *Individuals' attitudes and likely responses to the workplace pension reforms 2009: Report of a quantitative survey,* DWP research report 669.

19 Johnson P, Yeandle D and Boulding A, 2010, *Making automatic enrolment work: a review for the Department for Work and Pensions*, Cm 7954, TSO.

Reinvigoration objective

Increasing transparency and building trust, confidence and engagement in pension saving as the norm.

36. The Department therefore welcomes the initiative by the National Association of Pension Funds (NAPF) to develop an industry 'Code of Conduct' to disclose information about charges to employers and the proposals from the Association of British Insurers (ABI) for the industry to provide clearer information on charges and costs to consumers. We think these actions will help improve transparency in charges, ensuring scheme members receive information they can understand, making charges easier to compare and helping individuals to have trust in their pension savings.

37. This will complement guidance we have published on default funds for DC automatic enrolment schemes, which includes disclosing a breakdown of the overall charges and making clear the effect the charges will have on member outcomes. Disclosure of charges will, of course, include the effect of consultancy charges, where the Government would expect that a charge should only be applied where advice on a scheme leads to a tangible benefit for its members.

38. Our research shows that charges have fallen steadily over time and so far evidence suggests that this trend will continue. It currently shows that in DC workplace pensions the average annual management charge for trust-based schemes is 0.71 per cent of the fund per year and the average annual management charge for contract-based pensions is 0.95 per cent.[20]

39. However, we are monitoring charges, including consultancy charges, very closely and have been clear that we will take prompt action if we see evidence that charging structures are being used inappropriately or if charge levels are excessive. In particular, we have powers to stop a scheme from being used for automatic enrolment if its fees are too high or if members are required to pay for anything which doesn't deliver them a pension benefit. We could take action within months so the industry has every incentive to do the right thing.

The impact of the National Employment Savings Trust (NEST)

NEST's funds under management charge is 0.3 per cent, with a contribution charge of 1.8 per cent, which is broadly equivalent to a 0.5 per cent annual management charge overall. The Department anticipates that NEST will act as a benchmark for the industry, with research showing that providers expect that NEST will have a substantial impact on provider charges, setting the 'baseline' level.

20 Wood A, Wintersgill D and Baker N, 2012, *Pension landscape and charging*, DWP research report 804.

40. There is already evidence that NEST is encouraging other pension providers to re-evaluate their schemes and acting as a spur in critical areas such as charges. This has already begun to happen with schemes such as The People's Pension, who offer a product with a 0.5 per cent annual management charge and NOW: Pensions, who have an annual administrative charge of £18 and a 0.3 per cent annual management charge open to all.

41. Despite encouraging trends, we are conscious that charge structures tend to be complex. We are keen to continue to develop the monitoring regime for charges (which currently consists of a regular survey of trust and contract-based schemes[21]) to ensure that we have a robust evidence base to assess whether self-regulation is working and continues to be appropriate for schemes being used for automatic enrolment.

Issues for further examination

- Which charges are hardest to understand? What can we do about it?
- How could the Government's current approach to monitoring the market be made more comprehensive?

Investment strategies and returns

Reinvigoration objective

Increasing the amount people receive for their savings

42. The way in which the money people pay into their pension pot is invested can have a considerable impact on how their pot grows over the course of their working life. To a certain extent, this will depend on wider economic conditions, but savers can have involvement in the broad strategies that pension fund managers use to invest their pots and the performance of investment options should be monitored by those running the scheme.

43. Employers also play a significant role when choosing a scheme. Research into default funds in occupational schemes has shown that the fund performance of a scheme is a greater driver for scheme choice for employers than provider and fund management charge levels.[22]

21 http://research.dwp.gov.uk/asd/asd5/rports2011-2012/rrep804.pdf

22 Wood A, Young P and Wintersgill D, 2011, *The use of vesting rules and default options in occupational pension schemes*, DWP research report 725.

44. While investment decisions could largely be seen as an issue for individual choice for employers and savers, as well as those running the scheme, we recognise that many people will not get involved in active decision-making, particularly those saving for the first time through automatic enrolment. Currently 80-90 per cent of pension scheme members are in the default fund.[23]

45. The work of Government in this area therefore has three primary aims:

- to ensure that employers (and any individuals who wish to make active decisions) have clear information about any investment decisions they may wish to make;
- that good governance ensures investment strategies are regularly reviewed; and
- that default fund options are appropriate, particularly in a post-automatic enrolment world where many savers may not be actively engaged in their pension scheme.

Guidance

46. To that end, the Department and its related non-departmental public bodies have developed a number of pieces of guidance to encourage good investment decisions, including:

- guidance from the Investment Governance Group[24] on principles for best practice in investment governance of work-based pension schemes;
- an online Investment Choices Planner from the Pensions Advisory Service to support members of DC schemes in deciding how they would like their contributions to be invested; and
- guidance on default funds for DC automatic enrolment schemes which sets out standards that pension schemes, advisers and employers should follow to ensure that the default investment fund is of sufficient quality.

47. We are also supportive of work by other bodies on this issue. The NAPF's Pension Quality Mark states that simple investment options must be available, such as: a default fund; a limited choice of risk-related funds; or a wider choice, but only if advice and guidance is available. We are also aware that the ABI and the Investment Management Association are planning to jointly publish a paper focusing on the implementation, design and delivery of default funds. We will continue to work with stakeholders to ensure that consumers are offered competitive and robust products.

23 National Association of Pension Funds, 2011, *Annual Survey 2011.*
24 Investment Governance Group, 2010, *Principles for investment governance of work-based DC pension schemes.*

Would increased scale in pension schemes make a difference?

Reinvigoration objective
Increasing the amount people receive for their savings

The Department is keen to examine, with the pensions industry, whether a pensions market with a smaller number of larger-scale, multi-employer pension schemes might be able to provide greater value for money for employers and employees by using economies of scale and greater buying power to offer diverse investment options, reduced administrative costs and lower charges.

Many countries have collective occupational pension funds rather than employer specific schemes and it may be that the scale and size of occupational pensions are becoming increasingly important issues in seeking innovative solutions. For example, in Australia, Jeremy Cooper who reported on the Superannuation system for the Australian Government in 2010, also went on the record[25] to say that the hundreds of super funds need to reduce to far fewer – he thought 40, or 30, and that the ‘get big or get out’ motto really was appropriate.

Larger schemes also tend to be associated with higher levels of governance activity, more frequent meetings of the trustee board, better information provision, more training support provided to trustees and greater awareness of guidance offered by the Pensions Regulator.[26]

Smaller schemes tend to show much lower standards of governance. Trustee boards in small schemes were half as likely to be rated as governing ‘very effectively’ and 74 per cent of small DC schemes’ trustees have not undertaken any formal structured training in the last 12 months.[27] The Pensions Regulator survey shows that raising governance standards is difficult in these schemes, due to the fewer resources available to them.

However, there will be scenarios where smaller schemes might still offer good value and perhaps better reflect the needs of a particular membership. Equally, large scale schemes do not guarantee good outcomes and we need to ensure the regulatory regime for multi-employer schemes is appropriate with good governance mechanisms in place.

One critical question is how to bring about scale and what, if any, role there would be for the Government in doing so. The approach being taken with MySuper in Australia involves a requirement that trustees consider whether their members are being disadvantaged by lack of scale. Their regulator will also follow-up on funds that appear not to have sufficient scale. An alternative approach may be to have a high regulatory bar for multi-employer schemes which would require them to exist at scale.

25 Lateline Business ABC broadcast 5/7/10
26 The Pensions Regulator, 2012, *Occupational pension scheme governance: A report on the 2012 (6th) scheme governance survey.*
27 The Pensions Regulator, 2012, *Occupational pension scheme governance: A report on the 2012 (6th) scheme governance survey.*

These are difficult questions and we would need to engage further with industry and other interested parties before taking forward any proposals in this area.

Scale can also play a role in enabling risk-sharing, which will be explored in chapter 3.

Issues for further examination

- Would having fewer, larger schemes result in better value for money for savers?
- What might the role for government be in encouraging consolidation in the pensions market?

Decumulation

Reinvigoration objective
Increasing the amount people receive for their savings

48. Having built up a pension pot during their working life, the final factor affecting the income an individual receives in retirement is what they do with this pot, most often the annuity they secure. Most people with average or small pots will use this at retirement to purchase a lifetime annuity, giving them a guaranteed income for life. The amount payable depends mainly on the value of the fund, the age and health of the individual at the point of purchase and the type of annuity purchased – for example, whether it is flat-rate or increases each year in line with inflation. Annuities guarantee an income for life and by pooling longevity risk, allow people to make more effective use of their savings by ensuring they will not exhaust them before they die.

49. Individuals need to ensure that they secure the best annuity rate possible, but will often require support through the process. Pension providers must inform people of their right to the Open Market Option – the right to buy an annuity from a provider other than the one that holds their pension savings. It is essential for providers to get this message across to consumers as effective use of the Open Market Option can significantly increase income in retirement.

50. To support members through the annuitisation decision process, regulations and the FSA Conduct of Business Sourcebook require communications to be issued to the member between four and six months before their intended retirement date – often called a 'wake up pack'. This includes information from the provider and also a Money Advice Service (MAS) guide.

51. The Pensions Advisory Service and the MAS also provide online annuity tools to help support people through the annuitisation decision process.

52. The Department and HM Treasury have been working with the Open Market Option Review Group[28] to consider how to develop a default Open Market Option – that is how to move people into the Open Market Option in order to overcome inertia in relation to shopping around.

Reinvigoration objective

Increasing transparency and building trust, confidence and engagement in pension saving as the norm.

53. In March, the ABI launched a compulsory Code of Conduct on Retirement Choices. This Code incorporates some of the key elements of the Open Market Option Review Group discussions. It has been developed to ensure that people approaching retirement will receive much greater support to get the best possible retirement income. It will make sure that pension providers' communications to customers help every customer to make an informed decision.

54. Key elements of the code include:

- prohibiting providers from sending out application forms in the information pack sent out to consumers; this would address the inertia which can lead to consumers accepting the first and only offer from their current provider, which may not be the best option for them;

- the requirement for provider communications to engage the customer in a three step journey addressing: i) understanding retirement – the decisions the consumer needs to make and the timetable; ii) understanding the different ways of taking retirement income – highlighting the options for joint, enhanced and escalating annuities; and iii) understanding how to buy – encouraging the customer to obtain quotes from other providers and explaining how to go about this; and

- additional measures to increase awareness of enhanced annuity products and state clearly if the provider is not offering one.

55. Other members of the group are developing an online adviser and broker directory to assist consumers in finding the right type of further information and advice that meets their needs.

56. The Department considers that information and support for those making decisions about annuitisation is critical. The Open Market Option Review Group is currently developing an evaluation strategy in order to test how far the new ABI Code of Conduct and supporting changes create a difference in shopping around and improve member outcomes at annuitisation. Depending on the outcome of that work, we will consider taking further steps.

28 The OMO Review Group includes representatives from Government, industry and consumer organisations.

Other options at retirement

> **Reinvigoration objective**
> Increasing the amount people receive for their savings

57. However, buying a lifetime annuity at the point of retirement may not always be the best option for people. Annuity rates have fallen considerably over the last ten years – by around 18 per cent since 2003[29] – which has resulted in savers not receiving the income they might have expected in retirement.

58. One alternative is income drawdown, which allows people to take income from their pension fund while the fund remains invested and continues to benefit from any fund growth. However, in general, a substantial fund value is needed to make income drawdown cost-effective and there is a risk to retirement income if investment returns are poor and the level of income is reduced below what an individual had planned – the income is not guaranteed as with an annuity.

59. Another alternative is a fixed-term annuity where people exchange a lump sum from their pension funds for an income that typically lasts for five or ten years.

60. The advantage of these approaches is primarily flexibility. Pensioners are not locked in to a certain level of income for the rest of their life at the point of retirement, particularly at a time when annuity rates are low. However, both expose pensioners to the risk that annuity rates will have decreased further when they do annuitise, resulting in a reduced income in retirement, not only because of the lower annuity rate, but also because their pot will have decreased in the meantime.

61. Different approaches will work for different people and it is critical that people have the information and the time to make the right decision. However, retirement is a major life event and people will not necessarily be clear immediately before it what their needs will be and therefore what the right option will be. We are keen to explore any alternative approaches which might support people to make the best decision about their income in retirement.

29 DWP calculations based on data from the Annuity Bureau.

Case study: Alliance Bernstein's 'retirement bridge'

Alliance Bernstein research[30] has suggested that savers have little awareness of the process for turning their pension pot into income in retirement and need more time to assess their needs before making a decision. They have therefore developed the concept of the 'retirement bridge'.

This approach would mean a saver would take an income directly from their invested funds, using the income drawdown rules, allowing them to defer the purchase of an annuity until later, once they have considered the best option for them.

Alliance Bernstein recognise that income drawdown is too costly for most retirees, but contend that the costs of income drawdown can be reduced significantly by embedding age-appropriate strategies suitable for most retirees – covering both investment strategy and drawdown rates – in a simple fund.

Issues for further examination

- Are there further steps the Government can take to support people through the annuitisation process at the point of retirement? How can we help people to make decisions in their own best interests?
- Is there scope to explore alternatives to lifetime annuities and should more flexible products such as the 'retirement bridge' be encouraged?

62. Further discussion of options at decumulation can be found in chapter 3.

30 Alliance Bernstein, 2012, *Retirement Bridge: Providing a real choice for retirees.*

Providing greater clarity and building confidence

3

Background

1. A key part of the reinvigoration strategy is to explore whether current private pension structures will meet the needs of future generations of pension savers and pensioners. The Government is therefore exploring the scope for a new category of 'Defined Ambition' (DA) pensions to complement the DB and DC structures that dominate the market.

2. As discussed in chapter 2, DB and DC provide valuable options and offer the employer and member different things.[31] However, we question whether this provides the fullest set of options along the risk-sharing spectrum. Recent discussions with employers and other stakeholders as well as past findings about consumer preferences, indicate there is demand for an alternative that we have labelled 'Defined Ambition'.

3. The aim of a DA pension would be to create greater certainty for members about the final value of a pension pot than is provided by a pure DC pension. It would also seek to ensure less cost volatility for employers than pure DB pensions.

4. We think this could be achieved by sharing the longevity and investment risks between a number of parties, including employers, individuals, insurance and investment businesses.

31 In DB schemes the employer bears the risks of longevity, inflation and investment return, and in DC the member bears these risks pre-retirement. Insurance providers bear the risk on some elements, for example with a DC pension the member can buy a guaranteed income for life from an insurance provider, thereby transferring longevity and investment risk to the insurer (and potentially inflation risk, depending on the annuity bought).

Principles for development of Defined Ambition pensions

Reinvigoration objective

Enable industry innovation and development of new products including those which will give people more certainty about their pensions and encourage more risk-sharing.

- **Consumer focused** – a DA scheme should address consumer needs (members and employers).
- **Sustainability** – a DA scheme should be affordable to stakeholders (employers/pension providers/members) over the long term.
- **Intergenerationally fair** – a DA scheme should not be biased to pensioners, but also take on board needs of future pensioners.
- **Risk-sharing** – a DA pension scheme should incorporate genuine risk-sharing between stakeholders.
- **Proportionate regulation** – the regulatory structure needs to be permissive to enable innovation in risk-sharing, while protecting member interests.
- **Transparency** – any DA solution would need to be transparent and have high governance standards.

5. There are likely to be a number of different solutions and options that meet the DA challenge.

6. We know that some risk-sharing schemes are possible in the current regulatory structures. Some of these are outlined in the sections below. We need to explore what barriers exist to these types of schemes and whether incentives exist to encourage greater take-up.

7. Some options may look more like a slimmed down DB – an example might be DB without indexation requirements or spouse benefits. Other solutions might look more like DC, but have some kind of guarantee of either the fund or the final pension income. For ease of reference we have used the two familiar models of DB and DC as the starting point for developing DA options and discussing implications.

Working with the industry

8. To look at the scope for innovation, and how existing options and new ideas might be developed, the Department has been working with a Defined Ambition Industry Working Group. The Group first met in early August and is chaired by the Association of Consulting Actuaries (ACA). It includes providers, actuaries,

investment management firms, regulators and lawyers who are focusing on product and scheme design details. Some of the Group's early ideas that might provide templates for DA schemes are included in this chapter.

9. In addition to the Industry Working Group, the Department has also set up a Co-ordination Group to inform the development of DA pensions. This brings together all the key industry organisations and consumer groups.

DA Schemes – from a DB starting point

10. Discussions with a range of employers have indicated that some who want to move away from their current DB pension arrangements are keen to retain some element of DB, but with an element of risk-sharing. They regard this as part of building a long-term relationship with the employee.

11. A number of products and design options have been identified as potential ways of broadening the road from DB to DA arrangements and are now being explored in more detail.

Models already possible

Some models that share or mitigate risks are already available. We are keen to explore what incentives there are to encourage innovation around these models within the existing legislative/regulatory framework and how government might facilitate this further. These models include:

Career Average Revalued Earnings (CARE) schemes

A percentage of salary in each year (rather than the final years) is allocated to the member's pension. The pension is usually revalued on a yearly basis until the member reaches the scheme's pension age. The final benefits paid from the scheme then follow final salary DB arrangements in that they are paid by the employer over time and have to be indexed annually at least in line with the statutory minimum. Such schemes are likely to produce a lower variation in cost to the employer over time compared with final salary DB schemes.

Cash balance schemes

The employer specifies the pension fund amount for the member for each year the member works and so the size of the member's overall pension fund is defined, with the actual value dependent upon the revaluation factor specified in the scheme rules. When the member retires the total pension fund is then available for the purchase of an annuity. This means the pension income stream is not usually guaranteed by the employer and the risks of cost volatility to the employer are reduced since the commitment does not extend to the decumulation stage.

Schemes using longevity adjustment factors

This model can involve increasing the normal pension age for pension scheme members for future accrual in light of increasing longevity so that pensions commence at a later date. This therefore mitigates the financial cost of increased life expectancy for the employer.

Other risk management options

Schemes can mitigate risks by buying insurances. Some of the most common options are buy-outs, buy-ins (including partial arrangements which cover only certain classes of members), longevity swaps, and re-insurance.

Issues for further examination

- What are the key barriers to risk-sharing in DB-type provision?
- How might the Government encourage and facilitate more risk-sharing?

New models

12. We are also keen to explore ideas for new models that could be introduced to make continued provision of some elements of DB sustainable in future DA arrangements and support the transition from DB to DA schemes where this is desired. Four potential models which the Industry Working Group has identified for further exploration are described below.

Simplified/core DB schemes

13. This would be a lighter version of DB where employers offer a 'core' level of provision, with additional benefits above this minimum standard being discretionary. Options offered above the minimum (the 'ambition' element above the 'core' level) subject to lighter regulation which we want to explore further include:

- **Conditional and optional indexation**

  Conditional indexation – In this model, future indexation is not guaranteed, but is conditional on the funding of the scheme which is targeted at full revaluation. When the scheme is fully funded, the benefits would be increased in line with the scheme's target index. When there is a funding deficit, the next year's indexation would be withheld if the employer chose not to meet the deficit by making additional contributions. For years when pensions were not indexed, the resultant savings would reduce the funding deficit.

Optional indexation – This goes further by removing the statutory requirement for indexation, allowing employers to offer schemes that provide a pension not indexed to inflation.

- **Removing spouses' benefits**

  This would remove requirements for DB schemes to provide spouses' benefits.

Conversion of benefits

14. In this model, the employer would promise a defined level of benefit for the member and at the point the member leaves the scheme, retires or dies the defined benefit is crystallised, and converted to a DC amount of equivalent value.

15. This model would balance encouraging retention and rewarding long-term employees with DB-type provision, with the employer only being responsible for funding and risk proportionate to its active workforce. This model would also remove long-term longevity risk from the employer.

Fluctuating Pensions

16. Building on the idea of having simplified/core DB schemes, this model would allow schemes to provide pensions that fluctuate in payment according to the financial status of the scheme. For example, a scheme could provide a core non-increasing pension amount each year which the employer guarantees to provide, plus a discretionary supplement each year, the level of which depends on the strength of the scheme. The discretionary element would be subject to a lighter funding regime.

17. Allowing for adjustments to the discretionary supplement should provide greater flexibility in adverse financial conditions.

Linking scheme retirement age with changes to State Pension age

18. In this model an employer providing DB-type provision would have the option to adjust their scheme retirement age in line with increases in State Pension age. The increase in retirement age would apply both to future pension rights and those accrued from the date new legislation was introduced. This would enable companies to mitigate some of the increased cost of unexpected longevity. While Life Expectancy Adjustment Factors can already be operated under existing legislation, schemes can only apply such factors to future service.

19. While individuals might have to work longer than they expected, this would be balanced by their continuing to receive DB-type provision. Those close to retirement should perhaps have some degree of protection.

Issues for further examination

- Are there other key models or designs for exploration looking at DA from a DB starting point?

Initial thoughts on these models

20. The feasibility of these new models requires further assessment and development covering legal, government policy, and financial issues. Some of the common areas being explored are:

- how far changes to the pensions landscape since the Department's risk-sharing consultation in 2008 have boosted the case for revisiting some of the decisions made at that time;
- how to ensure an appropriate trade-off in balancing real cost reduction and member protection issues and how to manage issues of moral hazard in relation to ambitions above DB core benefits;
- how to resolve issues concerning fair treatment of early leavers, accrued rights and transfers; and
- likely take-up levels and measures to ensure member understanding and engagement.

DA schemes – from a DC starting point

21. Our discussions with employers, providers, consumer bodies, as well as qualitative research findings about loss aversion, all indicate that there is some consumer demand for more certainty about pension outcomes than a basic DC scheme offers. Anecdotal evidence suggests that employers who do not want to promise a retirement income or engage with the current DB scheme funding regime could be attracted to offer something that looks like DC, but offers more.

22. The Industry Working Group has identified a number of ways in which this type of DA design could be achieved within the current legislative framework.

Models already possible

DC with bonuses on top of a basic minimum

With profits' funds, provided by insurance companies, are available within existing insurance regulations – these provide a minimum investment growth, with additions on top of that determined by the performance of the overall fund.[32]

Deferred annuities

Deferred annuities are possible in the current legislative framework. This is where an annuity is purchased before the retirement date is reached. This locks-in certainty about that part of the retirement income before the individual reaches retirement.

Targeted or managed DC

Various products are already available that, on an individual basis, target an income in retirement by setting a pension target and managing that on an individual basis. The target is regularly reviewed, with either asset allocation and/or employer/employee contributions varied to keep in line with the desired target and increase the likelihood of the outcome.

Providing guarantees

23. Capital guarantees have increasingly been proposed as an attractive feature to include in what would otherwise be a DC pension plan. One suggestion is that a nominal guarantee of contributions would improve member engagement and participation as individuals would no longer need fear losing the money paid into their pension. Although potentially attractive, the cost of guarantees has meant that these products have not reached the majority of the market, or the middle to lower end.

The cost of guarantees

Recent papers by the Organisation for Economic Cooperation and Development (OECD)[33] and the Institute and Faculty of Actuaries (I&FoA)[34] have both considered the costs and benefits of guarantees in DC plans.

The OECD analysed two different[35] capital guarantees. The first kind guarantees the nominal sum of contributions at retirement only, while the second kind holds throughout the entire accumulation phase (an ongoing capital guarantee), such that on an annual basis the accumulated assets equal at least the nominal sum of contributions made until that point. The I&FoA looked only at the guarantee of total nominal contributions on retirement.

32 In the past whilst there have been some highly publicised failures of 'with profits' type products, there are also some ongoing success stories. So should new products be offered the Government needs to be assured that the levels of governance are robust enough to mitigate the risks.

33 Organisation for Economic Co-operation and Development, 2012, *'The Role of Guarantees in Retirement Savings Plans',* published in 'OECD Pensions Outlook 2012'.

34 Institute and Faculty of Actuaries, 2012, *'Is there a place in the UK Defined Contribution pensions market for a guaranteed savings product?'*

35 The OECD actually analysed six different guarantees but we focus only on the capital guarantees.

Assuming contributions and investment strategies are the same, both guarantees should lead to a lower expected fund on retirement compared to the case of no guarantee, due to the cost of the guarantee. Furthermore, the ongoing capital guarantee should be more expensive than the on-retirement capital guarantee because the former is more likely to be needed given the volatility inherent in DC investment strategies.

The OECD estimated that in order to purchase the on-retirement capital guarantee, the individual must pay, each year, six basis points on the fund value, or equivalently, 1.24 per cent of the contributions made.[36] The price of the ongoing capital guarantee is an estimated annual fee of 39 basis points on the fund value, or equivalently, just under 20 per cent of the contributions.

The total cost of the guarantee to individuals[37] of the on-retirement capital guarantee is a fund value that is 1.3 per cent lower than in the absence of a guarantee, while the ongoing capital guarantee results in a reduction of 7.1 per cent in the value of the fund relative to the no guarantee case.

The I&FoA analysis looked at costs on a commercial basis and estimated that, for an individual contributing over a 40 year period, the annual management charge inclusive of a guarantee charge levied on the fund would be in the range of 60 – 210 basis points, depending upon the investment strategy utilised.

The analysis assessed the likelihood of a fund with a guarantee achieving better returns (net of charges) than those from a portfolio of 'safe' investments (but no guarantee). It found that the probability of it doing so varied between 35 and 69 per cent, depending on the strategy chosen.

Ultimately, what both pieces of analysis clearly show is that while guarantees may be beneficial, they come at a price in terms of reduced income in retirement. The ultimate decision should rest with the individual – if they value the guarantee at greater than its cost, then it would be beneficial for them to have.

New models

24. The Industry Working Group has therefore been exploring how DC schemes or products could be constructed alongside a separate and additional element of affordable guarantee. This could be a guarantee in relation to certain limited aspects of pension risk – for example, capital, investment returns or longevity. The guarantee could be offered by employers or insurers or possibly by a Pension Protection Fund-style protection fund which is funded by a levy on members' funds. We are also exploring whether a targeted pot size or income stream is feasible.

25. Three potential models which the Industry Working Group has identified for further exploration are described below.

36 The OECD note that this does not include regulatory or administrative costs. These are likely to be significant and we would expect commercial prices to reflect that.

37 Measured as the percentage loss in the fund at age 65 with a guarantee as compared to the case of no guarantee.

Mutualised guarantees and risk-sharing

26. **A money back guarantee funded by a levy on members' funds.** This would share the investment risk between the individual member and the mutualised fund. Unlike current DC, the individual would be guaranteed to get back the contributions they had paid in at the crystallisation date, for example when they retire or at death. This guarantee would be for certain qualifying default funds only. Variations on this theme could be whether the guarantee related to employer contributions as well and whether the 'money back' was in the form of a lump sum only, or in the anticipated income-stream paid over time.

27. **A guarantee to cover retirement income in later years, funded by a levy on members' funds.** This would share the longevity risk between the provider of the retirement income (annuity providers or schemes) and this new mutual fund or guarantee provider. For the individual this would mean their pension income would be paid by the provider or scheme up to a certain age and then the guarantee would cover any further payments. This should generate more favourable annuity rates because the longevity risk is decreased for the provider.

28. As in DC schemes, the funding of these guarantees would not be provided by the employer – although they may opt to pay the levy for the individual. There would be certainty in cost for the employer and there would be no liability to show on the employer's balance sheet. The levy payment would be charged as a fee on the member relating to the funds invested. A mutualised fund guarantee would mean that the guarantee would not need to be underwritten on an individual basis by an insurer and could therefore be more cost efficient.

29. The challenge would be around how to deliver the mutualised fund. Potential models might include not-for-profit provision within the private sector, or alternatively a government-sponsored but industry-funded body, similar to the Pension Protection Fund.

Guarantees and risk-sharing provided by the insurance industry

30. **A guaranteed fixed-period return purchased on a member's behalf, incorporating risk sharing and guarantees.** This investment would involve a guaranteed minimum level of growth of the individual's pension savings, with potential to receive more than that minimum. The provider of the guarantee would take on the downside risk – i.e. that the investment did not reach the minimum guaranteed level. The consumer and the provider of the guarantee would share the upside, so if the fund performed over the minimum guarantee the provider and member would both take a share. This differs to basic DC where the consumer does not have any guarantee on positive investment returns, but would, broadly, not share as much of the upside. Unlike normal DC, the daily pricing and liquidity requirements that normally apply would be waived in respect of investments that meet the qualifying criteria.

31. **Standardised income guarantee insurance.** This would be a standardised income insurance product bought from a DA fund by the fund fiduciary on the individual's behalf, via a fixed annual deduction from the individual's fund. For example, from age 50 part of the individual's pension savings could be used to secure a guaranteed income in retirement. This income would go up with future investment returns, but would not fall.

32. Both the insurance-based products would not require employers to take on the risk of investment or longevity, although they could select to meet a certain part of the cost of the guarantee if they so wished.

Case study: Teachers Insurance & Annuity Association of America

Teachers Insurance & Annuity Association of America (TIAA) is a leading provider of lifetime retirement income in the US. One of TIAA's leading products is the 'Traditional Annuity' – a guaranteed annuity product offered to participants in employer-sponsored retirement plans. During the accumulation phase, the participant can purchase pension income using some of their accumulated fund. This income is guaranteed at a minimum rate. In the decumulation phase, individuals have their guaranteed minimum income plus any additional amounts that may be credited by TIAA in the light of sufficiently strong investment returns. A further uplift to retirement income may come from the reserves held back during the accumulation phase for the guarantees made. These are maintained for each cohort and distributed as additional annuity income as the need for reserves declines, thus providing potential additional income for retirees.

Plan design

33. **Employer-funded 'smoothing fund'.** The employer would pay a percentage of 'core' contributions into a central fund that is used to manage a targeted outcome at retirement, possibly via annual bonuses or final terminal bonus. The individual would have certainty as to the minimum income at retirement, but this could continue to grow, unlike standard deferred annuities.

34. This option would remove the longevity risk for employers, but would mean more volatility in costs for them than in a standard DC. The design might need to include specific parameters for contribution increases, in order to make this manageable for employers. Elements of this design might lend itself to the Collective Defined Contribution model described in the next section.

Issues for further examination

- Are there other key models or designs for exploration looking at DA from a DC starting point?

Initial thoughts on these models

35. As with the options from a DB starting point, these DC-based options require further work covering legal, government policy, and financial issues. Considerations include:

- assessing the cost of providing guarantees and the value ascribed to that guarantee by the consumer;
- balancing the capacity to transfer small pots and accrued rights with the need to ensure products are sustainable;
- how to deliver a mutualised fund and/or the role of Government; and
- likely take-up levels and measures to ensure member understanding and engagement

Collective Defined Contribution schemes

36. It has been suggested that Collective Defined Contribution (CDC) schemes could offer a structure for Defined Ambition schemes. CDCs are a fundamental part of pension provision in the Netherlands and Denmark and feature risk-sharing between the members, and also offer cost certainty for the employer.

Key features of existing CDC

37. The employer pays a fixed rate of contributions and risk is shared between the members. An expected benefit is calculated, but not promised – the actual pension benefit to be paid is based on the funding level of the scheme – so the pension in retirement is not certain. The extent of this uncertainty varies between schemes. Historically in the Netherlands once in payment, pensions have not been cut, but future indexation has been conditional. Other models might include the option to cut pensions in payment.

38. For example a small fall in investment returns could cause the scheme's funding level to drop which could lead to a reduction in future revaluation and indexation. In the case of a significant fall in returns, the basic benefits might also be reduced prior to and post retirement. Dependent on scheme design, the impact of the fall might be spread across all the members, or be designed to, for example, impact those approaching retirement less heavily.

39. The fund is collective, so it can stay invested in risk-seeking assets for longer than any individual member could do so in a typical DC arrangement (where they might switch to lower-risk assets a few years before retirement).[38] This should lead to higher expected pensions than under a standard DC arrangement. Further economies of scale could be gained in administration and investment management, owing to the existence of a single fund – individual savings accounts, individual investment decisions and switching might not be needed under CDC.

38 It is possible for individuals to stay invested in return seeking assets through a drawdown contract, although in practice this is not currently a mass market product.

40. In 2008/09 DWP examined the issues around CDCs and whether they could be delivered in the UK.[39] At that time the findings highlighted limited demand from employers for CDCs and that some of the CDC features were not permissible in the UK legislative system. There were also concerns about intergenerational fairness and the long-term stability of a scheme where membership was not compulsory (unlike the Netherlands). Analysis at that time also suggested that while there was, on average, a better outcome under CDC when compared to DC, there was still a significant range of possible outcomes and a high probability that benefits would be cut.

A future for CDC in the UK?

41. It is probably not feasible to simply implement Dutch-style CDC schemes in the UK due to distinct cultural and institutional differences, including acceptance of compulsion. However, as CDCs do offer a form of risk sharing we are exploring with the Industry Working Group whether elements of CDCs could now inform the development of Defined Ambition pensions.

42. This work includes considering what lessons might be drawn from the difficulties being experienced in the Netherlands where, due to under-funding, schemes have had to forego indexation and the historic model is being reviewed. Some schemes have announced that they will cut nominal benefits and are exploring greater hybridisation; lowering the value of guarantees; and greater sharing of risks.

43. We also need to review the legal framework within which CDCs might operate as there is uncertainty as to whether such models would be possible within the current legal framework without falling under the regulatory regime that applies to DB pensions.

Model for a CDC scheme

- Trust-based scheme.
- Provides a CARE (career average revalued earnings) based target for payment at a pension age variable between ages 55 and 75 (actuarially adjusted to be cost neutral).
- The target level of benefits accrues at X per cent of pay for each year of employment.
- Employer contributes Y per cent. These are pooled and invested in a 'with-profits' style fund to smooth the outcomes across all the members. Assets are invested in higher yielding riskier assets and, being collective, there is no need for lifestyling as individual members approach retirement.

39 DWP issued a Risk Sharing Consultation in June 2008 and a Government response to the consultation in December 2008. In 2009 a further assessment of whether and how CDCs could operate in the UK, including research into employer appetite for CDCs was also conducted. Findings and modelling was published in Dec 2009.

- Members can match with voluntary contributions up to Z per cent to provide extra pension or other benefits.
- Individual accounts maintained based on notional investment returns.
- Performance is reviewed annually, with option to maintain the target by increasing contributions or to reduce the target to ensure the scheme is fully funded.
- Pension awarded on retirement to match the target with application of smoothing determined by trustee discretion/actuarial methodology.
- Pensions are paid out of the schemes' own funds (self-annuitisation)
- Indexation is conditional on performance of the fund and may be increased or reduced year on year. The funds to secure indexation remain invested in higher yielding riskier assets.

Issues for further examination

- How might the Government facilitate and encourage the development of collective schemes?
- If the regulatory regime was changed to enable collective schemes, would there be sufficient demand from employers?

Importance of scale in DA

44. The Working Group is also exploring whether some of the ideas for new models outlined above might be more feasible if they were combined with the scale that might come from multi-employer schemes. Analysis of the Dutch and Danish systems suggests that scale is fundamental to delivering the elements of risk-sharing within those systems.

Could increased scale provide more Defined Ambition opportunities?

In chapter 2 we explored the potential advantages that scale might have for DC schemes. We are also keen to explore whether scale – that is, having a smaller number of larger-scale multi–employer schemes – could also open up new or different opportunities for DA schemes. For example:

- risk-sharing between members or between employers on certain types of guarantee or collective investment vehicles;
- a DA option offered as one fund choice among a number within a multi-employer scheme;
- development of several standardised DA options for the employer to chose from;
- transferability of elements of DA guarantees and reduced transition between schemes; and
- providing a mechanism for governance and engagement required for some of the DA models at a scheme level, rather than relying on the employer and/or provider relationship with the member.

Issues for further examination

- Building on the issues in chapter 2, could scale provide a platform for new types of risk-sharing opportunities?

Consumer perspective

45. The high level aim of DA pensions and the principles we have articulated are focused on what we currently know about the consumer (employer and employee) perspectives. This section looks at the specific challenge relating to the consumer as an individual scheme member and the consumer as an employer.

Individual members

46. Chapter 4 focuses on how we can help improve people's trust, confidence and engagement in pension saving – DA will also need to meet these challenges. However, an additional factor for DA will be that products that involve risk-sharing are likely to be more complex than traditional DB and DC pension schemes. DWP research[40] shows that knowledge of pensions generally is very low; that people have a poor understanding of risk and the long term nature of pensions; and they tend to be risk-averse. So specific challenges for DA include:

40 Clery E, Humphrey A and Bourne T, 2009, *Attitudes to pensions – 2009*, DWP research report 701. Clery E, McKay S, Phillips M and Robinson C, 2006, *Attitudes to pensions – 2006*, DWP research report 434.

- reconciling consumer attitudes to risk with products designed to improve outcomes through risk-sharing/'with profits';
- reconciling poor understanding about pensions with the complexity of products needed to provide a greater level of certainty about retirement income in DC models of provisions; and
- ensuring that each product 'does what it says on the tin' to reduce the risk that consumers are not confused/disappointed by the income secured.

47. It is important that there is confidence in the models that are proposed. Government will want to continue to work closely with the pensions industry to ensure DA models are of a good standard, as it has done recently in relation to incentive exercises where the Department worked closely with industry to develop a Code of Good Practice (published in June 2012) to address concerns, improve standards and increase confidence in future incentive exercises.

Employers

48. Given employers have the key role in choosing pension schemes for their employees, if DA pensions are to succeed it will be as important that they meet the needs of employers as they do of individuals. The needs of SMEs are a particular area of focus.

49. The Department is therefore exploring both consumer perspectives with the representative bodies involved in the Defined Ambition Co-ordination Group. As well as experts in product design this includes consumer bodies such as the Financial Services Consumer Panel, the TUC, and Which?

Next steps

50. The Department continues to work closely with industry and consumer bodies to develop possible models and designs for DA pensions. This includes assessing the implications for the regulatory and legislative systems in more detail. An early objective is to identify what might be possible without legislation and any early legislative enablers.

51. We will also be exploring the longer-term scope for amending the current regulatory framework to enable innovation in DA pensions and the scope to define a new appropriate regulatory framework for DA pensions that balances opportunities for risk-sharing with an appropriate level of consumer protection.

52. Our planning assumption at this stage is that an early outcome of this work is likely to be a publication outlining a framework for DA pensions, possibly jointly with industry. Any proposals for legislative or regulatory change will be subject to a formal impact assessment and consultation.

Increasing trust, confidence and engagement 4

Background

1. A clear theme throughout this strategy is the lack of engagement individuals have with pension saving. We know that, in part, this is due to insufficient trust and confidence in financial products generally[41], but pensions in particular can be seen as too complex and difficult.[42]

2. The Department published a literature review on trust and confidence in pensions in 2009[43] as part of the research into the introduction of automatic enrolment. The report highlighted the challenges for those seeking to influence individuals to make good decisions around pension saving:

> "The literature on pensions acknowledges potentially complex interactions between trust, knowledge and behaviour. Knowledge is needed to understand pensions and make decisions, but there is usually an information asymmetry between consumers and sellers, so individuals must depend on experts, which creates the need for trust. Risk and uncertainty are inherent in retirement planning and behaviour. Trust (usually affective) can serve to mitigate such risk but at the same time it is quite possible in some circumstances that knowledge, gained for example through information and communication campaigns, can, somewhat paradoxically, heighten perceived risks and require yet higher levels of (cognitive) trust."

41 Financial Services Authority, 2006, *Financial Capability in the UK: Establishing a Baseline.*

42 Thomas A, Jones J, Davies S and Chilvers D, 2009, *Individuals' attitudes and behaviours around planning and saving for later life*, DWP working paper 72.

43 Vickerstaff S, Macvarish J, Taylor-Gooby P, Loretto W and Harrison T, 2009, *Trust and confidence in pensions: a literature review*, DWP working paper 108.

3. In addition, we know that pension saving is further inhibited by the difficulty people have in focusing on their needs in the distant future rather than now. We also know that simply giving people information about retirement planning has little effect on actual behaviour. Too often, information about pensions does not capture people's attention.[44]

Automatic enrolment

4. As detailed above, the introduction of automatic enrolment recognises the systemic nature of these barriers and uses the power of inertia to encourage people to save. It has also provided us with an opportunity to look in detail about how people receive information and how to present this to encourage maximum clarity and reassurance.

5. Our research shows that it is still important in an automatic enrolment world that people understand what is happening and feel in control of the situation. Otherwise, people could feel confused or angry and opt out. Therefore communications and information remain important in a policy based on harnessing inertia.[45]

6. Of course, some desirable actions by pension savers, such as making decisions on decumulation, will require a positive choice by the individual and the provision of high quality information will have an important role to play in giving individuals the necessary confidence.

7. Automatic enrolment needs to be seen as a starting point. With its introduction we expect more people to engage in the need to save for retirement, to see the benefits of doing so in a workplace pension and, over time, for saving in a pension to become more of a social norm. Automatic enrolment will not by itself ensure improvement in confidence and engagement in pensions, but it provides a good base to build on.

Principles to aid engagement

8. To help ensure that automatic enrolment does lead to an increase in the proportion of employees who are engaged in their pension saving, we have established key principles for presenting pensions information to people who are thinking about pensions for the first time. Developed to support automatic enrolment, these principles can be applied throughout the pensions lifecycle. They also align well with a set of 'golden rules' developed by NEST[46] from DWP and NEST research to assist it in engaging successfully with its customers.

44 Bunt K and Barlow J, 2007, *Evaluation of Automatic State Pension Forecasts*, DWP research report 447.

45 Gray E, Harvey P and Lancaster J, 2008, *Why people may decide to remain in or opt out of personal accounts: Report of a qualitative study*, DWP research report 551.

46 www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/golden-rules-of-communication,PDF.pdf

Key principles for pension information

- Give people control – they must know they have a choice.
- Focus on the benefits to individuals, not on their responsibilities.
- Make it relevant now – engage with people as they are in their working lives.
- Give real examples to help people understand the context.
- Keep the presentation simple and let the facts speak for themselves.
- Build understanding of basic concepts but tailor the level of information to the individual.

9. In addition, attention to small details of presentation proved[47] to be essential when asking people to engage with pensions for the first time. A dense paragraph or an authoritarian-sounding word had the capacity to lose the attention of the reader quickly and consign pensions to the 'too difficult' category.

10. As many people are likely to change jobs several times during their lifetime (on average, an individual will work for 11 employers during their working life[48]), they may become members of many different pension schemes. As far as possible, the Department aims to ensure that consistent information is given by all pension schemes and that people are supported in taking personal responsibility for saving and planning for later life.

Small pots and transfers

Reinvigoration objective
Increasing the amount people receive for their savings

Reinvigoration objective
Increasing transparency and building trust, confidence and engagement in pension saving as the norm.

47 Department for Work and Pensions, 2011, *Automatic enrolment - information for workers, qualitative research*, DWP Communications Research Report 2. Department for Work and Pensions, 2012, *Automatic enrolment materials research*.
48 Johnson P, Yeandle D and Boulding A, 2010, *Making automatic enrolment work: a review for the Department for Work and Pensions*, Cm 7954, TSO.

11. This movement between jobs means that automatic enrolment will increase the number of small, dormant pots in the pension system, as pension pots will be created in successive employers' schemes. These small pots make it difficult for individuals to keep track of their pension saving and can be costly and inefficient to run. The Department estimates that, with the introduction of automatic enrolment, the number of dormant pots under £2,000[49] will increase to over 12 million by 2050.[50]

12. People easily lose track of older pension saving, and tracing past schemes takes time and effort and is not always successful. Furthermore, once older pension pots have been identified, the current voluntary transfer process can be time-consuming to operate. For these reasons, many people will not engage with their older pots and may end up with a lower income in retirement.

13. The Government has stated its intention to find a solution to address the small pots issue in order to help people engage with their savings, ensure they can build up substantive pots, and maximise their income in retirement. We also want to tackle market inefficiencies of administering multiple dormant small pension pots.

14. Following a consultation, which was met with overwhelming support for an automatic solution to the small pots issue (that is, one involving no or minimal action for the employee), we are pursuing a pot follows member model. This means that when a person changes employers his or her pension pot will be transferred to the new employer's scheme, unless he or she opts out. The Government has committed to working closely with stakeholders from all sides, including the joint industry and government Policy Engagement Group, in developing the policy to deliver a solution in this area. This work is currently underway.

Pensions lifecycle

15. Providing clear, understandable and useable information is vital to enable people to engage with pension saving – not just for automatic enrolment information, but across the pensions lifecycle, to encourage people to save persistently and, where appropriate, to contribute more.

16. A number of other organisations have come to similar conclusions with their research – that much more needs to be done to tailor information and communications to encourage engagement with pensions, or at least to make limited engagement more likely. The ABI[51] and the Actuarial Profession[52] have, for example, both concluded that the importance of a consistent and relevant customer journey for individuals that targets the right life stages and matches interventions and communication to them is an important step towards establishing and maintaining engagement and building trust and confidence.

49 In 2012 earnings terms
50 http://www.dwp.gov.uk/docs/small-pots-automatic-transfers-impact-assessment.pdf
51 Association of British Insurers, 2012, *Time to act: tackling our savings problems and building our future.*
52 The Actuarial Profession, 2011, *Transforming Consumer Information. Consumer Information Working Party.*

17. If a consensus can be reached on the key life stages within the pensions lifecycle, the Department has an important role to play in promoting action by the most appropriate stakeholders to engage with individuals at each one.

Targeting messages

Reinvigoration objective

Increasing transparency and building trust, confidence and engagement in pension saving as the norm.

We will examine working with HM Treasury, MAS and industry to map the pensions lifecycle to identify where appropriate interventions from various sources will assist in improving engagement, for example around life events. This work would consider options for targeting messages at particular life events, such as the thirtieth birthday. It would also examine the use of customer segmentation by pension providers to plan segment-specific messaging and engagement to improve outcomes, including opt-out rates and saving levels. This project should also assess which stakeholder, between government, employers and pension providers, is best placed to take the lead at particular life events.

Issues for further examination

- Are there any further examples of best practice from pension providers which DWP should assess as part of its work to identify the key moments for influencing individuals during their savings journey?

Activity underway to improve clarity and consistency

Improving disclosure of information to individuals

Reinvigoration objective

Increasing transparency and building trust, confidence and engagement in pension saving as the norm.

18. Legislation requires private pension schemes to disclose prescribed information to members and others (pension beneficiaries and trade unions, for example), and information is provided at various points of time, including:

- when members join the scheme;
- periodically (for example annual statements);

- following a request (some documents, for example annual reports, must be provided on request);
- approaching retirement (DC schemes issue a 'wake up' pack to alert members to the action that they need to take in order to access their pension savings at retirement);
- post-retirement (members who receive a pension directly from a scheme receive information about changes to the amount payable); and
- following a member's death (information is provided if survivors' benefits are payable).

19. The main requirements governing the disclosure of information are contained in two sets of regulations.[53] These requirements provide an enforceable disclosure regime which provides protection and clarity for members, as well as legal certainty on the information to be provided. After consulting, the Department agreed last year that a review of the existing legislation was appropriate to improve clarity for industry, under the banner of the Red Tape Challenge. We will be:

- consolidating the main disclosure of information requirements into one statutory instrument, streamlining them where possible to achieve consistency;
- simplifying terminology and removing overlaps with the FSA's Conduct of Business Sourcebook for personal pensions;
- reviewing the Statutory Money Purchase Illustrations' (SMPI) provisions in the context of the new pension landscape post-2012; and
- aligning other private pension legislation which contains a disclosure requirement with the provisions introduced in December 2010[54] which allow schemes to communicate with members electronically.

20. We are continuing with our plans to simplify and consolidate these regulations and aim to bring forward draft regulations for consultation early next year.

Best practice

Reinvigoration objective

Increasing transparency and building trust, confidence and engagement in pension saving as the norm.

53 These are: The Personal Pension Schemes (Disclosure of Information) Regulations 1987 (SI number 1987/1110); The Occupational Pension Schemes (Disclosure of Information) Regulations 1996 (SI number 1996/ 1655)

54 The Occupational, Personal and Stakeholder Pension Schemes (Disclosure of Information) (Amendment) Regulations 2010: (SI Number 2010/2659)

21. We encourage the pensions industry to adopt the information principles we have developed and to present information about pensions in a way that is clear and captures people's attention. As well as looking at language and presentation, we encourage the pensions industry to consider the communications channels that are best suited to different segments of pension savers.

22. For example, for many savers their annual benefit statement and SMPI may be more relevant, engaging and accessible if it were presented in a short, simple letter or email with signposting to further detail on a website. To this end we are considering bringing forward high-level best practice guidance developed in partnership with industry to help schemes produce communications that are clear, consistent and which meet the needs of members as well as meeting the requirements of the disclosure and SMPI regulations.

23. The Pensions Regulator's website provides guidance for trustees, schemes and employers on effective member communications.[55] This will also be a feature of the new draft Code of Practice for trust-based DC schemes. As the FSA is responsible for the regulation of personal pensions, rules and guidance for the disclosure of information by these schemes is included in its Conduct of Business Sourcebook.[56]

Clear and consistent language

Reinvigoration objective

Increasing transparency and building trust, confidence and engagement in pension saving as the norm.

24. The Department has developed and published a guide on language to help remove the barrier that technical and legalistic language can present to individuals' engagement with pensions.[57] This builds on the information principles developed following research to inform the development of automatic enrolment information for individuals.[58] It is also based on work undertaken by NEST, the Pensions Regulator, ABI, the Pensions Advisory Service and MAS. Feedback on the first version of the guide has been used to develop a second version[59] and we are looking to see how we can develop this further.

25. The Department aims to ensure that all of the pensions information it produces follows the language guide. It has also promoted the guide to other pension providers and industry stakeholders, and several are already using it. We call on the pensions industry to use the language guide to enable them to adopt a consistent approach to presenting information in plain English.

55 http://www.thepensionsregulator.gov.uk/guidance/guidance-member-communications.aspx
56 http://www.fsa.gov.uk/doing/regulated/newcob/disclosure
57 http://www.dwp.gov.uk/docs/auto-enrol-language-guide.pdf
58 Department for Work and Pensions, 2011, *Automatic enrolment - information for workers, qualitative research*, DWP Communications Research Report 2.
59 Department for Work and Pensions, 2012, *Automatic enrolment and pensions language guide version 2*.

Communications around automatic enrolment

26. The Department is undertaking a communications and information campaign about workplace pensions. This includes advertising, media partnerships, a suite of information and template letters for employers to use with their workers, information on the Government website (gov.uk), and a telephone information line. The aim is to raise awareness of the introduction of automatic enrolment into a workplace pension and of the benefits of pension saving. In doing so, we intend to bring individuals to the point of acceptance in advance of them being enrolled into workplace pension saving. This is being evaluated by a regular tracking survey to see if levels of awareness are increasing.

Proposals for future work with partners

Reinvigoration objective

Increasing transparency and building trust, confidence and engagement in pension saving as the norm.

27. The Department will continue to support the Pensions Regulator to guide employers to comply with their workplace pension duties. Where possible, it will be desirable to encourage a culture shift in employers to bring pensions into the mainstream of their communications with potential and existing employees. For example, employers should be encouraged to highlight their pension contributions when setting out employee benefits during the recruitment process and to present information confidently and prominently about their pension provision, in the main sections of their intranets, for example. The Department will play its part by continuing to encourage employers to mention their pension provision in vacancies displayed on Universal Jobmatch.

28. With the pensions industry, we will do further work to enhance the consistency and clarity of communications to individuals, encouraging industry to use consistent language (as supported by the language guide) and content (as required by the disclosure regulations). The information that schemes provide to their members on joining, in annual statements and at key points in their savings journey, has a vital role to play in engaging individuals with their pension savings.

29. DWP is working closely with MAS, the government body with responsibility for improving the British public's financial capability. DWP will take an active role in developing MAS's new financial capability strategy, to be delivered in March 2013, to help tackle the knowledge gaps which can inhibit individuals from saving into pensions. The Pensions Advisory Service will also play an important role in supporting individuals who are automatically enrolled and DWP is facilitating joint-working between our own information services and those provided by The Pensions Advisory Service and MAS. DWP will also support MAS in increasing its reach, including through contact channels with DWP customers.

30. The Government's Social Justice Strategy, led by DWP, is taking the lead on promoting financial inclusion and tackling over indebtedness. Increasing saving is an objective of this work. DWP is also working to increase the reach of affordable financial services, including bank accounts and saving products, by offering seed-corn funding to Credit Unions to modernise and expand their services. The Credit Union Expansion Project should bring more individuals with low financial confidence into formal financial products and therefore ultimately create a broader population who are sufficiently confident in financial products to begin saving. DWP is also developing budgeting support for claimants of the new benefit, Universal Credit, from October 2013. We have recently opened discussion with suppliers about the feasibility of new financial products with extra budgeting functions to support claimants.[60]

Further options and questions

31. There are a number of further options which we would like to explore. We would welcome the input of our partners to help shape this work.

Rules of thumb

Reinvigoration objective

Increasing transparency and building trust, confidence and engagement in pension saving as the norm.

In developing interventions through the pensions lifecycle we will consider the use of 'rules of thumb' for pension saving. Recent research highlights the role these can have in behaviour change.[61] We are exploring ways to design rules of thumb that are tailored to individuals with certain characteristics, at certain life-stages and with varying abilities to save. Any rules would also take into account automatic enrolment and the single-tier State Pension. Possible outcomes include rules of thumb to clarify the correlation between amounts saved and retirement incomes, rules based on experimental evidence on decision-making and general rules to promote saving to low-income individuals.

Issues for further examination

- Are there existing rules of thumb used to prompt individuals towards better saving behaviour which DWP should consider? Have any evaluation(s) of these been carried out?

60 http://www.dwp.gov.uk/newsroom/press-releases/2012/sep-2012/dwp102-12.shtml
61 Weyman A, Wainwright D, O'Hara R, Jones P and Buckingham A, 2012, *Extending working life: Behaviour change interventions.*

32. In developing the rules of thumb, we can examine what interventions might help individuals to understand the concept of retirement income, particularly to manage pension savers' expectations about how much income their pension pot will provide. This should include an assessment of the saving options beyond pensions, such as workplace ISAs.

Supporting employers and consumers with scheme choice

33. As was noted at the start of this chapter, people find pensions confusing. Levels of understanding of those brought into pension saving through automatic enrolment are likely to be low, not just for individual savers, but for many employers as well. This creates a risk that employers make decisions on scheme choice without having simple information which allows them to compare and contrast schemes and work out which is the best for them and their employees. Employers may also feel unable to choose a scheme without first talking to an intermediary. Equally, employees who are considering whether to stay enrolled in a new scheme, or whether to transfer in an existing pension pot, may feel unable to assess the scheme against others and place a relative value on the pension their employer offers.

34. We have put in place mechanisms to mitigate this risk by setting minimum scheme standards for automatic enrolment qualifying schemes as well as providing a simple, low-cost solution for employers in the form of NEST. Automatic enrolment has been designed so that regulated financial advice is not needed. However, we are keen to explore whether there is more we can do to help employers and individuals understand the features that schemes offer and make judgements about whether those are best suited to their requirements.

35. We recognise that it is not easy to objectively compare schemes and that industry standards, such as the NAPF quality mark, already exist. Additionally, in June 2012, the Pensions Regulator published a set of features on delivering good member outcomes at retirement, building on their six principles for good workplace DC schemes. They also published a list of questions employers can think about asking when selecting a pension product for automatic enrolment or reviewing the suitability of their existing scheme.

36. Nevertheless, if there is more we can do to allow simple comparisons between schemes, this could aid any decision-making by employers and employees and, over time, provide the encouragement to help raise scheme standards. We would like to examine possible mechanisms for achieving this, such as a rating or assessment system, and the practicalities of developing them.

Issues for further examination

- Are there mechanisms we can put in place to allow simple comparisons between schemes?

Further work

37. The reformed State Pension will be an essential building block in the calculation of their saving needs that individuals will need to face in future to arrive at an acceptable retirement income. As the reform takes shape, the Department will develop a clear narrative to communicate via its information channels and those of its partners. This will set out the rationale for the level of the future State Pension, but also make clear the limits of the lifestyle it will afford, and therefore the need for private saving. Universal Credit will provide particular opportunities to communicate this message to working age people on low incomes.

38. DWP will continue to liaise with the Department for Business, Innovation and Skills over the Consumer Empowerment Strategy, which allows individuals more access to and control over transaction data held by companies about them, to identify opportunities to promote greater engagement in pensions.

39. Each of government, employers and the pensions industry has a role to play in making pensions easier to understand. The Department will continue to support its partners to present essential information in the most effective ways and to develop and share an understanding of the critical moments in people's lives when communication about pensions will have the most impact.

Conclusion: A future pensions landscape

5

1. The issues set out in chapter 1 are some of the most fundamental problems facing our country today. The pension reforms we have begun to set in train to tackle them are critical steps forward. But this is really only the beginning. We are seeking to achieve a fundamental shift in the culture and attitude of working age people in this country towards savings and pensions. We recognise that this will take time – trust in pensions is low. However, as the number of people who are saving in a pension increases with the introduction of automatic enrolment, we can support this cultural shift by giving people confidence in the system into which they are saving.

2. This strategy represents the start of us doing just that. It seeks to outline the key issues across the pensions landscape that will impact on outcomes for savers and sets out the steps we need to take to build that confidence.

3. Individuals need to take responsibility for saving some of the money they currently earn for their retirement. We need employers to support them in this. The Government has put in place a system, in automatic enrolment, to make this as simple as possible and we will continue to examine ways to increase the amount people are saving to ensure they have the income they expect in retirement.

4. Those that remain in workplace pensions need to be confident that they are saving in quality schemes that provide them with value for money. We have therefore set out measures to ensure that schemes have appropriate charge levels and investment strategies. We are keen to ensure that regulation exists to protect consumers without overburdening schemes and employers with administrative costs. Our work on the future regulatory framework for pensions and ensuring appropriate governance structures should go some way towards achieving this.

5. We recognise that there will be a wide variety of engagement levels with pensions. The systems we have put in place through automatic enrolment do their utmost to ensure people make worthwhile savings with the minimum level of engagement. However, we may see engagement levels increase over time as more people begin to save and there remain points in the process, such as what people do with their pension pot on retirement, that require a greater degree of engagement. It is vital therefore that we make it as simple as possible for people to engage; that the information provided is understandable and accessible; and that pension providers and employers support savers to do so.

6. However, while engagement may increase, many of those saving through automatic enrolment will not be comfortable with the level of risk and uncertainty involved in saving in Defined Contribution pension schemes. Many of these schemes can offer good outcomes for savers, but we are keen to ensure that more certainty and risk-sharing can be offered, where possible. For that reason we are working closely with the industry to explore the scope for Defined Ambition schemes that share some of the risk and give people more confidence. By ensuring a good mix of schemes to suit a variety of needs, we can build a sustainable, effective pension system.

7. This strategy does not have all the answers to reinvigorate workplace pensions – clearly there is a lot of work to do to realise this aim. This strategy sets out a path and a vision for achieving that aim. By working with employers, savers and the pensions industry we can create the conditions for people to feel confident that their savings will give them the income they expect in retirement.

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