Defined contribution pension provision

Chris Dobson and Sarah Horsfield

A report of research carried out by Institute for PricewaterhouseCoopers LLP on behalf of the Department for Work and Pensions
Contents

Acknowledgements ........................................................................................................ v
The Authors ........................................................................................................... vi
Glossary of terms ................................................................................................... vii
Abbreviations ........................................................................................................ xv
Summary ................................................................................................................ 1

1 Project aims and research methodology ............................................................... 7
   1.1 Objectives of the report ............................................................................... 7
   1.2 Methodology .............................................................................................. 8
   1.3 Data limitations ....................................................................................... 8
   1.4 Structure of the report ............................................................................. 8

2 Introduction to defined contribution pensions ...................................................... 11
   2.1 Summary .................................................................................................. 11
   2.2 Introduction to private pensions .............................................................. 11
   2.3 Types of private pensions ...................................................................... 12
   2.4 Joining mechanisms for private pensions ............................................. 15
   2.5 Overview of private pension stakeholder environment ....................... 16
      2.5.1 Legal structure ............................................................................... 17
      2.5.2 Benefit type ..................................................................................... 18
      2.5.3 Facilitation ....................................................................................... 18
      2.5.4 Provider .......................................................................................... 18
      2.5.5 Legislators ..................................................................................... 18
2.5.6 Regulators .........................................................................19
2.5.7 Advisors ............................................................................19
2.5.8 Ombudsman services .........................................................19
2.5.9 Individuals .........................................................................19

3 Defined contribution membership – an overview of the current situation ...21
3.1 Summary .........................................................................................21
3.2 Introduction .....................................................................................22
3.3 Private pension scheme membership in Great Britain.................23
  3.3.1 Forty-two per cent of those aged between 20 and state pension age in Great Britain were members of a private pension scheme in 2005/06...............................................23
  3.3.2 Most individuals with private pension scheme membership in Great Britain have employer-sponsored membership......24
3.4 Employer-sponsored private pension scheme membership.............25
  3.4.1 Approximately half of all employees (13 million people) were members of an employer-sponsored pension scheme in 2008.................................................................26
  3.4.2 Almost all employer-sponsored DC pension scheme membership is found within the private sector ........27
  3.4.3 Most employer-sponsored DC membership is in contract-based rather than trust-based schemes ................29
  3.4.4 The majority of employer-sponsored stakeholder schemes have a small number of contributing employees........30
3.5 Membership segmentation analysis ..................................................30
  3.5.1 Employees working for smaller companies are less likely to be members of an employer-sponsored pension scheme .................................................................30
  3.5.2 Employees that are young and those aged over 60 are less likely to be members of an employer-sponsored pension scheme .................................................................32
  3.5.3 Females are as likely as males to be members of an employer-sponsored pension scheme but part-time workers have lower rates of membership ..................33
  3.5.4 Membership in employer-sponsored pension schemes also varies by industry .................................................................35
4 Defined contribution membership – trends over time ........................................39
  4.1 Summary ........................................................................................................39
  4.2 Introduction ....................................................................................................40
  4.3 Trends in private pension scheme membership in Great Britain .......... 40
    4.3.1 There was a slight decline in the proportion of the population aged between 20 and state pension age in Great Britain with some form of private pension scheme membership between 1999/00 and 2005/06 .....................40
    4.3.2 The self-employed saw a more significant decline in membership rates than employees ........................................41
  4.4 Trends in employer-sponsored private pension scheme membership .43
    4.4.1 Membership of occupational pension schemes is in decline, driven by the closure of DB pension schemes within the private sector .....................................................44
    4.4.2 Within the private sector, growth in DC contract-based scheme membership since the late 1990s has partly compensated for the decline in DB membership ..................45
    4.4.3 Employers see contract-based DC schemes as less costly and burdensome to run than DC occupational schemes ....47
    4.4.4 Most employers who do not currently provide pensions will enrol employees into the Personal Accounts scheme in 2012, rather than setting up their own scheme ............48
  4.5 Timeline of defined contribution events and trends ..............................48

5 Contributions to defined contribution pensions .................................................51
  5.1 Summary ........................................................................................................51
  5.2 Introduction ....................................................................................................52
  5.3 Aggregate contributions to private pension schemes .......................... 52
    5.3.1 Total contributions to private pension schemes have risen in real terms by 56 per cent since 1995 ..................................53
    5.3.2 The net cost to the Government of tax and National Insurance relief on pension contributions was equal to £18.6 billion in 2007/08 ..........................................................55
  5.4 Contribution rates to employer-sponsored pension schemes ............58
    5.4.1 Contribution rates to DC schemes are less than to DB schemes ..........................................................58
5.4.2 Employer contribution rates to DC schemes have increased at a faster rate than employee contribution rates in recent years ..........................................................60

5.4.3 There has been much commentary around the impact of the Pensions Act 2008 reforms on DC contribution rates...64

5.5 Design of contribution structures for employer - sponsored schemes ..........................................................................................65

5.5.1 Employers are increasingly using ‘matching’ to contribute to employee pension schemes...........................................65

5.5.2 ‘Salary sacrifice’ is an increasingly popular way of making contributions amongst employers.................................66

6 Defined contribution pension investments..................................................69

6.1 Summary .........................................................................................69

6.2 Introduction ....................................................................................70

6.3 Investment choice ............................................................................70

6.3.1 DC members now have a wide range of investment choices available to them ..................................................70

6.4 Use of default funds and life-styling....................................................73

6.4.1 Despite the wide range of investment choices available, the use of default funds tends to dominate.......................73

6.4.2 Most DC pension schemes use a life-style option as their default ..............................................................................75

7 Defined contribution pension charges ........................................................77

7.1 Summary .........................................................................................77

7.2 Introduction .....................................................................................77

7.3 Types of defined contribution charges..............................................78

7.3.1 Both explicit and implicit DC charges exist ...........................................78

7.4 Explicit charges ................................................................................78

7.4.1 The introduction of stakeholder pensions has led to significant reductions in charges for contract-based DC schemes..........................................................78

7.4.2 Charges for occupational schemes may be lower than for contract-based schemes .............................................79
7.5 Implicit charges ...........................................................................................................80
  7.5.1 Implicit DC pension charges vary by asset class and degree of active management...80
7.6 Impact of 2012 pension reforms on defined contribution charges ....80
  7.6.1 The Personal Accounts scheme is intended to be a low cost pension scheme available to all employers .................80
8 Defined contribution pension assets .............................................................................81
  8.1 Summary ....................................................................................................................81
  8.2 Introduction ..............................................................................................................82
  8.3 Aggregate defined contribution assets .................................................................82
    8.3.1 Aggregate assets in UK private pension schemes were worth approximately £1.9 trillion at 2007 .................82
    8.3.2 The recent financial downturn may have had a significant impact on DC asset values .....................................84
  8.4 Defined contribution assets with respect to broader household wealth .......................85
9 Decumulation in defined contribution ..........................................................................91
  9.1 Summary ....................................................................................................................91
  9.2 Introduction ..............................................................................................................92
  9.3 Decumulation choice ..............................................................................................92
    9.3.1 There is a wide range of different types of life-time annuities available and annuity pricing is becoming increasingly sophisticated ................................................92
    9.3.2 A wide range of income drawdown products is now available .........................................................95
  9.4 Use of the open market option ............................................................96
    9.4.1 Only a third of those purchasing an annuity do so on the open market .................................................96
  9.5 Size and segmentation of the annuities market ...................................................97
    9.5.1 The UK annuities market has increased in size by at least 50 per cent (in volume terms) since 2004 ..........97
    9.5.2 The majority of annuities are purchased with a fund size of less than £20,000 and by those aged under 65 ....98
    9.5.3 Falling long-term interest rates and increasing longevity have impacted on annuity rates ..................100
10 Financial capability, behaviour and attitudes of defined contribution pension members ..............................................................103

10.1 Summary ..............................................................................103

10.2 Introduction ...........................................................................104

10.3 Financial capability ...................................................................104

10.3.1 Many people have limited financial capability and understanding of pensions .........................................................104

10.4 Behaviour ...............................................................................106

10.4.1 Poor pension decision making can be explained by informational/attitudinal, structural and behavioural factors .................................................................106

10.5 Attitudes ...............................................................................108

10.5.1 The recent financial crisis may have made people more sceptical about pension saving ..............................................108

11 References ..............................................................................111

List of tables

Table 2.1 Simplified tax treatment of different methods of saving ..........12
Table 5.1 Pensions taxation and National Insurance relief, UK ....................57
Table 5.2 Number of members of UK private sector DC occupational pension schemes by structure of contributions, 2007 ................66
Table 5.3 Number of members of UK DC schemes by whether member contributions can be paid by a ‘salary sacrifice’ arrangement, 2007 .................................................................67
Table 8.1 UK household sector balance sheet, 2007..................................85

List of figures

Figure 1.1 The report structure follows the lifecycle of pension saving ..........9
Figure 2.1 Categories of private pension ..............................................14
Figure 2.2 Overview of main stakeholder roles in relation to private pensions ..................................................................................17
Figure 3.1 Membership in private pension schemes, population of Great Britain aged 20 to state pension age, 2005/06.................................24
Figure 3.2 Membership in private pension schemes for employees, self-employed and the economically inactive in Great Britain, 2005/06 ..................................................................................25
Figure 3.3 UK employee membership of employer-sponsored pension schemes, 2008 (all sectors) ..............................................................26
Figure 3.4 UK employee membership of employer-sponsored pension schemes, 2008 (public sector only) ..............................................27
Figure 3.5 UK employee membership of employer-sponsored pension schemes, 2008 (private sector only) ............................................28
Figure 3.6 UK employee membership of employer-sponsored DC pension schemes, 2008 (all employees with employer-sponsored DC scheme membership, private sector only) .............................................29
Figure 3.7 Proportion of employees who are members of an employer sponsored pension scheme, by size of organisation, 2007 (private sector only, Great Britain) ........................................................................31
Figure 3.8 UK employee membership of employer-sponsored pension schemes, by size of organisation, 2008 .............................................32
Figure 3.9 UK employee membership of employer-sponsored pension schemes, by age of employee, 2008 (all sectors) ...................................................33
Figure 3.10 UK employee membership of employer sponsored pension schemes, by gender of employee, 2008 (all sectors) ..................................................34
Figure 3.11 UK employee membership of employer-sponsored pension schemes, by full-time or part-time employee, 2008 (all sectors) ...........................................35
Figure 3.12 UK employee membership of employer-sponsored pension schemes, by industry, 2008 (all sectors) ..........................................................36
Figure 4.1 Membership of private pension schemes, population of Great Britain aged 20 to state pension age, 2005/06 ..................41
Figure 4.2 Membership of private pension schemes, employees in Great Britain aged 20 to state pension age, 1999/00 - 2005/06............42
Figure 4.3 Membership of private pension schemes, the self-employed in Great Britain aged 20 to state pension age, 1999/00 - 2005/06 ..43
Figure 4.4 Membership of occupational pension schemes, UK,1953-2007 ...........................................................................45
Figure 4.5 UK employee membership of employer-sponsored pension scheme, 1997-2008 (private sector only)....................................47
Figure 5.1 Aggregate contributions to UK private pension schemes by pension type, 1995 to 2007, real terms (public and private sector)........................................................................54
Figure 5.2 Aggregate contributions to UK private pension schemes with employer/individual split, 1995 to 2007, real terms (public and private sector)..........................................................55
Figure 5.3 Employer and employee contributions to UK DB, DC occupational and DC contract-based schemes as a percentage of salary, 2007 (private sector only) ..........................................................60
Figure 5.4 Employer contribution rates to UK DC schemes as a percentage of salary, 2000-2008 (private sector only)....................................62
Figure 5.5 Employee contribution rates to UK DC schemes as a percentage of salary, 1995-2007 (private sector only) .............................................63
Figure 6.1 Available investment choices, UK DC occupational pension scheme members, 2004 - 2007 .................................................................72
Figure 6.2 Members of UK DC occupational pension schemes by the number of funds into which a member may split their account, 2006-07 ................................................................. 73
Figure 6.3 Proportion of UK DC schemes with default funds, 2004-2008 ............................................................................. 74
Figure 6.4 Default funds used by UK DC schemes, 2008 ................. 75
Figure 8.1 Assets held in UK private pension schemes, 1988-2007, real terms (private sector and funded public sector schemes) ...... 84
Figure 8.2 Distribution of wealth amongst different types of assets for those aged 52 to 64 (mean values), 2002-03 ......................... 87
Figure 8.3 Distribution of wealth amongst different types of assets for those aged 52 to 56 and 60 to 64 (mean values), 2002-03 (more recent data not available) .................................................. 89
Figure 9.1 Breakdown of pension annuities sales in 2006 by type of product (percentage volumes/percentage values) .................. 95
Figure 9.2 Annuity sales by size of fund............................................. 98
Figure 9.3 Mean average fund size used to purchase an annuity, 2004-2008, nominal-terms ......................................................... 99
Figure 9.4 Annuity sales in 2007, by age and gender......................... 100

List of boxes
Box 2.1 The 2012 pension reforms and the Personal Accounts scheme.... 15
Box 3.1 What are the key differences between contract-based and occupational pensions from the member perspective? ............... 37
Acknowledgements

We would like to thank the Department for Work and Pensions (DWP) for initiating this review of defined contribution (DC) pension scheme provision.

We are grateful to Kevin Hughes and Donna Ward for providing guidance throughout the project and consolidating comments from others at DWP in a timely and helpful way. We also particularly thank Di Lewis who helped us to identify important data sources.

Emily Pinkerton and Milton Cartwright at the Financial Services Authority provided helpful comments on earlier drafts for which we are grateful.

We also thank colleagues at PricewaterhouseCoopers LLP (PwC) who brought their experience of pensions and research to the project. In particular, we would like to thank Alan Higham, John Lakin, David Brown, Dr Emiko Caerlewy-Smith and Richard Smith.
The Authors

Chris Dobson is a director in the PricewaterhouseCoopers LLP (PwC) Government and Public Sector practice. Prior to joining PwC, Chris worked for nine years in government, delivering a wide range of economics, research, policy and delivery work. He has held a number of senior roles in government including as a Senior Civil Servant in central government and two director posts in different Non-Departmental Public Bodies. He was also Head of the Secretariat to Lord Turner’s Pensions Commission. Chris has a BA Economics degree from Cambridge University, an MSc in Project Analysis, Finance and Investment and an MBA with Distinction.

Sarah Horsfield is a Consultant in the PwC Government and Public Sector practice. Sarah joined PwC in 2004 as an economist and has a broad range of experience in applying economics and analytical techniques across a range of issues and industries (both in the private and public sector). Sarah’s particular areas of expertise and interest include the economic appraisal and evaluation of government policy. Sarah has a BA Economics degree from Cambridge University and an MBA with Distinction.
## Glossary of terms

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Active member</td>
<td>A member who is currently accruing benefits into a pension scheme. This means that contributions (either by the employee/individual, employer or both) are currently being made to that scheme. Also known as a current member.</td>
</tr>
<tr>
<td>Annual management charge (AMC)</td>
<td>A charge levied annually by a pension provider on a member’s pension fund to cover the costs associated with providing that pension scheme. The charge is usually levied as a percentage of the total fund value.</td>
</tr>
<tr>
<td>Alternatively secured pension (ASP)</td>
<td>An investment which allows an individual reaching their 75th birthday to continue investing their pension savings while drawing an income from their fund at the same time. ASPs work in similar ways to unsecured pensions but have different limits and rules.</td>
</tr>
<tr>
<td>Annuity</td>
<td>An investment that converts a lump sum (for example a pension fund) into an income stream, usually guaranteed until the annuitant’s death.</td>
</tr>
<tr>
<td>Automatic enrolment</td>
<td>A pension scheme enrolment approach whereby an employer automatically enrols eligible employees into its pension scheme. Pure automatic enrolment is currently not available within the UK but from 2012 employers will have a duty to automatically enrol all eligible employees into a qualifying pension scheme and to make contributions on their behalf.</td>
</tr>
<tr>
<td><strong>Basic State Pension</strong></td>
<td>A non-earnings related pension paid by the State, based on the National Insurance contributions a person has paid, or been credited with, over the course of their working life.</td>
</tr>
<tr>
<td>------------------------</td>
<td>--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td><strong>Cash lump sum</strong></td>
<td>Individuals may take up to a quarter of their pension fund as a tax-free cash lump sum on retirement. The rest of the fund must be used to purchase an annuity before the age of 75.</td>
</tr>
<tr>
<td><strong>Contract-based pension scheme</strong></td>
<td>A defined contribution pension scheme purchased by an individual, either through their employer or individually, from a pension provider. It is owned entirely by the individual with the contract existing between the individual and the pension provider. It is also known as a personal pension.</td>
</tr>
<tr>
<td><strong>Contracting in</strong></td>
<td>By contracting in, an individual will contribute to the State Second Pension instead of transferring out those contributions to a private pension scheme (known as contracting out).</td>
</tr>
<tr>
<td><strong>Contracting out</strong></td>
<td>By contracting out, an individual, instead of building up entitlement to the State Second Pension, transfers those contributions out to a private pension scheme. The Pensions Act 2007 provides for the abolition of contracting-out for defined contribution (DC) pension schemes, although the act did not specify when the change will come into effect.</td>
</tr>
<tr>
<td><strong>Current member</strong></td>
<td>A member who is currently accruing benefits into a pension scheme. This means that contributions (either by the employee/individual, employer or both) are currently being made to that scheme. Also known as an active member.</td>
</tr>
<tr>
<td><strong>Decumulation</strong></td>
<td>The process of converting pension savings into retirement income.</td>
</tr>
</tbody>
</table>
### Deferred members
A member that no longer contributes to a pension scheme but retains rights to that scheme (for example, an individual who retains pension rights to a scheme held with a previous employer or holds a personal pension to which they no longer contribute).

### Defined benefit (DB) scheme
An occupational pension scheme that provides pension benefits related to the member's salary or some other value fixed in advance.

### Defined contribution (DC) scheme
A pension scheme that provides pension benefits based on the contributions invested, the returns received on that investment (minus any charges incurred) and the rate at which the final pension fund is annuitised.

### Employer-sponsored pension scheme
A private pension scheme where membership is facilitated through an employer.

### Equity release
A scheme that allows an individual to retain use of their home or other asset which has capital value while also obtaining a stream of income using the value of that asset.

### Group Personal Pension (GPP)
A form of employer-sponsored contract-based pension scheme. The employer facilitates access to the pension scheme but, as with all contract-based schemes, the legal contract existing is between the individual and pension provider.

### Group Stakeholder Pension (Group SHP)
Stakeholder pensions are a special type of contract-based pension which were introduced in April 2001 by the Government, and comply with regulations which limit charges and allow an individual flexibility with respect to their contributions. Employers with five or more employees are required to provide access to a Group SHP pension scheme unless they offer a suitable alternative pension scheme.

### Group Self-Invested Personal Pension (Group SIPP)
A specific type of employer-sponsored contract-based pension scheme where the member has greater freedom over what to invest in.
<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hybrid scheme</td>
<td>Pension schemes which combine elements of both DB and DC schemes.</td>
</tr>
<tr>
<td>Independent financial adviser</td>
<td>An individual or organisation that provides advice to its clients (companies or individuals) on the use of pensions and other financial products. All IFAs are regulated by the Financial Services Authority (FSA).</td>
</tr>
<tr>
<td>Income drawdown</td>
<td>A process whereby individuals, upon reaching retirement, can take a taxable income direct from their pension fund while keeping the remainder invested. Also known as pension fund withdrawal.</td>
</tr>
<tr>
<td>Indexed (escalating) annuity</td>
<td>An annuity which pays an increasing amount of income over time, thereby protecting the annuitant from inflation.</td>
</tr>
<tr>
<td>Investment-linked annuities</td>
<td>Investment-linked annuities link pension annuities to investments. With an investment-linked annuity retirement income is linked to the ups and downs of the underlying investment, rather than being pre-determined.</td>
</tr>
<tr>
<td>Joint-life annuity</td>
<td>An annuity which continues to pay an income to the spouse or partner of the annuitant should the annuitant die.</td>
</tr>
<tr>
<td>Level annuity</td>
<td>An annuity which pays the same amount of income for the rest of the annuitant's life and will therefore gradually decline in value in real terms due to inflation.</td>
</tr>
<tr>
<td>Life-style strategy</td>
<td>An investment strategy that automatically switches investment from more volatile assets into less volatile assets as the pension member approaches retirement. This can help to protect the member’s fund to a certain extent from sudden movements in the market – thereby stabilising the fund value with which members can buy an annuity and/or take a tax-free cash sum at retirement.</td>
</tr>
<tr>
<td>Life-time annuity</td>
<td>An annuity which provides the annuitant with an income stream for the rest of their life.</td>
</tr>
<tr>
<td><strong>Member/Membership</strong></td>
<td>A person who has joined a pension scheme, and is entitled to benefits under it, is a member of that scheme. Different types of membership exist and this report generally refers to ‘membership’ as a situation where the individual is a current (or active) member of the scheme and contributions (either by the employee/individual, employer or both) are currently being made to that scheme. Individuals may also, however, be deferred members of a scheme – retaining pension rights with a previous employer or holding personal pensions that no longer receive contributions. Finally, they may be pensioner members – currently receiving pension payments from the scheme.</td>
</tr>
<tr>
<td><strong>Money purchase schemes</strong></td>
<td>Alternative name for DC schemes – see definition above.</td>
</tr>
<tr>
<td><strong>Occupational pension scheme</strong></td>
<td>An employer-sponsored pension scheme provided through a trust. Benefits can be DC or DB.</td>
</tr>
<tr>
<td><strong>Open market option (OMO)</strong></td>
<td>The OMO means an annuitant is free to buy a pension annuity from any provider in the market.</td>
</tr>
<tr>
<td><strong>Pension fund withdrawal</strong></td>
<td>A process whereby individuals can take a taxable income direct from their pension fund while keeping the remainder invested. Also known as income drawdown.</td>
</tr>
<tr>
<td><strong>Pensioner member</strong></td>
<td>A member of a pension scheme who is currently receiving pension payments from that scheme.</td>
</tr>
<tr>
<td><strong>Pension fund</strong></td>
<td>The assets that form a pension scheme.</td>
</tr>
<tr>
<td><strong>Personal Accounts scheme</strong></td>
<td>As part of the 2012 workplace pension reforms, the Government plans to introduce a new low-cost, occupational pension scheme known as the Personal Accounts scheme.</td>
</tr>
<tr>
<td><strong>Pensions provider</strong></td>
<td>An organisation that designs, sets-up, administers and manages the funds of a pension scheme on behalf of members. In the case of employer-sponsored schemes, employers typically appoint a single provider to carry out both administrative and fund-management services (through a ‘bundled’ service) for contract-based schemes. For occupational schemes, trustees often appoint separate administrators and fund-managers to carry out these roles.</td>
</tr>
<tr>
<td>----------------------</td>
<td>-------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td><strong>Personal pension</strong></td>
<td>A contract-based pension scheme with the legal contract existing between the individual and the pension provider. Personal pensions can be provided as a part of an arrangement made for the employees of a particular employer (employer-sponsored DC contract-based scheme) or can be purchased by the individual (individual DC contract-based scheme).</td>
</tr>
<tr>
<td><strong>Private pension</strong></td>
<td>A pension that is not provided by the State.</td>
</tr>
<tr>
<td><strong>Retirement Annuity Contract (RAC)</strong></td>
<td>RACs are a type of pension plan that were introduced in 1956, aimed at the self-employed and those without access to pension schemes through their employment. Since 1st July 1988 with the introduction of personal pensions, no new RACs have been permitted to be issued.</td>
</tr>
<tr>
<td><strong>Salary sacrifice</strong></td>
<td>An agreement between the employer and employee whereby the employee forgoes part of their future earnings in return for a corresponding contribution by the employer to a pension scheme. Because of the lower salary payable, National Insurance contributions can be reduced for both employers and employees.</td>
</tr>
<tr>
<td><strong>Self-Invested Personal Pension (SIPP)</strong></td>
<td>A specific type of contract-based pension scheme where the member has greater freedom over what to invest in. SIPPs can be available for individuals to take out on their own, as well as through an employer in a group scheme (Group SIPP).</td>
</tr>
<tr>
<td>Term</td>
<td>Description</td>
</tr>
<tr>
<td>-------------------------------------</td>
<td>---------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Short-term annuity</td>
<td>An annuity which provides the annuitant with an income stream for up to five years.</td>
</tr>
<tr>
<td>Single-life annuity</td>
<td>A single-life annuity will only pay out income throughout the annuitant’s life (as opposed to a joint-life annuity which continues to pay an income to the spouse or partner should the annuitant die).</td>
</tr>
<tr>
<td>Stakeholder pension (SHP)</td>
<td>An SHP is a special type of contract-based pension which was introduced in 2001 by the Government and complies with regulations which limit charges and allows individuals flexibility around contributions. SHPs are available for an individual to take out on their own, as well as potentially through an employer in a group scheme (Group SHP).</td>
</tr>
<tr>
<td>State Earnings Related Pension</td>
<td>The SERPS from April 1978 until April 2002.</td>
</tr>
<tr>
<td>Scheme (SERPS)</td>
<td></td>
</tr>
<tr>
<td>State Second Pension</td>
<td>Replaced SERPS in April 2002.</td>
</tr>
<tr>
<td>Trivial commutation</td>
<td>Trivial commutation allows individuals with a modest pension fund to take the whole amount as a lump sum. There are a number of limits around the eligibility of trivial commutation including that the member must be over 60 but under 75 years of age and that all pension funds must be converted to cash within a 12-month period.</td>
</tr>
<tr>
<td>Trust-based pension</td>
<td>An employer-sponsored pension scheme with the scheme taking the form of a trust arrangement (alternatively known as an occupational pension scheme). Benefits can be either DC or DB.</td>
</tr>
<tr>
<td>Trustee</td>
<td>An individual or company appointed to hold assets for the beneficiaries of a trust-based pension scheme, in accordance with UK trust law.</td>
</tr>
<tr>
<td>Term</td>
<td>Definition</td>
</tr>
<tr>
<td>-----------------------------</td>
<td>-----------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Unit-linked investments</td>
<td>Unit-linked funds involve direct investment in units of an investment fund. Returns are linked to the funds invested in and members can often choose the types of funds depending on the level of risk and return sought.</td>
</tr>
<tr>
<td>Unsecured pension</td>
<td>An unsecured pension is an alternative to buying a life-time annuity and allows individuals to draw an income from their pension fund while the fund remains invested.</td>
</tr>
<tr>
<td>With-profits investments</td>
<td>A type of pooled investment fund run by insurance companies. Premiums for a with-profits policy are pooled with other with-profits policy holders and everyone in the fund shares the profits and losses.</td>
</tr>
<tr>
<td>Abbreviation</td>
<td>Description</td>
</tr>
<tr>
<td>--------------</td>
<td>-------------</td>
</tr>
<tr>
<td>ABI</td>
<td>Association of British Insurers</td>
</tr>
<tr>
<td>ACA</td>
<td>Association of Consulting Actuaries</td>
</tr>
<tr>
<td>AMC</td>
<td>Annual management charge</td>
</tr>
<tr>
<td>ASP</td>
<td>Alternatively Secured Pension</td>
</tr>
<tr>
<td>DB</td>
<td>Defined benefit</td>
</tr>
<tr>
<td>DC</td>
<td>Defined contribution</td>
</tr>
<tr>
<td>DWP</td>
<td>Department for Work and Pensions</td>
</tr>
<tr>
<td>ELSA</td>
<td>English Longitudinal Study of Ageing</td>
</tr>
<tr>
<td>EPP</td>
<td>Employers’ Pension Provision survey</td>
</tr>
<tr>
<td>GPP</td>
<td>Group Personal Pension</td>
</tr>
<tr>
<td>IFA</td>
<td>Independent financial adviser</td>
</tr>
<tr>
<td>ISA</td>
<td>Individual Savings Account</td>
</tr>
<tr>
<td>FOS</td>
<td>Financial Ombudsman Service</td>
</tr>
<tr>
<td>FRS</td>
<td>Family Resources Survey</td>
</tr>
<tr>
<td>FSA</td>
<td>Financial Services Authority</td>
</tr>
<tr>
<td>HMRC</td>
<td>Her Majesty’s Revenue &amp; Customs</td>
</tr>
<tr>
<td>NES</td>
<td>New Earnings Survey</td>
</tr>
<tr>
<td>OMO</td>
<td>Open market option</td>
</tr>
<tr>
<td>ONS</td>
<td>Office for National Statistics</td>
</tr>
<tr>
<td>OPSS</td>
<td>Occupational Pension Schemes Survey</td>
</tr>
<tr>
<td>Abbreviation</td>
<td>Description</td>
</tr>
<tr>
<td>--------------</td>
<td>----------------------------------</td>
</tr>
<tr>
<td>PADA</td>
<td>Personal Accounts Delivery Authority</td>
</tr>
<tr>
<td>PPF</td>
<td>Pension Protection Fund</td>
</tr>
<tr>
<td>PwC</td>
<td>PricewaterhouseCoopers LLP</td>
</tr>
<tr>
<td>RAC</td>
<td>Retirement Annuity Contracts</td>
</tr>
<tr>
<td>RPI</td>
<td>Retail Price Index</td>
</tr>
<tr>
<td>SERPS</td>
<td>State Earnings Related Pension Scheme</td>
</tr>
<tr>
<td>SIPP</td>
<td>Self-Invested Personal Pension</td>
</tr>
<tr>
<td>SHP</td>
<td>Stakeholder pension</td>
</tr>
<tr>
<td>WAS</td>
<td>Wealth and Assets Survey</td>
</tr>
</tbody>
</table>
Summary

The purpose of this report

A substantial amount is already known about defined contribution (DC) pensions from a variety of sources. However, this evidence previously existed in a variety of locations and had not been drawn together in one place. This made it difficult to systematically identify important trends and features of DC pensions and to draw out potential policy implications.

This report aims to provide a high-level overview of DC pension scheme provision by drawing together existing available evidence on DC pensions into one document.

The report takes an evidence-based approach. It focuses on presenting existing data and analysis in a systematic way, making judgements about the best sources to use where appropriate.

It was not within the remit of this study to undertake or present new analysis, to fill gaps in the available evidence, or to answer the questions that emerge from the exercise.

This report covers various aspects of DC pensions with a focus on the individual perspective. The following topic areas are examined:

- Background.
- DC membership.
- Contributions to DC pensions.
- DC pension investments.
- DC pension charges.
- DC pension assets.
- Decumulation in DC, and
- Financial capability, behaviour and attitudes of DC pension members.
Background

Private pensions are those pensions not provided by the State. There are two main categories of private pensions: DC and defined benefit (DB).

A DC pension scheme provides pension 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 accumulated is annuitised. In contrast, a DB scheme provides pension benefits which are based on the pension member’s salary or some other value fixed in advance.

There are two main legal types of DC pensions in the UK. In occupational pensions, the legal status of the pension is held under UK trust law and a board of trustees is responsible for ensuring that the pension scheme is run in members’ interests. In contract-based pensions, the legal contract is between the individual and the pension provider (often an insurance company).

Occupational pensions can be DB or DC. All contract-based pensions are DC.

Defined contribution membership

Forty-two per cent of those aged between 20 years and state pension age in Great Britain (13.7 million people) were members of a private pension scheme in 2005/06. Most individuals with private pension scheme membership have employer-sponsored membership (approximately 77 per cent of members in 2005/06).

Overall, around half of all employees (13 million people) were members of an employer-sponsored pension scheme in 2008. Within the public sector, 98 per cent of employer-sponsored membership was in DB pensions. In contrast, 62 per cent of employer-sponsored membership within the private sector was in DC schemes.

Within the private sector, membership in DB schemes is in long-term decline while membership in DC schemes is increasing. There is also a trend for contract-based schemes to replace occupational schemes. Employers tend to prefer contract-based pensions because they are typically less costly and burdensome to run.

1 ‘Membership’ in this report generally refers to a situation where the individual is a current (active) member of the scheme and contributions (either by the employee/individual, employer or both) are currently being made to the scheme.

2 Department for Work and Pensions (DWP), 2005/06, Family Resources Survey (FRS). FRS data for 06/07 and 07/08 are not available due to an underlying problem with the pension participation data.

3 DWP, 2005/06, FRS.

4 ONS, 2008, Annual Survey of Hours and Earnings (ASHE).

5 This was the view of providers and intermediaries according to recent qualitative research for the DWP into current practices in the workplace pension market. Wood, A., et al, July 2009, DWP Research Paper No. 591.
The introduction of automatic enrolment and the Personal Accounts scheme from 2012 is intended and expected to increase DC membership.

Contributions to defined contribution pensions

Upon joining a DC scheme, contributions can come from the individual/employee and/or the employer, in the case of employer-sponsored schemes. Total contributions to private pension schemes rose in real terms by 56 per cent between 1995 and 2007.6

While making comparisons between DC and DB contribution rates is complex due to the different characteristics of the two types of scheme, evidence suggests that typical contribution rates for DC schemes are considerably lower than for DB. According to the Occupational Pension Scheme Survey (OPSS), employer contributions rates at 2007 were 15.6 percent of salary for DB schemes compared with 6.5 per cent for DC occupational schemes. Employee contribution rates were 4.9 per cent of DB schemes compared with 2.7 per cent for DC occupational schemes.7

Employers are increasingly using ‘matching’ to contribute to employee pension schemes. This involves contributions made by employees being ‘matched’ by a corresponding employer contribution. Salary sacrifice arrangements are also increasingly popular. This involves an agreement between the employer and employee whereby the employee forgoes part of his or her earnings in return for a corresponding contribution by the employer to a pension scheme. Because of the lower salary payable, National Insurance contributions can be reduced for both employers and employees.

Defined contribution pension investments

Contributions into a DC scheme are invested in some way and members receive a return (either positive or negative) on this investment. Members of DC pension schemes are now typically offered a wide range of investment options.

Although not legally required to do so, 80 to 90 per cent of employers offer a default investment option for their Group Personal Pension scheme (GPP).8 Where a default fund is offered, the majority of scheme members invest in it (88 per cent of all plans with a default fund have more than 70 per cent of their members invested in that default).9 The majority of DC schemes offering a default option

---

6 ONS, 2009, Pension Trends.
8 This is according to pension providers and intermediaries whose views were examined as part of qualitative research into current practices in the workplace pension market recently conducted on behalf of DWP. Wood, A. et al, July 2009, DWP Research Paper No. 591.
9 ibid.
use a life-style strategy\textsuperscript{10} for that default (89 per cent in 2008).\textsuperscript{11}

In light of the current market environment, many schemes are considering revising their default investment choices (20 per cent of schemes according to the DC Sponsor Default Survey in 2009).\textsuperscript{12}

**Defined contribution pension charges**

Members typically incur charges for being part of a DC scheme. DC charges can be described as those costs that stand between the rate of return in the wholesale markets and the return which the individual pension member receives. Both implicit and explicit DC charges exist. Explicit charges are levied by the pension provider on members or overtly paid by the scheme trustee/administrator in an occupational scheme. Implicit charges are the costs of dealing incurred by fund managers which reduce total returns but which are not explicitly revealed to members.

Explicit charges are higher for contract-based schemes in comparison with occupational schemes.\textsuperscript{13} However, charges for contract-based schemes have fallen considerably since 2001 with the introduction of Stakeholder pension scheme (SHP) charging caps. Recent research found that typical Annual Management Charges (AMCs) levied on members of Group Personal Pensions (GPPs) and Group SHPs varied between 0.4 and one per cent.\textsuperscript{14} Implicit DC charges vary by asset class and are higher if active management is used.

The Personal Accounts scheme is being designed to be a low cost pension scheme and will be introduced in 2012 as part of the broader workplace pension reforms, alongside automatic enrolment. The Government has made clear its intention that the scheme be delivered with low charges for members.\textsuperscript{15}

\textsuperscript{10} A life-style strategy automatically switches investments from more volatile assets into less volatile assets as the member approaches retirement. This can help to protect the member’s fund to a certain extent from sudden movements in the market – thereby stabilising the fund value with which members can buy an annuity and/or take a tax-free cash sum at retirement.

\textsuperscript{11} National Association of Pensions Funds (NAPF), 2008, *Annual Survey*.

\textsuperscript{12} PensionDCisions in association with Incisive Media, 2009, *Default Investment Strategy Survey*. The survey covered 45 large UK plans, representing half a million DC members.


\textsuperscript{15} DWP, June 2007, *Personal accounts: a new way to save. Summary of responses to the consultation*. 
Defined contribution pension assets

Data available on aggregate DC pension scheme assets is extremely limited. High-level estimates indicate that aggregate assets in UK private pension schemes were worth approximately £1.9 trillion at 2007.\textsuperscript{16}

The recent financial downturn may have had a significant impact on DC asset values. Aon estimated that DC assets fell in value by a third (or £180 billion) between September 2007 and the end of February 2009 to £370 billion. Nevertheless, Aon found that DC assets started to recover in value from April 2009 and at the end of May 2009 were worth approximately £420 billion, an increase of ten per cent from the previous month.\textsuperscript{17}

For the average individual approaching retirement at 2002/03, the proportion of total net wealth in DC pensions (whilst likely high for a small number of individuals) was low, at approximately three per cent.\textsuperscript{18} Had the recent financial crisis taken place, instead, in ten years’ time its impact on DC retirees may have been significantly more damaging.\textsuperscript{19}

Decumulation in defined contribution

‘Decumulation’ refers to the process of converting the pension assets that a member has accumulated in their pension fund into a retirement income.

Developments in decumulation mean that DC members now face a wide range of options upon approaching retirement. Retirees can choose a life-time or short-term annuity which can be single or joint-life (i.e. providing benefits to a surviving spouse). Retirees can choose a guaranteed annuity that has a minimum guaranteed payment period, providing protection to dependents should the retiree die earlier than expected. Some retirees with a health problem or particular life-style can have access to an impaired annuity or enhanced annuity, which gives them a better annual income. Pension annuities can also be linked to investment – either unit-linked or with-profits. Retirees can also choose an income drawdown product.

Despite the range of products available, evidence suggests that most individuals still choose to purchase a single-life conventional life-time annuity. This may be partly due to the low average value of a DC pension fund, which can limit

\begin{itemize}
\item \textsuperscript{16} ABI, 2007, \textit{Money in funded pensions}.
\item \textsuperscript{17} Aon, 26th May 2009, Press release.
\item \textsuperscript{18} Here, wealth is defined broadly ranging from wealth held in financial assets to that held in less liquid assets such as owner-occupied housing. Banks, J. \textit{et al}, December 2008, FSA Consumer Research, \textit{Asset ownership, portfolios and retirement saving arrangements: past trends and prospects for the future}. More up-to-date data is unfortunately unavailable.
\item \textsuperscript{19} Watson Wyatt, February 2009, \textit{DC – reality bites: the impact of the financial crisis on DC pension provision}.
\end{itemize}
the availability and advantages of using more specialised pension products. The current market conditions may also be affecting people’s appetite for investing in these products which often have greater exposure to investment risk.

The open market option (OMO) means an annuitant is free to buy a pension annuity from any provider in the market. Nevertheless, evidence suggests that only a third of individuals purchasing their annuity do so on the open market.20

The number of annuities sold in the UK increased by 50 per cent between 2004 and 2008 – from approximately 310,000 to 450,000.21 The majority of annuities are purchased with a fund size of less than £20,000 and by those aged under 65.22

Financial capability, behaviour and attitudes of defined contribution pension members

Many people have low levels of financial capability and a poor understanding of pensions. Investment risk and decumulation appear to be areas that cause particular confusion.

Large numbers of people are not saving sufficiently for retirement and, when they do save, will often make poor decisions. This has been documented by the Pensions Commission and others.23 Poor saving decisions can be explained by the existence of so-called ‘barriers to saving’, further characterised as ‘information/attitudinal’, ‘structural’ and ‘behavioural’ barriers.24 As an example, ‘behavioural’ barriers include the tendencies for individuals to procrastinate when it comes to making decisions about their future and strongly discount the future.

Evidence suggests that confidence in pension products, and in saving more generally, has suffered in recent times. The number of people who said nothing would persuade them to increase pension saving was recently found to be at its highest level in more than three years.25

20 ABI, 2008, Research paper No. 8, Pension Annuities.
21 ABI research.
22 DWP calculations using ABI research data.
1 Project aims and research methodology

1.1 Objectives of the report

This report aims to provide a high-level overview of defined contribution (DC) pension scheme provision within the UK by drawing together existing available evidence on DC pensions into one document.

A substantial amount is already known about various aspects of DC pensions from a range of sources including internal Department for Work and Pensions (DWP) analysis and research, other central government departments and industry bodies/regulators and elsewhere. However, this evidence previously existed in a variety of locations and had not been drawn together in one place. This made it difficult to systematically identify important trends and features of DC pensions and to draw out potential policy implications. This document aims to draw together existing evidence and information on DC pensions in one document.

The report takes an evidence-based approach. It focuses on presenting existing data and analysis in a systematic way, making judgements about the best sources to use where appropriate. It was not within the remit of this study to undertake or present new analysis, to fill gaps in the available evidence, or to answer the questions that emerge from the exercise.

This report covers various aspects of DC pensions ranging from trends in membership and decumulation to member attitudes and behaviour. The focus of the work is on the individual perspective and main findings and trends emerging from the analysis are therefore drawn from this viewpoint. A key aim of this work has been to place DC pensions within the wider context of private pensions, including defined benefit (DB) pensions. Reference and comparisons are therefore made to DB schemes throughout the report.
1.2 Methodology

This report has sought to review the key sources of data and information relating to DC pensions and highlight the emerging trends. An evidence ‘fact-based’ approach has been taken to the work and a wide range of data/information sources have been reviewed. A comprehensive review of the literature and data available is not, however, within the scope of this work and has not been attempted. Sources of information reviewed include:

- Government data and statistics (including Office for National Statistics (ONS) data and a range of central government publications).
- Internal DWP analysis.
- Information from regulators, industry bodies and the private sector.
- Academic papers, and
- Conversations with the pensions industry – through the PricewaterhouseCoopers LLP (PwC) Pension Group.

1.3 Data limitations

In developing our key findings and conclusions, we have sought to draw on evidence from a range of sources – bearing in mind that not all data sources are always directly comparable, consistent or complete. Where major inconsistencies exist in the data, these have been highlighted. In cases where limited data is available on a particular issue, the review has sought to utilise the best sources of information available, bearing in mind that these sources may not always be 100 per cent robust or reliable.

1.4 Structure of the report

The report has been structured around the ‘life-cycle’ of a typical DC pension member – as illustrated in Figure 1.1, which provides a ‘roadmap’ for the report.

The body of the report begins with Chapter 2 which will provide an introduction to DC pensions, including an explanation of the main different types of DC pensions and how they differ to other types of pensions.

The first decision an individual faces when contemplating DC pensions is whether to join a DC scheme or not. Chapters 3 and 4 will examine DC membership, with Chapter 3 providing a current picture of DC membership across the UK and Chapter 4 focusing on trends in DC membership over time.

Upon joining a DC scheme, contributions are generally made into that scheme on behalf of the member – whether by the individual/employee or employer. Chapter 5 discusses contributions to DC schemes.
Contributions into a DC scheme are invested in some way and members receive a return (either positive or negative) on this investment. DC pension investments are discussed in Chapter 6.

Members typically incur charges for being part of a DC scheme, which reduces the total return they receive on their investments. These charges can be both explicit and implicit and are discussed in Chapter 7.

The assets that a DC pension member accumulates into their pension fund is a function of the contributions made into their scheme and the investment returns received on those contributions, minus any charges incurred. DC pension assets are discussed in Chapter 8.

Upon reaching retirement, DC pension members enter the ‘decumulation’ stage of the DC life-cycle. This is the process of converting the pension assets that a member has accumulated into a retirement income and is discussed in Chapter 9.

Finally, the financial capability, attitudes and behaviour of DC scheme members influence the outcomes that are observed across the DC life-cycle in this report. This is discussed in Chapter 10.

Figure 1.1 The report structure follows the lifecycle of pension saving

![Diagram of the life cycle of pension saving]

Source: PwC.
2 Introduction to defined contribution pensions

2.1 Summary

- Private pensions are those pensions that are not provided by the State.

- Private pensions are one way in which individuals can save for the future. Other methods of saving include use of savings products - for example, Individual Savings Accounts (ISAs) or direct investment in shares or property.

- Defined contribution (DC) pension schemes provide pension members with a pension based on the contributions invested, the returns received on that investment (minus any charges incurred) and the rate at which the final pension fund is annuitised.

- It is possible to categorise types of private pension in different ways – for example, by legal structure and benefit type.

- There are three main categories of DC pension schemes – DC occupational (trust-based), employer-sponsored DC contract-based and individually organised DC contract-based.

- A range of different government regulators and other stakeholders play a role in relation to private pensions.

2.2 Introduction to private pensions

Private pensions are those pensions that are not provided by the State. Investing in private pensions is one way in which individuals can save for their retirement. Other methods of saving include use of savings products – for example, ISAs or direct investment in shares or property.

---

26 Occupational pensions provided to public sector employees are included within the definition of private pensions.
There are different tax advantages to different forms of saving. Table 2.1 illustrates, for three forms of saving, where tax is payable at different stages in the life-cycle of the investment. Although a gross simplification, this can be a useful way of thinking about the tax implications of different savings instruments.

The 2009 budget marked a significant change to tax treatment of pensions. Since 1921, the Treasury had granted tax relief at a person’s highest marginal rate for any contributions made into a plan. However, from April 2011, tax relief on pension contributions for people earning more than £150,000 will be cut. This change may significantly reduce the incentives that earners in this income bracket have to save in private pensions.

Table 2.1 Simplified tax treatment of different methods of saving

<table>
<thead>
<tr>
<th>Method of saving</th>
<th>Contributions</th>
<th>Build-up</th>
<th>Decumulation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private pension</td>
<td>E</td>
<td>E</td>
<td>T</td>
</tr>
<tr>
<td>ISA</td>
<td>T</td>
<td>E</td>
<td>E</td>
</tr>
<tr>
<td>Non-tax advantaged savings</td>
<td>T</td>
<td>T</td>
<td>E</td>
</tr>
</tbody>
</table>

E = income tax exempt, T = income taxable

Source: PricewaterhouseCoopers LLP (PwC)

2.3 Types of private pensions

There are many different types of private pension. A raft of different terminologies describing private pensions has developed over the years, reflecting the complexity of the subject as well as the nature of legislation that surrounds it. This section aims to clarify what the main categories of private pension are, and to provide definitions for terms that will be used throughout the rest of the report.

It is possible to categorise private pensions in a number of different ways, as illustrated in Figure 2.1. The term ‘occupational’ is used to refer to employer-sponsored pensions provided through the legal form of a trust-based scheme. Employer-sponsored schemes can also, however, be contract-based, provided via a Group Personal Pension (GPP) scheme. Here, the legal contract is between the individual and the pension provider, but with the employer facilitating the process, bulk negotiating charges and, often, contributing. Individuals can also organise their own individual contract-based pensions, separately from their employment. It is important to note that there is no legal distinction between employer-sponsored and individually organised contract-based pensions – in both cases it is the individual that holds the legal contract with the pension provider.

Private pensions can also be categorised by the type of pension benefit which members are provided with. A defined benefit (DB) scheme provides pension

---

27 Relief on contributions will taper from 50 per cent for people earning £150,000 and above to the basic rate of 20 per cent for those with incomes of £180,000 or more. These rules come into effect alongside the new 50 per cent rate of income tax for those earning more than £150,000.
member benefits which are linked to the member’s salary or other value fixed in advance. A DC pension scheme provides pension 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 accumulated is annuitised (or other product bought). DC schemes can sometimes be referred to as Money Purchase schemes.

Hybrid schemes also exist and combine characteristics of both DB and DC schemes. There are many different types of hybrid pension schemes. With an underpin scheme, for example, contributions are invested on both a DB and DC basis with the member receiving benefits according to whichever calculation provides the better benefit. Cash balance schemes appear similar to traditional DC schemes, however, the benefits a member receives are less directly related to the returns achieved on the underlying investment, with some element of ‘smoothing’ occurring to reduce volatility.

Drawing on Figure 2.1, there are four main categories of private pension although, within each category, there are many further types of private pension. The first category is **DB occupational**. This relates to employer-funded pension schemes where the pension provided is related to salary or some other fixed value in advance. Examples include determining the pension according to final salary or some average of career salary and years worked. DB pensions are established and funded by the employer but provided via a trust, which is legally separate from the employer.

The remaining three categories relate to DC pension schemes and can be described as follows:

- **DC occupational (trust-based)**. These are employer-sponsored DC pension schemes provided via a trust.

- **DC contract-based (employer-sponsored)**. These are DC pensions where membership is facilitated through an employer but with the legal pension contract existing between the individual and the pension provider. Three particular types of employer-sponsored DC contract pensions are worth highlighting:
  - **Group Personal Pensions (GPPs)**. GPPs can be described as a simple form of employer-sponsored contract pension. The employer facilitates access to the pension scheme but, as with all contract-based schemes, the legal contract existing is between the individual and pension provider.
  - **Group Stakeholder Pensions (Group SHPs)**. Stakeholder pensions (SHPs) are a special type of contract-based pension which were introduced in 2001 by the Government, and comply with regulations which limit charges and allow individuals flexibility around contributions. Employers with five or more employees are required to provide access to a Group SHP pension scheme unless they offer a suitable alternative pension scheme.
– **Group Self-Invested Personal Pensions (Group SIPPs)** are a specific type of employer-sponsored contract pension where the member has much greater freedom over what to invest in. The member can have control over the investment strategy or can appoint a fund manager or stockbroker to manage the investments.

• **DC contract-based (individual).** These are DC pensions that an individual organises themselves, not through an employer, with the legal contract again existing between the individual and the pension provider. As well as ‘plain vanilla’ Personal Pensions, both SHPs and SIPPs are available for an individual to take out on their own, as well as potentially through an employer in a group scheme.

**Figure 2.1 Categories of private pension**

<table>
<thead>
<tr>
<th></th>
<th>DB occupational</th>
<th>DC occupational</th>
<th>DC contract-based (employer-sponsored)</th>
<th>DC contract-based (individual)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Legal structure</td>
<td>Occupational (trust-based)</td>
<td>Personal (contract-based)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Benefit type</td>
<td>Defined benefit</td>
<td>Defined contribution</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Facilitation</td>
<td>Employer sponsored</td>
<td>Not employer sponsored</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


From 2012, the Government plans to introduce a new low-cost pension scheme, currently referred to as the Personal Accounts scheme. The Personal Accounts scheme will be an Occupational (trust-based) multi-employer DC scheme. Box 2.1 provides more information.
Box 2.1  The 2012 pension reforms and the Personal Accounts scheme

The Pensions Act 2008 was introduced to take forward measures aimed at encouraging greater private pension saving.

From 2012, a new system will be introduced in stages under which employers will have a duty to automatically enrol all eligible workers into a qualifying workplace pension scheme and to make contributions on behalf of those that do not opt-out. Under this system, a minimum employer contribution of three per cent on a band of earnings will be required. The total minimum contribution for eligible workers should equal eight per cent of that band of earnings. This is made up of employer contributions, worker contributions and tax relief.

A new DC scheme - currently referred to as the Personal Accounts scheme - will be set up. This new scheme is designed to be low-cost and will ensure that all employers have access to a suitable qualifying pension arrangement in order to fulfil their new duties under the reforms. Unlike other pension providers who are not required to provide services to all employers who request them, the Personal Accounts scheme will be obliged to accept all those employers who choose to use it.

The Personal Accounts scheme will be an Occupational (trust-based) DC scheme. A trustee will be responsible for holding assets for the scheme beneficiaries and ensuring that the scheme is run in their interests.

2.4 Joining mechanisms for private pensions

While individually organised pensions are subject to voluntary ‘opt-in’ enrolment (i.e. the individual must actively choose whether to join the pension scheme or not) other mechanisms for pension enrolment can exist for employer-sponsored schemes. These are discussed briefly below:

- Traditional ‘opt-in’ enrolment – this is an arrangement in which the default option is for employees to not be enrolled in their employer’s pension scheme. Employees do, however, have the option of enrolling if they so wish.

- Automatic enrolment – this is a situation in which employees are automatically enrolled into an employers’ pension scheme upon starting employment with that employer. Employees do, however, have the ability to opt-out. Pure automatic enrolment is currently not available in contract-based schemes but will be from 2012. ‘Streamlined joining’ is currently available for contract-based schemes. Although technically an ‘opt-in’ method of enrolment, this method of enrolment greatly reduces the effort required of employees to join the employer-sponsored scheme (compared to some other forms of ‘opt-in’ enrolment, for example requiring application forms).
• Compulsory enrolment – this occurs when employees must be a member of their employers’ pension scheme to fulfil their conditions of employment. Until 1986, when the Social Security Act was passed, employers had the option to make membership of their occupational pension scheme compulsory, but this is no longer allowed.

Perhaps in anticipation of the 2012 reforms, employers appear to be moving towards more automatic methods of enrolment. In their 2006 DC survey, Watson Wyatt report that employers are increasingly using streamlined enrolment methods as opposed to those which require use of application forms.28

2.5 Overview of private pension stakeholder environment

A number of different government regulators and other stakeholders play a role in relation to private pensions, as illustrated in Figure 2.2. Further description is provided in the text ahead.

---

### Figure 2.2 Overview of main stakeholder roles in relation to private pensions

<table>
<thead>
<tr>
<th></th>
<th>DB occupational</th>
<th>DC occupational</th>
<th>DC contract-based (employer-sponsored)</th>
<th>DC contract-based (individual)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Legal structure</strong></td>
<td>Occupational (trust-based)</td>
<td>Personal (contract-based)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Benefit type</strong></td>
<td>Defined benefit</td>
<td>Defined contribution</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Facilitation</strong></td>
<td>Employer sponsored</td>
<td>Not employer sponsored</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Provider</strong></td>
<td>Provider or Administrator/Fund-manager</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Legislators</strong></td>
<td>Department for Work and Pensions (DWP)</td>
<td>HM Revenue &amp; Customs (HMRC)</td>
<td>HM Treasury</td>
<td>Financial Services Authority (FSA)</td>
</tr>
<tr>
<td><strong>Regulators</strong></td>
<td>The Pension Regulator</td>
<td>HMRC</td>
<td>FSA</td>
<td></td>
</tr>
<tr>
<td><strong>Advisors</strong></td>
<td>The Pensions Advisory Service</td>
<td>Independent financial advisors</td>
<td>FSA Money Made Clear</td>
<td></td>
</tr>
<tr>
<td><strong>Ombudsman services</strong></td>
<td>Financial Ombudsman Service (FOS)</td>
<td>Pensions Ombudsman</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Individuals</strong></td>
<td>Individual</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Source: PwC.*

### 2.5.1 Legal structure

In occupational pensions, the legal status of the pension sits under UK trust law and there is a board of trustees who are responsible for holding assets for the scheme beneficiaries and ensuring that the scheme is run in members' interests.
In contract-based pensions, the legal contract is between the individual and the pension provider and there is no entity recognised in law or regulation that acts solely on the members’ behalf (although providers must meet Financial Services Authority (FSA) regulatory requirements relating to, for example, ‘treating customers fairly’). There is no legal distinction between employer-sponsored and individually organised contract-based pensions.

2.5.2 Benefit type
In a DB scheme, the pension is related to the member’s final salary or some other valued fixed in advance. In a DC scheme, the pension the member receives is based on the contributions invested, the returns received on that investment (minus any charges incurred) and the rate at which the final pension fund accumulated is annuitised.

2.5.3 Facilitation
Private pensions can be employer-sponsored or they can be organised by the individual. In trust-based schemes, the employer is responsible for appointing trustees who are required to run the scheme in the interests of members. In contract-based schemes, employers are responsible for selecting the group pension provider and determining the contract to be offered to the employee. In these cases, the employer is also responsible in an administrative capacity for collecting employee contributions via payroll deduction. Some employers play a more active role than others beyond this in facilitating the pension provision process.

2.5.4 Provider
Pension providers design, set-up, administer and manage the funds of a pension scheme on behalf of members. In the case of employer-sponsored schemes, employers typically appoint a single provider to carry out both administrative and fund-management services (through a ‘bundled’ service) for contract-based schemes. For occupational schemes, trustees often appoint separate administrators and fund-managers to carry out these roles. Providers sometimes outsource elements of their offering, and it is becoming more common for them to offer funds managed by other institutions.

2.5.5 Legislators
The Department for Work and Pensions (DWP) sets the overall legislative framework for pensions. The FSA has responsibility for regulating the financial services industry. HM Treasury are responsible for tax policy and, in this respect, legislate across all types of pensions. HM Revenue & Customs (HMRC) also has a legislative role to play through its responsibility for collecting, administering and paying taxes and benefits in relation to pensions.


The FSA is an independent non-governmental body, given statutory powers by the Financial Services and Markets Act.
2.5.6  Regulators
The Pensions Regulator is the UK regulator of work-based (employer-sponsored) pension schemes. The FSA regulates the providers and sellers of all contract-based pensions. HMRC and DWP also have roles to play in setting and monitoring regulations to support their policy and legislative roles in relation to pensions.

2.5.7  Advisors
The Pensions Advisory Service is an independent voluntary organisation, grant-aided by DWP. It provides information and guidance to members of the public on both state and private pension schemes. Independent financial advisors (IFAs) are a common source of advice for people planning retirement and for employers who are seeking advice on the most appropriate choice of pension provider or scheme for their employees. Employee Benefits Consultants also advise employers. The FSA Money Made Clear service aims to provide independent and user-friendly advice to consumers on a wide range of financial services and products.31

2.5.8  Ombudsman services
The Pensions Ombudsman investigates and settles pension complaints between members of pension schemes or their beneficiaries, employers, trustees, managers and scheme administrators. The Financial Ombudsman Service (FOS) investigates and settles individual complaints between consumers and businesses providing financial services. The FOS examines complaints made with reference to most financial markets including personal pensions, although complaints regarding occupational pension schemes would generally be referred to the Pensions Ombudsman.

2.5.9  Individuals
In contract-based pensions, the individual holds a legal contract with the pension provider and, should the individual cease employment with their current employer, has the option of maintaining active membership and continuing to receive contributions to it (either from themselves, or future employers, possibly). In trust-based pension schemes, individuals are scheme members and, should their employment cease with their current employer, their membership will become deferred – allowing them to retain rights to the pension fund accrued but not to continue to receive contributions to it.

This chapter has provided a brief summary of the different types of private pension schemes and a description of the main stakeholders involved in the private pension environment. Chapters 3 and 4 will now discuss private pension scheme membership, with a focus on DC membership. Chapter 3 will provide an overview of the current membership situation while Chapter 4 will discuss trends over time.

31  http://www.moneymadeclear.fsa.gov.uk
3 Defined contribution membership – an overview of the current situation

3.1 Summary

- Forty-two per cent of those aged between 20 years and state pension age in Great Britain (13.7 million people) were members of a private pension scheme in 2005/06.³²
- Most individuals with private pension scheme membership in Great Britain have employer-sponsored membership (approximately 77 per cent of members in 2005/06).³³
- Overall, around half of all employees were members of an employer-sponsored pension scheme in 2008. The majority of public sector employees are members of an employer-sponsored scheme (80 per cent of employees or 5.5 million employees in 2008) while the minority of private sector employees are members (35 per cent of employees or 6.1 million employees in 2008).³⁴
- Most employer-sponsored membership within the public sector is in defined benefit (DB) schemes (98 per cent of employee membership in 2008) while most employer-sponsored membership within the private sector is in defined contribution (DC) schemes (62 per cent of employee membership in 2008).³⁵

³² Department for Work and Pensions (DWP), 2005/06, *Family Resources Survey (FRS)*.
³³ DWP, 2005/06, *FRS*.
³⁴ ONS, 2008, *ASHE*.
³⁵ *ibid.*
• Most employer-sponsored DC membership is in contract-based schemes (60 per cent of employee membership within the private sector in 2008) rather than trust-based schemes (40 per cent of employee membership in 2008).  

• The majority of employer-sponsored Stakeholder schemes have a small number of contributing employees.  

• Employees working for smaller companies, those working part-time, the young and those aged over 60 are far less likely to be members of an employer-sponsored pension scheme.  

• The extent and type of employer-sponsored pension scheme membership varies significantly by industry.  

3.2 Introduction

This chapter gives an overview of private pension scheme membership, focusing on DC membership.

An individual may be a member of a number of different pension schemes simultaneously. They may be a current (or active) member of a pension scheme facilitated through their employer which, in turn, could be an occupational (trust-based) or a personal (contract-based) scheme. They may also have a personal pension which they have organised independently of any employment (as may the self-employed and others not in employment). Individuals may also be deferred members of a scheme, retaining pension rights with a previous employer, or holding personal pensions that no longer receive contributions. Finally, individuals may be pensioner members, retired and currently receiving pension payments from the scheme to which they belong.

It is not possible to find data sources that provide comprehensive and reliable estimates of the total number of individuals with different types of pension membership. It is possible, nevertheless, to draw on the range of data sources that do exist to highlight some key messages.

Private pension ‘membership’ in this report generally refers to a situation where the individual is a current (active) member of the scheme and contributions (either by the employee/individual, employer or both) are currently being made to the scheme. This is not always the case, however, and data coverage varies by the specific source in question. Further information on the specific sources utilised is provided throughout the chapter.

This chapter is divided into three sections:

36 ibid.
37 DWP, 2007, EPP Survey.
38 ONS, 2008, ASHE.
39 ibid.
• Section 3.3 looks at proportions of the population in Great Britain as a whole that belong to private pension schemes.\textsuperscript{40}

• Section 3.4 focuses on membership of employer-sponsored (UK) pension schemes, which is the most common form of private pension membership. Differences in membership between the public and private sector are discussed here.

• Section 3.5 provides some segmentation analysis – looking at how private pension scheme membership varies by age, industry, gender, size of employer and type of employment (full-time or part-time) within the UK.

3.3 Private pension scheme membership in Great Britain

This section provides estimates of the proportions of the population within Great Britain aged between 20 and state pension age that belong to different types of private pension schemes. The data derives from the DWP FRS, which collects information on the incomes and circumstances of private households. Respondents to the survey are asked about their membership in different types of private pension schemes.\textsuperscript{41} The data does not provide a breakdown between DC and DB scheme membership.

3.3.1 Forty-two per cent of those aged between 20 and state pension age in Great Britain were members of a private pension scheme in 2005/06\textsuperscript{42}

Figure 3.1 illustrates private pension scheme membership for those aged between 20 and state pension age in Great Britain at 2005/06\textsuperscript{43}. Forty-two per cent of the population were members of a private pension scheme in 2005/06 (13.7 million people). The majority of members belonged to an employer-sponsored pension scheme (32 per cent of the population). Ten per cent of the working age population were members of an individual pension scheme and one per cent were members of both an employer-sponsored and individual scheme.\textsuperscript{44}

\textsuperscript{40} For women, therefore, coverage is between the ages of 20 and 60. For men, coverage is between the ages of 20 and 65.

\textsuperscript{41} The FRS survey aims to capture ‘active’ membership of private pension schemes, which occurs when contributions (either by the employee/individual, employer or both) are currently being made to the scheme(s).

\textsuperscript{42} DWP, 2005/06, FRS.

\textsuperscript{43} FRS data for 06/07 and 07/08 are not available due to an underlying problem with the pension participation data.

\textsuperscript{44} Some Group Personal Pension (GPP) and Group Stakeholder (GSHP) scheme membership, although by definition ‘employer-sponsored’, may be counted as ‘individual’ pension scheme membership in the data presented. This is due to possible inconsistencies with the FRS survey data.
Figure 3.1 Membership in private pension schemes, population of Great Britain aged 20 to state pension age, 2005/06

Source: DWP, 2005/06, FRS.

3.3.2 Most individuals with private pension scheme membership in Great Britain have employer-sponsored membership

Figure 3.2 disaggregates the same data for different strata of the population – employees, the self-employed and the economically inactive. As illustrated, employees had the highest rate of private pension membership at 2005/06 with 56 per cent of employees being members of a private pension scheme compared with 34 per cent of the self-employed and three per cent of the economically inactive.

Most private pension scheme membership in Great Britain is employer-sponsored. Seventy-seven per cent of individuals with private pension scheme membership in 2005/06 were part of a pension scheme facilitated through their employer.\(^45\)

Self-employed membership in pension schemes is, generally, in individually organised schemes. There are, however, cases of employer-sponsored schemes existing for the self-employed.\(^46\)

---

\(^{45}\) DWP, 2005/06, FRS.

\(^{46}\) For example, doctors and dentists in General Practice who are often self-employed individuals with access to an employer-sponsored pension.
3.4 Employer-sponsored private pension scheme membership

This section provides additional information on employer-sponsored pension scheme membership, which is the most common form of private pension membership. As distinct from the previous section, it provides a breakdown between membership in DC and DB schemes, drawing on a range of sources.

This section refers to individuals who are members of a pension scheme provided by their current employer and therefore excludes all those individuals who belong to pension schemes that have no connection with their current employer. This includes the self-employed, those who are members of a pension scheme provided by a previous employer and those who are members of a pension scheme organised individually. The data also excludes those individuals who may be eligible to join their employer-sponsored scheme but choose not to do so.

Source: DWP, 2005/06, FRS.
3.4.1 Approximately half of all employees (13 million people) were members of an employer-sponsored pension scheme in 2008\(^{47}\)

The Annual Survey of Hours and Earnings (ASHE) provides information on employee membership of employer-sponsored pension schemes. Figure 3.3 shows membership of employer-sponsored schemes for the UK’s 26.2 million employees at 2008.\(^{48}\)

According to ASHE, approximately 49 per cent of employees (13 million employees) were members of an employer-sponsored scheme at 2008, 49 per cent of employees were not members and, for two per cent of employees, it was not known whether the employee was a member. Of those employees that were members, approximately a third were members of a DC scheme (16 per cent of total employees) and approximately two-thirds were members of a DB scheme (33 per cent of total employees).

**Figure 3.3 UK employee membership of employer-sponsored pension schemes, 2008 (all sectors)**

Source: Office for National Statistics (ONS), 2008, Annual Survey of Hours and Earnings (ASHE).

\(^{47}\) ONS, ASHE, 2008. Note that ASHE and FRS data are not entirely consistent.  
\(^{48}\) ASHE is a survey of employers about their employees. As part of the ASHE survey, employers are asked to indicate whether each of their employees is a ‘member’ of a pension scheme facilitated by their organisation and, if so, what is the main type of pension scheme that they are a member of. Confirmation of ‘membership’ does not imply that contributions (by either the employer, employee or both) are occurring although, according to ASHE, this is generally the case – i.e. in most cases where employers confirm membership of a pension scheme contributions are being made to that scheme. Data is counted on a job basis. To the extent that an individual may have more than one job, individual employees may appear more than once in the data and thus be ‘double counted’.
3.4.2 Almost all employer-sponsored DC pension scheme membership is found within the private sector

There are considerable differences in private pension membership between the public and private sector. While the majority of public sector employees are members of an employer-sponsored pension scheme, most private sector employees are not members of an employer-sponsored scheme. Within the public sector, those that have employer-sponsored scheme membership are almost all members of a DB scheme, while, within the private sector, the majority are members of a DC scheme. These stark differences in pension membership between the private and public sector are attracting increasing attention from the media and others.

Figure 3.4 shows membership of employer-sponsored pension schemes for the 6.8 million employees within the public sector at 2008, according to ASHE.\textsuperscript{49} Eighty per cent of public sector employees were members of an employer-sponsored pension scheme (5.5 million employees) in 2008. Ninety-eight per cent of these were members of a DB scheme and only two per cent of public sector employees in total were members of a DC scheme.\textsuperscript{50}

Figure 3.4 UK employee membership of employer-sponsored pension schemes, 2008 (public sector only)

Source: ONS, 2008, ASHE.

\textsuperscript{49} Number of employees in public sector represented in Figure 3.4 and number of employees in private sector represented in Figure 3.5 do not sum to figures represented in Figure 3.3, since the latter includes ‘unclassified’ organisations, which are organisations that have not been categorised as belonging to one of either sector (for example, third sector organisations).

\textsuperscript{50} This figure may even appear high to some. However, many jobs with pension provision within the public sector only offer DC provision. For example, fixed-term contract workers are typically only entitled to DC pensions and are not offered DB membership.
Figure 3.5 shows membership of employer-sponsored pension schemes for the 17.4 million employees within the private sector at 2008. As illustrated, 35 per cent of employees had employer-sponsored membership at 2008 (6.1 million employees), 63 per cent of employees had no membership and, for two per cent of employees, it was not known whether the employee was a member. Of those employees that did have pension membership, DC scheme membership was the most common form, accounting for 62 per cent of employee membership. DB scheme membership accounted for just 14 per cent of private sector employees.

**Figure 3.5  UK employee membership of employer-sponsored pension schemes, 2008 (private sector only)**

Source: ONS, 2008, ASHE.

---

51 Number of employees in public sector represented in Figure 3.4 and number of employees in private sector represented in Figure 3.5 do not sum to figures represented in Figure 3.3, since the latter includes ‘unclassified’ organisations, which are organisations that have not been categorised as belonging to one of either sector (for example, third sector organisations).

52 Figures presented may differ to those illustrated in Figure 3.4 due to rounding.

53 It should be noted that there are other sources of information on private sector employer-sponsored pension scheme membership. The Employers’ Pension Provision (EPP) survey, published by DWP most recently in 2007, is an example. The EPP data presents a similar story here with the majority of employees having no membership of an employer-sponsored scheme (69 per cent) at 2007. Where membership exists, the most common type of scheme is similarly DC (18 per cent of employees). The EPP survey finds that nine per cent of employees have employer-sponsored DB membership and four per cent of employees are members of an employer-sponsored hybrid scheme. While the EPP survey is designed to be broadly representative of employers, the ASHE survey has a larger sample and is designed to be representative of employees. Because this report is primarily concerned with the individual perspective, the ASHE survey has been selected as the preferred data source here.
3.4.3 Most employer-sponsored DC membership is in contract-based rather than trust-based schemes

For those with employer-sponsored DC pension schemes, membership in DC contract-based schemes is more common than in DC occupational schemes. Focusing in on the private sector, where the vast majority of DC pensions lie, Figure 3.6 shows, for those employees that have employer-sponsored DC pension scheme membership, how that membership breaks down between different types of DC schemes according to ASHE at 2008.

Data on membership in DC occupational, GPP and Stakeholder pension (SHP) schemes is presented. As illustrated, membership in contract-based schemes was more common than membership in occupational schemes at 2008. While occupational schemes constituted 40 per cent of total DC membership, contract-based schemes constituted 60 per cent of membership. Of contract-based scheme membership, the data illustrates that GPP scheme membership was more common than SHP scheme membership – 37 per cent of total DC membership was in GPP schemes while 23 per cent was in SHP schemes. It should be noted that other data sources present slightly different messages here.54

Figure 3.6 UK employee membership of employer-sponsored DC pension schemes, 2008 (all employees with employer-sponsored DC scheme membership, private sector only)

As previously, there are other sources for information on private sector employer-sponsored pension scheme membership. The EPP 2007 survey presents smaller estimates for the proportion of employer-sponsored DC membership which is in occupational schemes (at 17 per cent compared to the figure of 40 per cent presented by the ASHE data above). The EPP survey estimates that 44 per cent of employer-sponsored DC membership was in GPP schemes, 28 per cent was in SHP schemes and 11 per cent was in schemes where employers contributed to personal pensions organised by the individual.
3.4.4 The majority of employer-sponsored stakeholder schemes have a small number of contributing employees

Employers with five or more employees are legally required to offer their employees access to a SHP where they do not provide any other form of pension arrangement. SHPs comply with regulations which limit charges and allow individuals flexibility around contributions and were introduced in 2001 by the Government as an effort to encourage more long-term saving.

However, the majority of members of SHP schemes do not contribute to the pension schemes available to them.55 The 2007 DWP Employers’ Pension Provision EPP survey found that smaller firms were more likely to have schemes with no actively contributing members. However, even in the largest firms (with more than 1,000 employees), 54 per cent of firms reported that less than 20 employees were contributing to the SHP scheme.56 This may be because employers obliged to provide these schemes are not obliged to make contributions to them. In 2004, the Pensions Commission reported that there was little evidence of a net increase in ongoing pension contributions flowing into personal pensions as a result of the introduction of SHPs.57

3.5 Membership segmentation analysis

The following section provides some segmentation analysis – looking at how private pension scheme membership varies by age, gender, industry, size of employer and type of employment (full-time or part-time). The data presented here refers to employer-sponsored pension schemes, which are the most common type of private pension scheme, and for which most data is available.

3.5.1 Employees working for smaller companies are less likely to be members of an employer-sponsored pension scheme

Employees working for smaller companies are significantly less likely to be members of an employer-sponsored pension scheme. As illustrated in Figure 3.7, just 13 per cent of employees who work in private sector organisations of between one and four employees are members of employer-sponsored pension schemes. In contrast, 44 per cent of employees who work in private sector organisations of over 1,000 employees are members of employer-sponsored pension schemes.

55 These individuals will not generally be counted as being pension scheme ‘members’ in this report – for example, in data presented in Figure 3.6 – since ‘membership’, as defined in this report, generally refers to a situation where contributions (either by the employer, employee or both) are currently being made.

56 DWP, 2007, EPP Survey.

Individuals who work for smaller organisations and are members of an employer-sponsored pension scheme are also more likely to have DC rather than DB membership, and to be members of a contract-based rather than occupational scheme.

Figure 3.8 shows type of scheme membership for all employees with employer-sponsored membership, by size of organisation. Membership in DC contract-based schemes (as opposed to DB or DC occupational schemes) is comparatively more likely for those working in smaller organisations. Of those employees with some form of employer-sponsored pension membership, 85 per cent within organisations of between one and 12 employees had DC membership (15 per cent DB) compared with just 19 per cent for organisations with over 1,000 employees. DC contract-based pensions are also more common than occupational pensions within smaller organisations. Of those employees with some form of employer-sponsored DC membership, 80 per cent within organisations of between one and 12 employees had contract-based provision (20 per cent occupational) compared with 36 per cent for organisations of over 1,000 employees.
3.5.2 Employees that are young and those aged over 60 are less likely to be members of an employer-sponsored pension scheme

Figure 3.9 shows membership of employer-sponsored pension schemes for all employees, by employee age. As illustrated, employees in the age range 30 to 60 are far more likely to be members of an employer-sponsored pension scheme.

Of those employees in the age range 16 to 21, nearly 90 per cent do not have employer-sponsored pension scheme membership. This may reflect a reluctance of employees to take part in pension schemes at a young age, despite being offered membership, and lower quality provision of employer-sponsored pensions to this age range (perhaps as a reflection of the lower average quality of jobs taken by younger employees). There is also a particularly high level of non-membership amongst employees aged 65 and over – with 83 per cent without membership. A lower average quality of jobs taken by employees at this age, reflected in lower quality pension provision, may also be an explanation for this finding.
Finally, Figure 3.9 illustrates that, where pension membership exists, this is far more likely to be DC than DB the younger the employee is. This phenomenon partly reflects the trend over time for DC pensions to replace DB for new employees (as will be discussed in the next chapter). Of those with some form of employer-sponsored membership, 46 per cent of employees aged 16 to 21 had DC membership while 54 per cent had DB membership. In comparison, 25 per cent of employees aged over 65 with some form of employer-sponsored membership had DC membership while 75 per cent had DB membership.

Figure 3.9 UK employee membership of employer-sponsored pension schemes, by age of employee, 2008 (all sectors)

3.5.3 Females are as likely as males to be members of an employer-sponsored pension scheme but part-time workers have lower rates of membership

Females are as likely as males to be members of an employer-sponsored pension scheme, as illustrated in the 2008 ASHE data presented in Figure 3.10. Approximately 50 per cent of female employees and 50 per cent of male employees are members of an employer-sponsored scheme. However, as illustrated, female
employees are more likely to be members of a DB scheme. This may reflect the higher proportionate representation that female employees have within the public sector.

In contrast, part-time employees are significantly less likely than full-time employees to be members of an employer-sponsored pension scheme. As illustrated in Figure 3.11, while approximately 56 per cent of full-time employees are members of an employer-sponsored pension scheme, only 34 per cent of part-time employees are.

**Figure 3.10 UK employee membership of employer-sponsored pension schemes, by gender of employee, 2008 (all sectors)**

![Bar chart showing UK employee membership of employer-sponsored pension schemes by gender, 2008.](chart.png)

Source: ONS, 2008, ASHE
3.5.4 Membership in employer-sponsored pension schemes also varies by industry

As well as varying by age of employee and size of employer, patterns of employer-sponsored pension scheme membership also vary by industry – see Figure 3.12.

Industries with high levels of public sector participation, for example public administration and defence and education, tend to have higher levels of employer-sponsored pension membership. This is often DB dominated, as is common for the public sector as a whole (see discussion in section 3.4).

Other industries with good levels of membership, as illustrated in Figure 3.9, include electricity, gas and water and finance. While the utilities are now mainly privatised, some legacy DB pension schemes are likely to remain. The financial sector also has high levels of pension scheme membership.

Employees in the hotels and restaurants industry are least likely to have employer-sponsored pension membership, with less than ten per cent of employees being members of a scheme. Agriculture, wholesale and retail trade and construction
also have relatively poor pension membership. Where membership exists, that membership is more likely to be in DC rather than DB schemes.

Figure 3.12 UK employee membership of employer-sponsored pension schemes, by industry, 2008 (all sectors)

Source: ONS, 2008, ASHE
Box 3.1 What are the key differences between contract-based and occupational pensions from the member perspective?

From a legal/regulatory perspective, occupational (trust-based) and contract-based pension schemes are quite different. In occupational schemes, the legal status of the pension is held under UK trust law and a trustee or board of trustees is responsible for holding assets for the scheme beneficiaries. In contract-based schemes the legal contract is between the individual and the pension provider and there is no entity recognised in law or regulation that acts on the members’ behalf. Providers must, nevertheless, meet FSA regulatory requirements relating to, for example, treating customers fairly and ensuring business is conducted in a fit and proper way.

Despite these differences, qualitative/anecdotal evidence indicates that the member experience of occupational and contract-based schemes may be quite similar. In both cases, consumers must choose whether to join, how much to contribute, how to invest and when and how to turn their pension fund into a pension income.

One area where differences may be experienced is in relation to the degree of investment choice offered to members. There is some limited evidence to suggest that the trustee role within occupational schemes may reduce the number of investment choices made available to members to a sub-set that are deemed more appropriate.

There is evidence (again anecdotal) that suggests that it is common for individuals to not know which type of pension they have, or the differences between different types of pension scheme.

This chapter has provided an overview of private pension scheme membership currently. Chapter 4 now goes on to discuss how trends in pension membership have changed over time.
4 Defined contribution membership – trends over time

4.1 Summary

- There was a slight decline in the proportion of the population aged between 20 and state pension age in Great Britain with some form of private pension scheme membership between 1999/00 and 2005/06 (a fall from 46 per cent to 42 per cent). The self-employed saw a more significant drop in membership than employees.\(^\text{58}\)

- Within the public sector, employer-sponsored membership (which is mainly defined benefit (DB)) increased from the 1950s to the 1970s, but has since seen cyclical fluctuations with no overall trend.

- Within the private sector, membership in DB schemes is in long-term decline (with a decrease from 4.6 million members in 2000 to 2.7 million in 2007, according to the Occupational Pension Schemes Survey (OPSS))\(^\text{59}\) while membership in defined contribution (DC) schemes has increased.

- There is also a trend for membership in DC contract-based schemes to replace membership in DC occupational schemes. Employers tend to prefer contract-based pension schemes because they are viewed as less costly and burdensome to run.\(^\text{60}\)

---

\(^\text{58}\) Department for Work and Pensions (DWP), 1999/00 – 2005/06, *Family Resources Survey (FRS)*.


\(^\text{60}\) This is according to providers and intermediaries as documented in recent qualitative research into the workplace pension market, carried out on behalf of DWP. Wood, A. *et al*, July 2009, DWP Research Paper No. 591.
• The introduction of automatic enrolment and the Personal Accounts scheme from 2012 is intended and expected to increase DC membership. Employers with existing pension provision are generally keen to enrol people into their existing scheme, rather than a new scheme or the Personal Accounts scheme, in order to meet the requirements of the 2012 reforms.61

4.2 Introduction
This chapter discusses trends in private pension membership over time with a focus on DC membership. The data coverage and sources utilised are similar to that applied in Chapter 3 and are discussed in the Introduction section to this chapter – see Section 3.2.

Similar in structure to Chapter 3, the chapter proceeds as follows:
• Section 4.3 looks at trends in proportions of the population in Great Britain as a whole that belong to private pension schemes (either employer-sponsored or not).
• Section 4.4 focuses on trends in membership of employer-sponsored pension schemes.

4.3 Trends in private pension scheme membership in Great Britain
This section discusses trends in proportions of the population in Great Britain aged between 20 and state pension age that are members of different types of private pension schemes. As in Section 3.3, the data derives from the DWP FRS. The data does not provide a breakdown between DC and DB pension scheme membership.

4.3.1 There was a slight decline in the proportion of the population aged between 20 and state pension age in Great Britain with some form of private pension scheme membership between 1999/00 and 2005/06
As illustrated in Figure 4.1, the proportion of the population in Great Britain aged between 20 and state pension age with some form of private pension scheme membership declined slightly over the period 1999/00 – 2005/06.62,63 In 1999/00, 46 per cent of the population were members and by 2005/06 this figure had fallen to 42 per cent.

62 FRS data for 06/07 and 07/08 are not available due to an underlying problem with the pension participation data.
63 The FRS survey aims to capture ‘active’ membership of private pension schemes, which occurs when contributions (either by the employee/individual, employer or both) are currently being made to the scheme(s).
4.3.2 The self-employed saw a more significant decline in membership rates than employees

Figure 4.2 and Figure 4.3 disaggregate the equivalent data for employees and the self-employed. While both employees and the self-employed experienced a decline in private pension scheme membership over the period, the decline was more significant for the self-employed. The proportion of employees with membership fell by nine per cent between 1999/00 and 2005/06 (from 61 per cent to 56 per cent) while the proportion of the self-employed with membership fell by 27 per cent (from 46 per cent to 34 per cent). For employees, the decline in membership was driven by a reduction in both employer-sponsored and individually organised pension scheme membership. For the self-employed, a reduction in individually organised pension scheme membership drove the overall decline.64

---

64 Some Group Personal Pension (GPP) and Group Stakeholder (GSHP) scheme membership, although by definition ‘employer-sponsored’, may be counted as ‘individual’ pension scheme membership in the data presented. This is due to possible inconsistencies with the FRS survey data.
The economically inactive experienced only very small changes in private pension membership over the period.

Figure 4.2 Membership of private pension schemes, employees in Great Britain aged 20 to state pension age, 1999/00 - 2005/06

Source: DWP, FRS.
4.4 Trends in employer-sponsored private pension scheme membership

This section provides further information on employer-sponsored pension scheme membership, which is the most common form of private pension membership. It refers to individuals who are members of a pension scheme provided by their current employer and excludes all those individuals who belong to pension schemes that have no connection with their current employer – for example, those who are members of a pension scheme organised individually. This section provides breakdowns on DC versus DB pension scheme membership, as distinct from the previous section.
4.4.1 Membership of occupational pension schemes is in decline, driven by the closure of DB pension schemes within the private sector

Occupational pension scheme membership has been in long-term decline since the late 1960s. Figure 4.4 shows membership of occupational pension schemes over the period 1953 to 2007, broken down between the public and private sector, and with a split between DC and DB schemes for recent years. The source for the data is the OPSS, which became an annual survey in 2004 but before then was carried out less frequently (every three to five years).

From the early 1950s to the late 1960s, total membership in occupational schemes increased quickly but since the late 1960s membership has steadily fallen. This decline in occupational scheme membership has been driven by a reduction in DB scheme membership within the private sector.

Focusing firstly on the public sector, Figure 4.2 shows that occupational scheme membership rose from the 1950s to the 1970s. Since then it has seen substantial cyclical fluctuations, but no overall trend up or down. The vast majority of public sector occupational scheme membership relates to DB schemes.

Looking now at the private sector, Figure 4.4 shows that membership in DC occupational schemes has stayed relatively constant over the period 2000-2007 while membership in DB schemes has fallen significantly over this period – from membership of 4.6 million in 2000 to 2.7 million in 2007. While a split between DB and DC schemes is not available before 2000, the high proportion of DB schemes at 2000 suggests that the long-term decline in private sector occupational membership has been driven by a fall in DB membership.

Overall then, it is clear that private sector occupational membership has been in long-term decline since the end of the 1960s. This has been driven by a steep reduction in DB scheme membership while DC occupational membership has remained relatively stable (at least since 2000). In contrast, public sector occupational membership (which is almost entirely DB) has seen an increase since 1953.

65 The OPSS surveys employers about the occupational schemes they make available to employees. ‘Members’ here are defined as current employees who would normally contribute (or have contributions made on their behalf) to the pension scheme.

66 This was demonstrated in Chapter 3. Only 1.7 per cent of public sector employees were members of a DC scheme at 2008 (ONS, Annual Survey of Hours and Earnings).
4.4.2 Within the private sector, growth in DC contract-based scheme membership since the late 1990s has partly compensated for the decline in DB membership

Focusing on the private sector, where the vast majority of DC provision exists, Figure 4.5 shows how pension membership for different types of occupational and contract-based schemes has changed over the period 1997-2008. The source for this data, Annual Survey of Hours and Earnings (ASHE), is different - but is broadly consistent with the OPSS data displayed above for occupational membership.

The ASHE data illustrates a clear shift from DB to DC contract-based scheme membership within the private sector. Over the period 1997 to 2008, membership in private sector DB schemes fell from 5.3 million to 2.4 million. Membership in DC occupational schemes stayed relatively constant over the period – at
approximately 1.5 million in 2008. Meanwhile, membership in DC contract-based pension schemes grew – from 0.2 million employees in 1997 to 2.6 million in 2008.

Over the period 1997 to 2001, membership of DC contract-based schemes increased sufficiently to roughly balance the decline in DB membership – such that the total number of employees with some form of employer-sponsored pension membership stayed roughly the same. Since 2001, membership in DC contract-based schemes has grown less quickly than the decline in DB membership – so that the number of private sector employees with employer-sponsored pension membership has fallen.

The increase in DC contract-based scheme membership has been driven by growth in membership in both GPPs and Stakeholder (SHP) schemes, according to the ASHE data. There is also evidence to suggest that membership in Group Self-Invested Personal Pensions (Group SIPPs) is increasing. Recent qualitative research into current practices in the workplace personal pension market found that, while few pension providers currently offered Group SIPPs, many believed it was beginning to emerge as a considerable growth area for a certain audience.67 This audience is typically directors and senior managers, who are often targeted quite differently to the mass market when it comes to pension provision. The fact that group SIPPs gives their members more control over their underlying investments was seen as attractive to directors and senior managers in this study.

---

Figure 4.5  UK employee membership of employer-sponsored pension scheme, 1997-2008 (private sector only)\textsuperscript{a}

![Graph showing UK employee membership of employer-sponsored pension scheme, 1997-2008 (private sector only).](image)

Source: ONS, 1997/08, ASHE.

\textsuperscript{a} Changes in methodology in the ASHE survey for 2006 (and onwards) mean that comparisons with 2005 and earlier should be treated with caution. The ASHE survey replaced the New Earnings Survey (NES) in 2004.

4.4.3 Employers see contract-based DC schemes as less costly and burdensome to run than DC occupational schemes

The gradual closure of DB schemes has been well documented – for example, there are many high-profile examples of large employers, such as British Petroleum (BP), closing their DB schemes to new members.\textsuperscript{68} The reasons for the shift from DB to DC have also been well documented, for example by the Pensions Commission who cite economic, demographic and cultural factors as being responsible for the change.\textsuperscript{69} The obvious attraction of DC schemes for employers is certainty over costs as a result of the transfer of investment and other risks from the employer to the employee. Figure 4.6 provides a brief time-line of the history of DC, summarising some of the trends.

\textsuperscript{68} From April 2010, BP will close its final salary pension scheme to new members.

The tendency for employers to select contract-based over occupational DC schemes has been less well documented. Recent qualitative research for the DWP into current practices in the workplace pension provision market found that providers and intermediaries felt employers saw occupational schemes as being too expensive to run, with most no longer wanting to take on the responsibility of being trustees. In contrast, according to providers and intermediaries, employers typically saw contract-based schemes as less costly and burdensome to run, offering more investment choice to members without the need for trustees to be involved in the process.70

4.4.4 Most employers who do not currently provide pensions will enrol employees into the Personal Accounts scheme in 2012, rather than setting up their own scheme

From 2012, legislative changes will give employers a duty to automatically enrol all eligible employees into a qualifying pension scheme and to make contributions on their behalf of those who do not opt out. A new DC occupational scheme, known as the Personal Accounts scheme, will be set up to ensure that those employers who are not currently served by pension providers in the private sector will be able to make provision for their employees. The current working assumption is between four and seven million individuals participating in the personal accounts scheme with hundreds of thousands of sponsoring employees.71 DC membership is therefore expected to increase as a result of the reforms.

Recent DWP research into employers’ likely responses to the 2012 workplace pension reforms found that employers with existing pension provision were, generally, keen to enrol people into their existing scheme, rather than a new scheme or the Personal Accounts scheme, in order to meet legislative requirements.72 By contrast, employers that were making a contribution to an employee’s own individually organised personal pension commonly thought that they would move to the Personal Accounts scheme in 2012. Most employers who did not currently provide any form of pension provision considered, in general, that they would enrol their employees into the Personal Accounts scheme from 2012 – rather than setting up their own scheme.

4.5 Timeline of defined contribution events and trends

1950 – 1970
- DB schemes are the most popular form of pension benefit delivery model due to very attractive tax breaks, buoyant stockmarkets and lower mortality assumptions.

---

71 DWP.
• Retirement Annuity Contracts (RACs) introduced in 1956. These were aimed at the self-employed and those without access to pension schemes through their employment.

1970 – 1995
• Growing cost of DB becomes more visible.
• Companies closing DB schemes replace them with occupational (trust-based) DC while new companies opt for DC rather than DB schemes.
• Government introduces open market option (OMO) in 1978 which provides pension policyholders with the right to shop around for annuities and purchase from any provider in the market.73
• Personal pensions introduced in 1988, replacing RACs. Ability to contract out of State Earnings Related Pension Scheme (SERPS) on an individual basis is introduced.

1995 – 2005
• Income drawdown introduced in 1995, allowing individuals who do not wish to purchase a life-time annuity at retirement to draw income from their pension fund while keeping the remainder of the fund invested in an unsecured pension.74
• Changes in taxation, increasing longevity and poor stock market performance of 2001 to 2003 push most DB schemes into deficit. New accounting rules make the deficits more transparent.
• Stakeholder pension schemes (SHPs) introduced in 2001 as a new low-cost pension scheme aimed at encouraging saving for people on low to average earnings.
• Finance Act 2004 simplifies pension tax regime leaving fewer tax advantages for occupational schemes in relation to employer contributions.
• Pensions Act 2004 increases obligations of trustees in occupational schemes.
• Alternatively secured pensions (ASPs) introduced in 2006 as an alternative way to draw a pension income.75
• New DC arrangements, generally contract-based.

2005 and beyond
• Pensions Act 2007 provides for the abolition of contracting out of the State Second Pensions (the replacement for SERPS) into DC schemes. The date at which the change will come into effect is yet to be determined.

73 Discussed in more detail in Chapter 9 (decumulation).
74 ibid.
75 ibid.
‘A day’ (6th April 2006) sees the introduction of a number of reforms including simplification of the pension tax regime and increased flexibility regarding contributions and the number of schemes individuals can invest into.

- Group SIPPs grow in use.
- Trend from DB to DC and trust to contract-based DC continues.
- Automatic enrolment with compulsory employer matching contributions and the introduction of the Personal Accounts scheme scheduled for 2012.

Source: PricewaterhouseCoopers LLP (PwC) analysis

This chapter has examined trends in private pension scheme membership over time. Chapter 5 will now discuss contributions to DC pension schemes.
5 Contributions to defined contribution pensions

5.1 Summary

- Contributions to a private pension scheme can come from the individual/employee and/or the employer, in the case of an employer-sponsored scheme.

- Total contributions to private pension schemes rose in real terms by 56 per cent between 1995 and 2007. At 2007, total contributions to private pension schemes were £85.3 billion, of which 70 per cent derived from employer contributions and 30 per cent derived from individual/employee contributions.\(^{76}\)

- Pension contributions receive tax and National Insurance relief, which cost the Government £18.6 billion in 2007/08.\(^{77}\)

- While making comparisons between defined contribution (DC) and defined benefit (DB) contribution rates is complex, due to the different characteristics of the two types of scheme, evidence suggests that contribution rates for DC schemes are considerably less than for DB schemes. For example, 2007 employer contribution rates to occupational schemes were 15.6 per cent of salary for DB schemes compared with 6.5 per cent of salary for DC schemes, according to the Occupational Pension Schemes Survey (OPSS).\(^{78}\)

- DC employer contribution rates are significantly higher than employee contribution rates, a trend emphasised in recent years due to the tendency for employer rates to increase more quickly than employee rates.

- There has been much commentary on the impact of the 2012 automatic enrolment reforms on DC contribution rates.

---

\(^{76}\) Office for National Statistics (ONS), 2009, Pension Trends.

\(^{77}\) ibid.

\(^{78}\) ONS, 2007, OPSS.
• Employers are increasingly using matching scales to contribute to employees’ pension schemes.

• Salary sacrifice is also increasingly popular and involves employees forgoing part of their earnings in return for a corresponding contribution by the employer to the pension scheme. Because of the lower salary payable, National Insurance contributions can be reduced for both employers and employees.

5.2 Introduction

In the case of an individually organised personal pension scheme, it is up to the individual member to contribute. In the case of employer-sponsored pension schemes, contributions can come from the employee, the employer or a combination of the two.

It is important to note that contribution levels alone do not provide a measure of pension adequacy. In DC schemes, the pension also depends on the returns received on the funds invested (minus any charges incurred) as well as the cost of an annuity (or alternative).

This chapter highlights some high level trends in pension contribution rates – comparing contribution rates between different types of private pension scheme and looking at how contributions have changed over time. As before, it is difficult to find a single data source which provides reliable and comprehensive data. This chapter draws on a range of data sources to highlight some key messages, proceeding as follows:

• Section 5.3 looks at aggregate contributions to private pension schemes as a whole including the tax relief received on these contributions.

• Section 5.4 focuses on contribution rates to employer-sponsored schemes. Employer-sponsored schemes are the most common form of private pension (in terms of membership) and more data is available on contributions to these schemes.

• Section 5.5 provides some additional information on the design of contribution structures for employer-sponsored schemes – including the use of matching contribution scales and salary sacrifice.

5.3 Aggregate contributions to private pension schemes

This section provides information on aggregate contributions to private pension schemes over time, including the tax relief received on these contributions. It includes both occupational and contract-based pensions (employer and not employer-sponsored) and covers both the public and private sector.
5.3.1 Total contributions to private pension schemes have risen in real terms by 56 per cent since 1995

Figure 5.1 shows aggregate contributions to UK private pension schemes by pension type, for the period 1995 to 2007. Data on contributions to funded occupational schemes, unfunded occupational schemes and contract-based (personal) pensions is presented. Many public sector pension schemes are unfunded. The main exception to this is local government pension schemes for local authority employees which are funded and therefore included within the ‘funded’ category. Other funded occupational pension schemes are found within the private sector.

Figure 5.1 shows that, at 2007, total contributions to private pension schemes were £85.3 billion. Funded occupational schemes made up 52 per cent of total contributions while unfunded occupational schemes and personal pensions make up 25 per cent and 23 per cent of total contributions, respectively.

Figure 5.2 presents the same aggregate data, but this time split between employer and employee/individual contributions. At 2007, 70 per cent of contributions were from employers and 30 per cent were from employees/other individuals.

Aggregate contributions to private pension schemes have grown in real terms by 56 per cent since 1995. The period 2001 to 2006 saw particularly strong growth, with total contributions rising by 41 per cent over the five year period. Most of this growth was driven by increases in employer contributions to funded occupational schemes – in turn, likely to be associated with requirements to finance deficits in funded DB schemes over this period.\(^{79}\) Between 2006 and 2007 aggregate contributions fell by a small amount due to a reduction in employer contributions to funded schemes. The pressure to finance deficits in DB schemes reversed to some extent in 2007 when many schemes moved into surplus – providing an explanation for this change.\(^{80}\)

It is important to note that the introduction of auto-enrolment and the Personal Accounts scheme from 2012, as a result of the Pensions Act 2008 reforms, will also impact on total contributions to private pension schemes (see Box 2.1 for more information on the reforms). The impact of the 2012 reforms on pension contributions is discussed in further detail later in this chapter.

\(^{80}\) *ibid.*
Figure 5.1 Aggregate contributions to UK private pension schemes by pension type, 1995 to 2007, real terms (public and private sector)$^a, b, c$

---

$^a$ Prices at 2007 level. Nominal values have been deflated using an average earnings index.

$^b$ Contributions to funded occupational schemes do not include contributions made as single premiums.

$^c$ Contributions to personal pensions do not include contributions made to Self-Invested Personal Pensions (SIPPs).

---

Source: ONS, 2009, Pension Trends.
5.3.2 The net cost to the Government of tax and National Insurance relief on pension contributions was equal to £18.6 billion in 2007/08\(^\text{81}\)

Individuals receive tax and National Insurance relief on pension contributions and pension fund investment returns, but pay tax on pension income.

The cost to the Government of tax relief on contributions and investment income was nevertheless greater than the tax received from pensions paid in 2007/08. As illustrated in Table 5.1, the net cost of tax relief to Government was £18.6 billion at 2007/08. While tax relief granted was equal to a total of £29 billion (£23.1 billion for tax relief on contributions and £5.9 billion for tax relief on investment income of funds), tax liable on pension payments was £10.4 billion.

---

Tax relief on contributions increased over the period 1998/99 to 2007/08 from £10.7 billion to £23.1 billion. This is largely in line with the increase in contributions themselves, previously discussed, although changes in the average marginal rate at which tax relief was granted also had an effect.

Tax relief on investment income of funds fell in the period prior to 2002/04, mainly as a result of falling investment returns over this period. Since then, this form of tax relief has recovered, reaching £5.9 billion in 2007/08. This component does not include tax relief on capital gains made by pension funds as data is not available. It also excludes tax relief on lump sum pension payments (Her Majesty’s Revenue & Customs (HMRC) estimates that the cost of such relief would have been £2.5 billion in 2007/08).

Total tax liable on pension payments rose from £6.1 billion in 1998/99 to £10.4 billion in 2007/08.

National Insurance relief on employer contributions also increased from £2.8 billion in 1998/99 to £8.2 billion in 2006/07 and 2007/08. This reflects the strong growth seen in employer contributions over the period 2001 to 2006, partly to account for deficits in DB schemes experienced at this time. The pressure to finance deficits in DB schemes reversed to some extent in 2007 when many schemes moved into surplus and partly explains the levelling off in National Insurance relief on employer contributions seen.\(^8^2\)

Table 5.1  Pensions taxation and National Insurance relief, UK\textsuperscript{a}

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax relief on contributions\textsuperscript{b}</td>
<td>10.7</td>
<td>11.8</td>
<td>12.7</td>
<td>13.1</td>
<td>14.3</td>
<td>16.0</td>
<td>18.1</td>
<td>20.6</td>
<td>22.7</td>
<td>23.1</td>
</tr>
<tr>
<td>Tax relief on investment income of funds\textsuperscript{c}</td>
<td>4.3</td>
<td>4.3</td>
<td>4.1</td>
<td>3.7</td>
<td>3.5</td>
<td>3.8</td>
<td>4.2</td>
<td>4.5</td>
<td>5.2</td>
<td>5.9</td>
</tr>
<tr>
<td>Less</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax liable on pension payments\textsuperscript{d}</td>
<td>6.1</td>
<td>6.6</td>
<td>7.3</td>
<td>7.5</td>
<td>8.1</td>
<td>8.3</td>
<td>8.8</td>
<td>9.7</td>
<td>10.2</td>
<td>10.4</td>
</tr>
<tr>
<td>Net cost of tax relief\textsuperscript{e}</td>
<td>8.9</td>
<td>9.5</td>
<td>9.5</td>
<td>9.3</td>
<td>9.7</td>
<td>11.5</td>
<td>13.5</td>
<td>15.4</td>
<td>17.7</td>
<td>18.6</td>
</tr>
<tr>
<td>Memorandum item:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>National Insurance relief on employer contributions</td>
<td>2.8</td>
<td>3.4</td>
<td>3.6</td>
<td>3.8</td>
<td>4.3</td>
<td>6.8</td>
<td>6.8</td>
<td>7.6</td>
<td>8.2</td>
<td>8.2</td>
</tr>
</tbody>
</table>

\textsuperscript{a} Figures for 2005/06, 2006/07 and 2007/08 are provisional estimates.

\textsuperscript{b} Includes relief at appropriate rate on contributions from employers, self-employed and other individuals.

\textsuperscript{c} Assuming relief at the basic rate of tax. Does not include relief on capital gains made by pension funds as data is not available.

\textsuperscript{d} Assuming pension payments represent top slice of taxable income.

\textsuperscript{e} Does not include tax relief on lump sum payments. HMRC estimates that this would have cost £2.5 billion in 2007/08.

Source: ONS, 2009, Pension Trends.
5.4 Contribution rates to employer-sponsored pension schemes

This section focuses on contributions to employer-sponsored pension schemes, which are the most common form of private pension scheme (in terms of membership). This section looks purely at the private sector and ignores the public sector since DC schemes are unusual in the public sector.83

5.4.1 Contribution rates to DC schemes are less than to DB schemes

It is difficult to make comparisons between DB and DC contribution rates for a variety of reasons. DB contribution rates can be different from the value of pension rights being accrued and from the rates required to meet the pension promise over the long-term – which limits the appropriateness of making straightforward comparisons between DB and DC contribution rates. Many DB schemes historically took ‘contribution holidays’ and, more recently, are paying higher levels of contribution rates to correct deficits, which may skew DB contribution levels upwards in comparison with DC schemes.

DB and DC schemes also typically provide very different services to members – for example, high DB contributions will often reflect life assurance and ill-health benefits (which are often funded separately in DC schemes). Finally, while the majority of DB schemes are contracted out of the additional state pension (the State Second Pension), the majority of DC schemes are contracted in. This is discussed in more detail ahead.

Bearing in mind these caveats, Figure 5.3 nevertheless makes comparisons between DB, DC occupational and DC contract-based scheme contribution rates as a percentage of salary, using a range of sources.84 While estimates vary by source, total contribution rates (sum of employer and employee rates) for DB schemes are higher than DC schemes in all cases. The range of sources displayed in Figure 5.3 reflects the fact that there is no single most reliable data source for contribution rates.

Looking firstly at employer contribution rates, the ONS OPSS found that employer contribution rates to DB schemes were over twice those to DC occupational schemes at 2007–15.6 per cent of salary for DB schemes compared to 6.5 per cent for DC occupational schemes.85 The Association of Consulting Actuaries (ACA) survey tells a similar story, finding employer contribution rates for DB schemes to

---

83 For example, only 1.7 per cent of public sector employees were members of a DC scheme at 2008. Historically, DC membership in the public sector has also been negligible. ONS, ASHE survey.

84 All data presented refers to 2007 except for National Association of Pension Funds (NAPF) Annual Survey which refers to 2008.

be over three times higher than for DC occupational schemes (22.6 per cent of salary versus 6.2 per cent) at 2007.

Figures from other sources are less contrasting, but in all cases employer contribution rates for DB schemes are higher than for DC schemes. Contributions to occupational schemes also appear to be, on average, slightly higher, than to contract-based (Group Personal Pension (GPP) and Stakeholder pension (SHP)) schemes.

Looking now at employee contribution rates, Figure 5.3 indicates that contribution rates to DB schemes are also higher than for DC schemes. The OPSS found an average employee contribution rate of 4.9 per cent for DB schemes compared with 2.7 per cent for DC occupational schemes at 2007 while the ACA survey found an average employee contribution rate of 6.1 per cent for DB schemes compared with a rate of 4.1 per cent for DC occupational schemes. In contrast, the Employers’ Pension Provision (EPP) survey found no difference between employee contribution rates to DB and DC occupational schemes (both at five per cent of salary). Evidence on employee contribution rates to contract-based DC schemes is limited. However, the ACA survey found rates of 4.1 per cent and 3.9 per cent of salary for SHP and GPP schemes respectively – similar figures to that found for DC occupational schemes.

As highlighted above, most DB schemes are contracted out of the State Second Pension while most DC schemes are contracted in. By contracting out, instead of building up entitlement to the State Second Pension, an individual will instead contribute to a private arrangement. The Pensions Act 2007 provides for the abolition of contracting out for DC pension schemes, although the Act did not specify when the change will come into effect. In 2007, 95 per cent of contributing members of private sector DB schemes were contracted out compared with 27 per cent of contributing members of DC schemes.\(^\text{86}\)

The relatively low contribution rates of DC schemes may be partly explained by the dominance of schemes which are contracted in – since members of such schemes benefit from accrual of State Second Pension, as well as contributions to their private pension. Some of the contributions into DB schemes are to correct deficits, rather than because of new accruals, which may explain more of the gap. However, the balance of the evidence and the view of most commentators is that DB schemes are typically substantially more generous than both trust and contract-based DC provision.

\(^{86}\) ONS, 2007, Occupational Pension Schemes Survey.
5.4.2 Employer contribution rates to DC schemes have increased at a faster rate than employee contribution rates in recent years

This section of the chapter now focuses on average DC contribution rates and, specifically, looks at how they have changed over time.

There is evidence to suggest that employer contribution rates to DC schemes have shown increases in recent years, at least for occupational schemes, while employee contribution rates appear to have increased at a lesser rate. Figure 5.4

---

**Figure 5.3** Employer and employee contributions to UK DB, DC occupational and DC contract-based schemes as a percentage of salary, 2007 (private sector only)^a,b^  

---

^a^ All data presented refers to 2007 except for NAPF which refers to 2008.  
^b^ NAPF data represents a mix of DC occupational and contract-based schemes.  


---

^87^ At 2008, 54 per cent of schemes responding to the NAPF DC survey were occupational schemes, 21 per cent were Group Personal Pension (GPPs), 24 per cent were Stakeholder pension (SHPs) and one per cent were Group Self-Invested Personal Pension (SIPPs).
shows how employer contributions to both DC occupational and contract-based schemes have changed since 2000 while Figure 5.5 presents the same information for employee contribution rates (this time going back to 1999). All contribution rates are expressed as a percentage of salary.

Looking firstly at employer contribution rates (Figure 5.4) evidence suggests that employer contribution rates to DC occupational schemes may have increased quite markedly. The OPSS found that rates increased from 4.3 per cent in 2000 to 6.5 per cent in 2007 while the ACA found increases from 5.1 per cent in 2002 to 6.2 per cent in 2007. The ACA found that employer contribution rates to GPP schemes increased, although the change is more slight (5.6 per cent in 2002 to 6.0 per cent in 2007). The ACA found decreasing employer contribution rates to SHPs – falling from five per cent in 2002 to 4.1 per cent in 2007. Almost since their introduction in 2001, it appears that employer contribution rates to SHPs have been on a downward trend.

Looking now at employee contribution rates, the evidence is more mixed. In contrast with a finding of increasing employer contribution rates, the OPSS found that employee contribution rates to DC occupational schemes stayed roughly constant over the period 2000 to 2007 – at 2.7 per cent of salary. The ACA figures show slightly increasing employee contribution rates for occupational, SHP and GPP schemes. In contrast, NAPF figures, which represent a mix of contract-based and occupational schemes, show a more significant increase in employee contribution rates – rising from 2.5 per cent in 1999 to 4.4 per cent in 2008.88

Employer contribution rates appear significantly higher than employee contribution rates, particularly in recent years. At 2007, employer contribution rates for DC occupational and GPP schemes averaged approximately six per cent with a lower rate of four per cent for SHPs, see Figure 5.4. In contrast, employee contribution rates for DC schemes varied between 2.7 per cent and 4.5 per cent, depending on the source utilised.

---

88 The NAPF and ACA figures both derive from surveys of approximately 300 or less schemes. In contrast, the OPSS survey is a national survey with approximately 1,000 responses. Results from the OPSS survey are therefore likely to be more accurate as a representation of the population of UK pension schemes.
Figure 5.4 Employer contribution rates to UK DC schemes as a percentage of salary, 2000-2008 (private sector only)a, b, c, d, e


- OPSS data is for schemes with 12 or more members only.
- OPSS and NAPF data includes schemes where standard contributions were zero. For ACA data, only SHPs were found to include a significant number of schemes where contributions were zero and these were excluded from the calculation of average contribution rates.
- NAPF and ACA data include contributions paid as fixed, as well as regular, amounts. OPSS data excludes contributions paid as fixed amounts.
- Changes in methodology to the OPSS survey at 2006 mean that comparisons with earlier years should be made with caution.
- OPSS survey became an annual survey in 2004. Figures for 2001, 2002 and 2003 have been interpolated.
Figure 5.5  Employee contribution rates to UK DC schemes as a percentage of salary, 1995-2007 (private sector only) a, b, c, d, e, f

- OPSS data is for schemes with 12 or more members only.
- OPSS and NAPF data includes schemes where standard contributions were zero. For ACA data, only SHPs were found to include a significant number of schemes where contributions were zero and these were excluded from the calculation of average contribution rates.
- NAPF and ACA data include contributions paid as fixed, as well as regular, amounts. OPSS data excludes contributions paid as fixed amounts.
- Changes in methodology to the OPSS survey at 2006 mean that comparisons with earlier years should be made with caution.
- NAPF data was not available for 2004 and 2006 and so figures have been interpolated.
- NAPF data represents a mix of DC occupational and contract-based schemes.89

89 At 2008, 54 per cent of schemes responding to the NAPF DC survey were occupational schemes, 21 per cent were GPPs, 24 per cent were SHPs and one per cent were Group SIPPs.
5.4.3 There has been much commentary around the impact of the Pensions Act 2008 reforms on DC contribution rates

There has been much discussion around the impact of the Pensions Act 2008 reforms on contribution rates. From 2012, a new system will be introduced under which employers will have a duty to automatically enrol all eligible employees into a qualifying pension scheme and to make contributions on behalf of those who do not opt out. Under this system, a minimum employer contribution of three per cent on a band of earnings will be required. The total minimum contribution for eligible workers should equal eight per cent of that band of earnings. This is made up of employer contributions, employee contributions and tax relief (see Box 2.1 for more information).

In the recently published ONS Pension Trends, some analysis is made of current contribution rates for DC schemes that are not contracted out of the State Second Pension, as this group is considered broadly comparable with the new Personal Accounts scheme.\(^90\) Despite limitations to the analysis\(^91\), the ONS finds that employees in DC schemes with 12 or more members, which were comparable in terms of contracting out status to the Personal Accounts scheme and other defined contribution schemes under the new system, contributed less in 2007 than they would to a scheme with minimum contributions under the new system. In contrast, employers contributed more than twice what they would have to contribute as a minimum under the new system.\(^92\)

Further commentators have speculated that, as a result of the 2012 reforms, some employers may reduce the contributions they make into pension schemes. Recent DWP research into employers’ likely responses to the workplace pension reforms found that employers who were currently contributing three per cent or more were, generally, keen to maintain their current levels of contributions for all workers.\(^93\) Such employers were committed to providing pensions for their employees, and said they saw this as part of their social responsibility, and as a

---


\(^91\) Pension Trends highlights that all comparisons should be treated with caution. In particular, some of the characteristics of contributors in the new Personal Accounts scheme (and in other ‘not contracted out’ DC schemes from 2012) may be different from those in current DC pension schemes that are not contracted out. Also, OPSS contribution rates are expressed as a percentage of gross salary while the minimum contribution rates for the Personal Accounts scheme and other qualifying schemes are expressed as a percentage of a band of earnings. It is possible to calculate examples of contribution rates as a proportion of gross salary under the new system, allowing broad comparison with the 2007 OPSS results, but such comparisons should be treated with caution.


means of maintaining parity with the rest of their industry. Employers who were currently contributing less than three per cent, contributing nothing or who did not provide access to a pension scheme commonly said they would increase their contribution levels to the minimum level, thus meeting legal requirements.

5.5 Design of contribution structures for employer-sponsored schemes

This section discusses the design of contribution structures typically used by employers for workplace pension schemes – including the use of ‘matching’ and ‘salary sacrifice’ arrangements.

5.5.1 Employers are increasingly using ‘matching’ to contribute to employee pension schemes

DC pension scheme contribution structures can be designed in a number of ways. Contribution rates may be ‘flat’, so that there is one contribution rate for all members, or they may vary according, for example, to age, length of service, choice of the member, grade or seniority of the employee.

DC pension schemes may also provide for ‘matching’, such that any contributions made by employees are ‘matched’ by a corresponding employer contribution.

Table 5.2 shows the ways in which structure of contributions varied between members of DC occupational schemes at 2007. For 0.3 million members (or 43 per cent of active members of DC occupational schemes) contributions were made at the same rate for every member. Of those members that were enrolled in schemes where contribution structures varied, variation according to the choice of the employee was the most common (0.3 million members), followed by member’s age (0.2 million or 31 per cent of active members). The number of active members whose contributions were calculated so as to target a particular level of benefit at retirement was minimal.

Watson Wyatt found that the proportion of schemes offering matching contributions is increasing. In 2006, Watson Wyatt found that in 66 per cent of plans employers offer some form of additional matching contribution. The matching bases are typically 1:1 or 1:2 up to a maximum limit.

---


95 ibid.
Table 5.2  Number of members of UK private sector DC occupational pension schemes by structure of contributions, 2007a,96

<table>
<thead>
<tr>
<th>Structure of contributions</th>
<th>Millions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Made at the same rate for every member</td>
<td>0.3</td>
</tr>
<tr>
<td>Variable</td>
<td></td>
</tr>
<tr>
<td>Depending on the member’s age</td>
<td>0.2</td>
</tr>
<tr>
<td>Depending on the member’s length of service</td>
<td>0.1</td>
</tr>
<tr>
<td>At the choice of member</td>
<td>0.3</td>
</tr>
<tr>
<td>Depending on grade or seniority</td>
<td>0.1</td>
</tr>
<tr>
<td>Calculated individually for each member</td>
<td>0.0</td>
</tr>
<tr>
<td>Other approach</td>
<td>0.1</td>
</tr>
</tbody>
</table>

*The survey question was a multiple response question so members may appear in more than one category.

Source: ONS, 2007, OPSS.

5.5.2 ‘Salary sacrifice’ is an increasingly popular way of making contributions amongst employers

Some DC schemes offer an approach to making contributions known as ‘salary sacrifice’. This is an agreement between the employer and employee whereby the employee forgoes part of their salary in return for a corresponding contribution by the employer to a pension scheme. Because of the lower salary payable, National Insurance contributions can be reduced for both employers and employees. Salary sacrifice is an increasingly popular way in which employers are contributing to pension schemes.

Table 5.3 shows numbers of members of DC occupational schemes by whether or not member contributions can be paid by a ‘salary sacrifice’ arrangement. In 2007, 0.5 million members of DC occupational schemes could contribute through a ‘salary sacrifice’ arrangement and 0.4 million could not. Of those members that could contribute via ‘salary sacrifice’, the majority used an arrangement whereby members’ salaries were reduced by a notional amount of contributions and all contributions are paid by the employer.

96 This data derives from the OPSS which surveys employers about the occupational schemes they make available to employees. ‘Members’ here are defined as current employees who would normally contribute (or have contributions made on their behalf) to the pension scheme.
Table 5.3  Number of members of UK DC schemes by whether member contributions can be paid by a ‘salary sacrifice’ arrangement, 2007a

<table>
<thead>
<tr>
<th>Salary sacrifice arrangement in place</th>
<th>Millions</th>
</tr>
</thead>
<tbody>
<tr>
<td>No</td>
<td>0.4</td>
</tr>
<tr>
<td>Yes, salaries reduced by a notional amount of contributions and all contributions paid by employer</td>
<td>0.3</td>
</tr>
<tr>
<td>Yes, whole or part of annual pay awards redirected to contributions</td>
<td>0.1</td>
</tr>
<tr>
<td>Yes, bonuses redirected to form contributions to scheme</td>
<td>0.1</td>
</tr>
<tr>
<td>Yes, by other method</td>
<td>N.A.</td>
</tr>
</tbody>
</table>

* The survey question was a multiple response question so members may appear in more than one category.

Source: ONS, 2007, OPSS.

This chapter has discussed contributions to DC schemes, including comparisons between DB and DC schemes, a discussion of the different methods which employers now use to contribute and the possible impacts on contribution rates of the Pensions Act 2008 reforms. Chapter 6 will now discuss DC pension investments. This includes a discussion of the degree of choice that members of DC schemes have about where to invest contributions made into their pension schemes, including what investment choices dominate and the degree to which default investment funds are used.
6 Defined contribution pension investments

6.1 Summary

- Members of defined contribution (DC) pension schemes are now typically offered a wide range of investment options.
- More occupational schemes now offer the option to invest in gilts, bonds and ‘ethical’ funds. There is a trend for with-profits funds to be withdrawn as an investment choice.\textsuperscript{97}
- Although not legally required to do so, 80 to 90 per cent of Group Personal Pension schemes (GPPs) offer a default investment option.\textsuperscript{98}
- Where a default investment fund is offered, 81 per cent of members invest in it.\textsuperscript{99}
- 89 per cent of DC funds offering a default option use a life-style strategy for that default.\textsuperscript{100}
- There can be significant variation in the way that life-style strategies are implemented.

\textsuperscript{97} Office for National Statistics (ONS), 2004-07, Occupational Pension Schemes Survey (OPSS).
\textsuperscript{98} This is according to pension providers and intermediaries, whose views were examined as part of qualitative research into current practices in the workplace pension market recently conducted on behalf of the Department for Work and Pensions (DWP). Wood, A. \textit{et al}, July 2009, DWP Research Paper No. 591.
\textsuperscript{99} PensionDCisions in association with Incisive Media, 2009, Default Investment Strategy Survey. The survey covered 45 large UK plans, representing half a million DC members and £8.3 billion in assets.
\textsuperscript{100} National Association of Pension Funds (NAPF), 2008, Annual Survey.
One in five DC plans is considering changing their default in light of the current market environment.¹⁰¹

6.2 Introduction

Contributions that are made into a DC pension scheme are invested in some way and members receive a return (either positive or negative) on this investment. This chapter discusses the extent of investment choice that members of DC schemes are typically offered and the most common forms of investment strategy implemented. It also discusses the use of default funds and life-styling, including the variability in the way in which life-style strategies are implemented.

6.3 Investment choice

6.3.1 DC members now have a wide range of investment choices available to them

Most occupational and contract-schemes offer members a range of active and passively managed investment funds. The 2007 OPSS found that 96 per cent of members of occupational DC schemes were offered an investment choice.¹⁰² In those schemes which offered a choice of investment, the same range of choices was normally offered to all members of the scheme below retirement age, including deferred members.

There is limited evidence to suggest that contract-based schemes may offer members greater choice than occupational schemes. Watson Wyatt’s FTSE 100 DC pension plan survey revealed two out of three contract-based DC schemes offer 50 or more investment options – compared to fewer than three per cent of trust based DC schemes which offer this degree of choice.¹⁰³

Scheme respondents to the OPSS were asked to indicate whether ten types of fund identified as commonly offered were available to members of that scheme. As illustrated in Figure 6.1, seven of the ten commonly identified funds were available to over half of members in 2007. The most commonly available investment choices available were UK equity funds, UK gilt funds, cash funds and ‘life-style’ funds (see Section 6.4).

¹⁰³ Watson Wyatt, March 4 2009, DC investment funds: choice up, thumbs down.
Figure 6.1 also illustrates that there was an overall increase in the choice of investment funds available between 2004 and 2007. The availability of investing in UK corporate bonds and gilts showed a particularly strong increase. At 2004, approximately 70 per cent of DC occupational scheme members had the option to invest in UK gilts and approximately 40 per cent had the option to invest in corporate bonds. By 2007, these figures had increased to 90 and 70 per cent respectively. This finding may be in recognition of the need to provide a less volatile alternative to UK equity based investment funds in the current economic climate. Over three-quarters of respondents to the NAPF 2008 survey of occupational and contract-based schemes said that their scheme offered gilt or fixed interest investment funds.104

There were also strong increases in the proportion of members offered investment in property and ‘ethical’ funds between 2004 and 2007. The proportion of members offered investment in property funds increased from approximately 20 per cent to 45 per cent between 2004 and 2007 while the proportion offered investment in ‘ethical’ funds increased from approximately 25 per cent to 40 per cent.

With-profits is a type of pooled investment fund run by insurance companies. Premiums for a with-profits policy are pooled with other with-profits policy holders and everyone in the fund shares the profits and losses. Figure 6.1 illustrates a trend for with-profits funds to be withdrawn as an investment choice for some DC occupational members. Approximately 30 per cent of members had the choice to invest in with-profits funds in 2004 compared with approximately 20 per cent in 2007. Anecdotal evidence suggests strong negative perceptions of with-profits funds in recent years, probably connected with problems experienced by Equitable Life dating back to the 1990s.

---

104 NAPF, 2008, Annual Survey. The NAPF survey is based on a relatively limited sample size of approximately 300 schemes responding and so results deriving from it should be treated with caution.
Figure 6.1 Available investment choices, UK DC occupational pension scheme members, 2004 - 2007\textsuperscript{a,105}

<table>
<thead>
<tr>
<th>Investment Type</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other type of fund</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>UK property fund</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>An &quot;ethical&quot; fund</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A with-profits fund</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>UK corporate bond fund</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Managed or balanced fund</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>UK gilt fund</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Overseas fund</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A &quot;lifestyle&quot; fund</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A cash fund (sterling)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>UK equity fund</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: ONS, 2004-07, OPSS.

\textsuperscript{a} Changes in methodology for 2006 onwards means that comparisons with 2004 should be treated with caution.

Figure 6.2 shows that member investment choice also increased between 2004 and 2007 to the extent that there was an increase in the number of funds into which members may split their account. At 2007, almost all members of DC occupational schemes were able to split their investment between more than one fund. Between 2006 and 2007, there was an increase in the proportion of members able to split between five to nine investment funds and ten or more investment funds and a significant reduction in the proportion with no choice.

\textsuperscript{105} This data derives from the OPSS which surveys a sample of occupational pension schemes registered with the Pensions Regulator. ‘Members’ here are defined as current employees who would normally contribute (or have contributions made on their behalf) to the pension scheme.
6.4 Use of default funds and life-styling

This section discusses the use of default funds and life-styling as an investment strategy for DC pension schemes.

6.4.1 Despite the wide range of investment choices available, the use of default funds tends to dominate

Despite the large range of investment choices typically available to members of DC contract-based and occupational schemes now, default options are typically used by the vast majority of members.

A default investment fund is the investment used when an individual member does not indicate an investment choice or wishes to use the default investment fund selected by the trustees, employer or provider. NAPF report that the proportion of DC schemes with default options increased from 66 per cent in 2004 to 85 per
cent in 2008, as illustrated in Figure 6.3. Recent qualitative research conducted on behalf of DWP found that, according to pension providers and intermediaries, 80 to 90 per cent of GPPs schemes offered a default investment option.

Since their introduction in 2005, all Stakeholder pension schemes (SHPs) have been required by law to offer a default fund. When the workplace pension reforms are introduced in 2012, all qualifying DC schemes will be required to offer a default fund.

Figure 6.3 Proportion of UK DC schemes with default funds, 2004-2008

Where a default investment fund is offered, the majority of scheme member contributions are invested in that fund. The 2009 DC Sponsor Default survey reports that 81 per cent of members invest in their pension plan’s default option. Qualitative research conducted on behalf of DWP found that, according to pension providers and intermediaries, 60 to 100 per cent of members invest in the default fund. The same research found that the proportion of members that invested in the default fund was believed to depend upon the extent to which the member received one-to-one communication and advice, which itself depended on how

---

106 NAPF, 2008, Annual Survey. The NAPF survey is based on a relatively limited sample size of approximately 300 schemes responding and so results deriving from it should be treated with caution.


engaged the employer was in providing employees access to such advice.\textsuperscript{109}

6.4.2 Most DC pension schemes use a life-style option as their default

Most DC pension schemes providing a default use a life-style option as that default. Figure 6.4 shows types of default fund used by DC schemes responding to the NAPF survey. At 2008, 89 per cent of schemes used a ‘life-style’ fund as their default fund with ‘mixed/managed’ funds as the next most common type of fund, used by seven per cent of schemes. NAPF report that the number of schemes offering life-style as the default increased from 79 per cent in 2007 to 89 per cent in 2008.\textsuperscript{110}

Figure 6.4 Default funds used by UK DC schemes, 2008

The theory behind life-styling is to transfer savings automatically into less volatile funds as the member gets closer to retirement. This can help to protect the member’s fund from market movements as they approach retirement.

The most common way in which life-styling is implemented is to start switching from an equity or ‘balanced’ fund some years prior to retirement, moving progressively to a final year allocation, typically combining bonds and cash. This is usually done automatically via a predefined formula, and is carried out on an individual basis. The change from one asset class to another typically starts at either five or ten years before retirement age.

The way in which life life-style strategies are implemented has nevertheless been found to vary quite significantly. In a study of 31 current pension plans, Blake et al found significant variation in the mix of assets typically utilised and the time


\textsuperscript{110} NAPF, 2008, Annual Survey.
period over which the lifestyling process is implemented.\textsuperscript{111} The 2009 DC Sponsor Default Survey found that 70 per cent of plans use a 100 per cent allocation to equity funds as the default but that regional allocations within equity strategies varied significantly, with allocations to UK equities varying between 34 and 100 per cent.\textsuperscript{112}

The current market environment may also be impacting on the choice of investment strategies used in DC default funds. In the 2009 DC Sponsor Default Survey 20 per cent of pension plans stated that they are considering changing their default in light of the current market environment.

Investment decision making in DC default funds was part of the focus of a review conducted by Paul Myners in 2001. Myners made a number of recommendations to improve investment decision-making and these have become known as the Myners Principles.\textsuperscript{113} Included in Myners’ review was the recommendation that where an occupational (trust-based) scheme is offering a default option, trustees should ensure that an objective is set for the default option including expected risks and returns. Myners also made recommendations around the governance and investment allocations of DC funds, including the recommendation that schemes should seek further diversification away from traditional asset classes and towards alternative classes such as hedge funds and private equity.

In 2007, the Treasury commissioned NAPF to review the progress of pension funds in applying the Myners Principles which resulted in the Myners Principles being updated to become more high level and flexible, while remaining voluntary. The Pensions Regulator is currently leading further work in this area.\textsuperscript{114}

This chapter has discussed investment in DC schemes. The following chapter, Chapter 7, will now discuss the charges which individuals incur for being members of a DC pension scheme. The chapter includes a discussion of the different types of pension charge (explicit and implicit) that DC members incur and how charges can vary between different types of DC scheme.

\textsuperscript{111} Blake \textit{et al}, July/August 2007, \textit{Default funds in UK defined contribution plans}. The most common structure (selected by 13 of the 31 plans examined) is to start switching from an equity or ‘balanced’ fund five years prior to retirement, moving progressively to a final year allocation of 75 per cent long-dated bonds and 25 per cent cash. A further 11 plans use the same 75:25 final year allocation, but begin switching between six and ten years prior to retirement. Other plans implement quite different strategies: two plans switched to a final allocation of 100 per cent long bonds, and four plans offered life-cycle profiles that have a final year asset allocation of 100 per cent cash.

\textsuperscript{112} PensionDCisions in association with Incisive Media, 2009, \textit{Default Investment Strategy Survey}. The survey covered 45 large UK plans, representing half a million DC members and £8.3 billion in assets.

\textsuperscript{113} Myners, 2001, \textit{Institutional investment in the UK: a review}.

\textsuperscript{114} http://www.thepensionsregulator.gov.uk/mediaCentre/newsByEmail/Myners.aspx
7 Defined contribution pension charges

7.1 Summary

- Defined contribution (DC) charges can be described as those costs that stand between the rate of return in the wholesale markets and the return which the individual DC member receives.

- Both implicit and explicit DC charges exist. Explicit charges are levied by the pension provider on members or overtly paid by the scheme trustee/administrator in an occupational scheme. Implicit charges are the costs of dealing incurred by fund managers which reduces total return but which is not explicitly revealed.

- Explicit DC charges may be higher for contract-based schemes than for occupational schemes. However, charges for contract-based schemes have fallen considerably since 2001 with the introduction of stakeholder charging caps.

- Implicit DC charges vary by asset class and are higher if active management is used.

- The Personal Accounts scheme is being designed to be a low cost pension scheme and will be introduced in 2012 as part of the broader work place pension reforms. A consultation on the charges that will apply to the Personal Accounts scheme has taken place but detailed decisions relating to its charging structure and levels have yet to be made.

7.2 Introduction

DC pension scheme members typically incur charges on the money that has been invested in their pension scheme. This reduces the total return they receive. This chapter discusses different types of DC pension charge before providing some evidence on the quantitative values of these charges, including how they vary between different types of DC scheme. The chapter will conclude by briefly discussing the impact of the introduction of the 2012 automatic enrolment reforms on DC charges.
7.3 Types of defined contribution charges

7.3.1 Both explicit and implicit DC charges exist

DC charges refer to the selling, processing and administrative costs that members of DC schemes experience. They can be described as those costs that stand between the rate of return in the wholesale markets and the return which the individual saver receives.

The first report of the Pensions Commission describes two forms of pension charges:

- **Explicit charges** levied by the pension provider on members or overtly paid by the scheme trustee/administrator in an occupational scheme. For personal pension contracts, regulation requires that these are explicitly revealed.

- **Implicit charges** (the cost of dealing incurred by fund managers) which reduces total return, but which is not explicitly revealed.

7.4 Explicit charges

7.4.1 The introduction of stakeholder pensions has led to significant reductions in charges for contract-based DC schemes

Pension providers design, set-up, administer and often manage the funds of a pension scheme. In the case of employer-sponsored schemes, employers typically appoint a single provider to carry out both administrative and fund-management services (through a ‘bundled’ service) for contract-based schemes. For occupational schemes, trustees often appoint separate administrators and fund-managers to carry out these roles.

Pension providers typically charge for their services via an explicit annual management charge (AMC). This charge is levied annually on a member’s pension fund, usually as a percentage of the total fund value.

The introduction of Stakeholder pensions (SHPs) in 2001 has led to a significant reduction in explicit charges for contract-based pension schemes. Employers with five or more employees who do not already offer a pension scheme to their employees are required to set up a Group SHP. One of the features of SHPs is that their charges are regulated. Currently, the legal maximum AMC for a SHP is 1.5 per cent, for the first ten years, falling to one per cent thereafter.

Recent qualitative research conducted on behalf of the Department for Work and Pensions (DWP) found that, according to pension providers, the introduction of Group SHPs has lead to Group Personal Pension (GPPs) being forced to adopt similar charging levels in order to remain competitive. Although the SHP charging cap was increased to 1.5 per cent in 2004 for the first ten years, moving to one per cent thereafter, competition was said to have kept charges for GPPs at one

---

per cent or below.\textsuperscript{116} This research found that, for providers in the study surveyed, typical AMCs levied on members of GPPs and SHPs varied between 0.4 per cent and one per cent.

Employers providing GPPs and Group SHPs will usually use an intermediary to advise them on the most appropriate choice of pension provider and pension scheme. Intermediaries typically charge for their service in one of two ways. They may be fee-based: in this case they charge the employer a fee for their service. Alternatively, intermediaries may work on a commission basis in which the provider pays the intermediary according to the pension products sold. In this case, the provider may seek to recover the cost of the commission by increasing the AMC that they apply to members’ funds. In general terms, the largest intermediaries are often fee-based and deal with larger employers; smaller intermediaries are often commission-based and deal with a wider range of sizes of employer.\textsuperscript{117}

Qualitative research for DWP found that where the provider paid the intermediary for all of its services via commission, fees were higher than when the intermediary was paid for via a fee. Where services were paid for via commission, the typical mid-range AMC for GPPs and SHPs was found to be 0.9 per cent. Where services were paid for via a fee, the typical mid-range AMC for GPPs and SHPs was found to be 0.5 per cent.\textsuperscript{118}

The same research found that the structure of scheme charges for Group Self-Invested Pension Plans (Group SIPPs) was different. Group SIPPs are a specific type of contract-based pension scheme where the member has greater freedom over what to invest in. Reflecting the wider range of investment options provided to members of Group SIPPs, specific fees were charged for each of the different services offered, rather than through a single AMC. The range of charges that could be applicable was thus found to be far greater when compared with GPPs and SHPs.

### 7.4.2 Charges for occupational schemes may be lower than for contract-based schemes

Less evidence is available on DC charges for occupational schemes although the Pensions Commission, reporting in 2004, found that explicit charges tend to be lower for occupational schemes than for contract-based schemes. Charges were also found to decrease with the size of the occupational scheme, perhaps reflecting lower costs as a result of economics of scale.\textsuperscript{119}

At 2004, the Pensions Commission found that large scale occupational schemes, whether defined benefit (DB) or DC, can have explicit charges as low as 0.2 per cent of fund value each year, while small occupational schemes can have an explicit cost of up to half a per cent. In contrast, ranges of half a per cent to one per cent...
GPPs may levy higher charges on members than occupational schemes because, while GPPs are bulk negotiated by employers, the legal contract is with the individual employee, generating individual-specific administration costs. Such costs are often, although not always, passed onto the consumer.

### 7.5 Implicit charges

**7.5.1 Implicit DC pension charges vary by asset class and degree of active management**

Implicit costs are the costs incurred by fund managers which reduces total returns to the pension provider and member. They may include items like bid-offer spreads and stamp duty. This report will not focus heavily on implicit DC pension costs. It is nonetheless worth noting that implicit DC costs add significantly to overall DC charges with implications for post-cost return. The Pension Commission found that implicit costs vary significantly depending on asset classes and are higher when there is a greater degree of active management. They assume a figure of 0.4 per cent – 0.5 per cent on average across all asset classes at 2004 for implicit pension charges.

### 7.6 Impact of 2012 pension reforms on defined contribution charges

**7.6.1 The Personal Accounts scheme is intended to be a low cost pension scheme available to all employers**

The Personal Accounts scheme is a new low cost pension scheme which will be introduced in 2012 as part of the broader workplace pension reforms (see Box 2.1 for further information). Unlike commercially run pension providers who are not required to provide services to all employers who request them, the Personal Accounts scheme will be available to all employers. The Government has made clear its intention that the scheme be delivered with low charges for members, consistent with the aspirations of the Pensions Commission. A consultation on the charges that will apply to the Personal Accounts scheme has taken place but detailed decisions relating to the charging structure, the level of charges and any additional charges for particular services in the Personal Accounts scheme have yet to be made.

This chapter has discussed pension charges incurred by members of DC pension schemes. Chapter 8 will now discuss DC pension assets, which refers to the stock of pension funds accumulated in DC pension schemes.

---

120 ibid.

121 ibid.

8 Defined contribution pension assets

8.1 Summary

- Data available on aggregate defined contribution (DC) pension scheme assets is extremely limited but this chapter nevertheless presents some high-level estimates of aggregate UK private pension scheme assets based on the data available.

- Aggregate assets in UK private pension schemes were worth approximately £1.9 trillion at 2007.\(^{123}\)

- Despite increasing membership of contract-based DC schemes, 2007 marked the second consecutive year that assets in these schemes fell in value. The retirement of early policy-holders and ‘A-day’ changes may provide an explanation for this trend.

- Assets in defined benefit (DB), DC occupational schemes and Self-Invested Personal Pension SIPPs combined increased in real terms by 64 per cent between 2002 and 2007. This is likely to reflect the historically high contribution rates into occupational schemes and their continuing maturity, as well as a recent move into SIPPs.

- The recent financial downturn has had a significant impact on DC asset values. Aon estimated that DC assets fell in value by a third (or £180 billion) between September 2007 and the end of February 2009.\(^{124}\) There is, however, evidence of some recovery and Aon reported an increase of ten per cent in DC asset values over the month of May 2009.\(^{125}\)

- Had the recent financial crisis taken place, instead, in ten years’ time its impact on DC retirees may have been significantly more damaging.\(^{126}\)

---

124 Professional pensions, March 2009.
125 Aon, 26th May, 2009.
8.2 Introduction

The assets that a DC pension member accumulates into their pension fund is a function of the contributions made into their scheme and the investment returns received on those contributions, minus any charges incurred. This chapter discusses DC pension scheme assets at an aggregate level – for the UK as a whole. The following chapter (Chapter 9) discusses DC assets at an individual level (the average fund value with which members purchase an annuity) as part of a broader discussion of DC decumulation.

Data on aggregate DC pension scheme assets is very limited but it is possible to construct some rough estimates of values based on the evidence available. This chapter includes a comparison of how aggregate assets in UK private pension schemes have changed over time including what the impact of the recent financial crisis has been. The chapter continues with a discussion of the relative importance of DC assets in relation to other forms of wealth holding for the average household.

8.3 Aggregate defined contribution assets

8.3.1 Aggregate assets in UK private pension schemes were worth approximately £1.9 trillion at 2007

Figure 8.1 illustrates aggregate assets held in UK private pension schemes for the period 1988 to 2007, in real terms. The data is produced by the Association of British Insurers (ABI) and derives from information provided by insurance companies to the Office for National Statistics (ONS) and the Financial Services Authority (FSA). Estimates are presented for the amount of funds held in insurer-administered individual pensions, insurer-administered occupational pensions and self-administered pensions not administered by insurance companies. DC assets are not split out.

At 2007, aggregate assets held in UK private pension schemes were equal to approximately £1.9 trillion. This represents a real increase of over threefold since 1987 (when assets were equal to £635 billion at 2007 prices). Between 2000 and 2002, aggregate assets fell in value, from approximately £1.6 trillion to £1.3 trillion, reflecting the market falls that occurred at this time. Between 2006 and 2007 total assets held in all pension schemes remained steady.

Assets held in insurer-administered individual pensions refers to funds held in contract-based pension schemes such as Group Personal Pensions (GPPs), Stakeholder pensions as well as individually organised contract-based pensions. At 2007, assets held were equal to £415 million. Despite increasing membership of contract-based DC in recent years, 2007 marked the second consecutive year that assets in these schemes fell in value. There are some possible explanations for this. Prior to 1988, contract-based pension policies were only available to the self-employed, but from July 1988 a change in pension legislation allowed anyone in employment to take out their own personal pension. As many of these
early policyholders retire, pension funds held in contract-based schemes may be being withdrawn. Following the introduction of ‘A-day’ changes on 6th April 2006, the benefits of investing in SPPPs changed. Insurance company providers were now faced with new competition for pension products from non-insurance company providers. This may have lead to some pension savings being moved out of insurance companies into these other types of organisations, who do not contribute to these figures.

Assets held in insurer-administered occupational pensions refer to assets held in both DB and DC occupational schemes. Between 2002 and 2007, assets held in such schemes almost doubled in value (from £225 billion in 2002 to £440 billion in 2007), despite declining occupational scheme membership (see Chapter 4). This increase in assets may partly reflect the strong increase in employer contributions to DB schemes that occurred over the period 2001 to 2006, when many of these schemes moved into deficit, see Chapter 5. Historically high contribution rates (when compared with contract-based schemes) and the continuing maturity of occupational schemes may also explain the rise in asset values observed.

Assets held in self-administered pensions are likely to be mainly DB scheme assets. They experienced a steep drop in value between 2000 and 2002, reflecting the market crash experienced at this time. However, between 2002 and 2007, assets increased in value by 53 per cent, from £670 billion to £1.1 trillion. This is likely to reflect the maturing DB scheme market and deficit correction activity.

---

127 ABI, 2007, Money in funded pensions.
128 ibid.
8.3.2 The recent financial downturn may have had a significant impact on DC asset values

The impact of the recent financial crisis on DC assets may have been quite significant. At March 2009, PwC estimated that some investments in DC schemes had declined in value to the extent that they were worth less than the cash contributions paid into them. PwC estimated that a saver – contributing five per cent of their salary or around £250 a month into an equity-based strategy over the
past decade – would have invested £24,000 into a DC fund, the present value of which would be £21,000, equating to an average annual loss of three per cent.\(^{129}\)

Aon estimated that DC assets fell in value by a third (or £180 billion) between September 2007 and the end of February 2009, to a value of £370 billion.\(^{130}\) Nevertheless, Aon found that DC assets started to recover in value from April 2009. At end of May 2009, they reported a DC asset value of £418 billion, an increase of ten per cent over the previous month.\(^{131}\)

### 8.4 Defined contribution assets with respect to broader household wealth

Table 8.1 presents a household sector balance sheet at 2007 produced by the ONS.\(^{132}\) In 2007, net equity in life assurance and pension funds made up over half of households’ total financial assets and 29 per cent of their net wealth. Investment held in residential buildings constituted 54 per cent of households’ net worth. Taking into account all assets and liabilities, the net worth of the household sector in 2007 was £7,520 billion.

<table>
<thead>
<tr>
<th>Table 8.1 UK household sector balance sheet, 2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>£ billion</td>
</tr>
<tr>
<td><strong>Assets</strong></td>
</tr>
<tr>
<td>Financial</td>
</tr>
<tr>
<td>Currency and deposits</td>
</tr>
<tr>
<td>Shares and other equity</td>
</tr>
<tr>
<td>Net equity in life assurance and pension funds</td>
</tr>
<tr>
<td>Other</td>
</tr>
<tr>
<td>Total</td>
</tr>
<tr>
<td>Non-financial</td>
</tr>
<tr>
<td>Residential buildings</td>
</tr>
<tr>
<td>Other</td>
</tr>
<tr>
<td>Total</td>
</tr>
<tr>
<td>Total assets</td>
</tr>
<tr>
<td><strong>Liabilities</strong></td>
</tr>
<tr>
<td>Loan secured on dwellings</td>
</tr>
<tr>
<td>Other</td>
</tr>
<tr>
<td>Total</td>
</tr>
<tr>
<td><strong>Net worth</strong></td>
</tr>
</tbody>
</table>

Source: ONS, March 2009, Pension Trends.

---


\(^{130}\) Professional pensions, March 2009.

\(^{131}\) Aon, 26th May 2009.

Looking now at the individual level and focusing specifically on those individuals who are approaching retirement (in the age range 52 to 64), Figure 8.2 shows how net wealth is distributed, on average, amongst different types of assets. The data is based on English Longitudinal Survey of Ageing (ELSA) data at 2002/03. As illustrated, on average, individuals had around two-thirds of their wealth held in some form of pension (61 per cent) with the rest held in owner-occupied housing (26 per cent) and other financial assets (eight per cent).

Of pension wealth held, about a half of this was held in the form of state pensions and the other half held in private pensions for the average individual. Of private pensions, 44 per cent was held in current DB pension schemes, ten per cent in current DC pension schemes and 46 per cent in other private pension schemes – where this category refers here to wealth held in pensions to which an individual has retained rights (deferred member) or from which an individual is already drawing a pension.

It should be emphasised that the data here refers to wealth holding of the average individual and should not be misinterpreted as applying to all individuals. The distribution and extent of wealth holding of individuals has been found to vary significantly by income and other factors.

---


134 Values do not sum to 100 per cent because of the methodology used to calculate mean average values from the survey sample.

Figure 8.2  Distribution of wealth amongst different types of assets for those aged 52 to 64 (mean values), 2002-03a, b, c, d

<table>
<thead>
<tr>
<th>Percentages</th>
</tr>
</thead>
<tbody>
<tr>
<td>100</td>
</tr>
<tr>
<td>90</td>
</tr>
<tr>
<td>80</td>
</tr>
<tr>
<td>70</td>
</tr>
<tr>
<td>60</td>
</tr>
<tr>
<td>50</td>
</tr>
<tr>
<td>40</td>
</tr>
<tr>
<td>30</td>
</tr>
<tr>
<td>20</td>
</tr>
<tr>
<td>10</td>
</tr>
<tr>
<td>0</td>
</tr>
</tbody>
</table>


a Values do not sum to 100 per cent because of the methodology used to calculate mean average values from a survey sample.

b Unit of observation is the individual. However, wealth of individuals in couples refers to the combined wealth of the couple since virtually all couples operate their finances jointly.

c DB pension wealth is calculated as the discounted present value of the stream of income from current DB scheme to which an individual currently has entitlement.

d DC pension wealth is calculated as the discounted present value of the stream of annuity income that an individual would receive if they annuitised their current pension fund immediately.

Figure 8.3 presents the same information as Figure 8.2 but this time broken down between two different age categories – 52 to 56 and 60 to 64. As illustrated, the younger group held more of their wealth in current pensions (22 per cent of wealth compared with nine per cent of wealth). However, this is almost offset by the older group having more of their wealth in ‘other private pensions’ (where the member is no longer contributing to the pension but retains deferred rights to it or is already drawing from it). The younger group had slightly more of their wealth held in current DC pensions (3.6 per cent of wealth compared with 2.5 per cent of wealth), perhaps reflecting the trend experienced over time for DC pensions to replace DB pensions, see Chapter 4.
Unfortunately, recent data on the DC assets of those approaching retirement is not available. However, for the average individual approaching retirement at 2002/03, the proportion of total net wealth in DC pensions (whilst likely high for a small number of individuals) was low, at approximately three per cent. We may expect the figure now (at 2009) to be somewhat greater, but of the same order, reflecting the cohort effect of the shift from DB to DC pensions. Following the 2012 reforms, the importance of DC pensions as a source of retirement income is likely to continue to increase. Given this, Watson Wyatt note that if the precipitous fall in global stock markets (combined with low annuity rates) that recently occurred had taken place, instead, in ten years’ time, the impact would have been significantly more damaging.\textsuperscript{136}

It should also be noted that a new longitudinal survey that collects information about the economic well-being of households and individuals will soon provide additional information about the assets that people hold in pensions and how that compares to other forms of wealth holding. The Wealth and Assets Survey (WAS) covers all forms of personal income, assets and debt and also reviews the take-up of pensions.\textsuperscript{137} Preliminary ‘experimental’ results from WAS were published in January 2008 based on half the Wave 1 sample and designed to indicate the range of data to be gathered by the survey. Analysis of pension data was very limited at this stage but the breadth and coverage of pension data that will ultimately be available from WAS will increase significantly. The main survey is scheduled for publication in late 2009.

\textsuperscript{136} Watson Wyatt, February 2009, \textit{DC – reality bites: the impact of the financial crisis on DC pension provision}.

\textsuperscript{137} ONS is producing the survey with input from other funding organisations which are: Department for Work and Pensions (DWP); Department for Business, Innovation and Skills; HM Treasury; HM Revenue & Customs; Department for Communities and Local Government and the Cabinet Office.
Figure 8.3  Distribution of wealth amongst different types of assets for those aged 52 to 56 and 60 to 64 (mean values), 2002-03 (more recent data not available)a

This chapter has discussed total DC pension assets. Chapter 9 will now discuss decumulation in DC – which refers to the process of converting pension funds that have been accumulated in DC pension schemes into retirement income.


More recent data is not available. We expect that DC assets would be a little more significant today, but of the same order.
9 Decumulation in defined contribution

9.1 Summary

- Decumulation refers to the mechanisms people use to turn their accumulated pension pots into streams of pension income in retirement.

- Developments in decumulation mean that defined contribution (DC) members now face a wide range of options upon approaching retirement. Yet despite the range of products available, evidence suggests that the majority of individuals still choose to purchase a single-life conventional life-time annuity.\textsuperscript{138}

- Annuity pricing is becoming more sophisticated. For example, new impaired/enhanced annuities provide higher than standard rates to purchasers with poorer life expectations.

- The open market option (OMO) means an annuitant is free to buy a pension annuity from any provider in the market. Nevertheless, evidence suggests that only a third of individuals purchasing their annuity do so on the open market.\textsuperscript{139}

- The number of annuities sold in the UK increased by 50 per cent between 2004 and 2008 – from approximately 310,000 to 450,000.\textsuperscript{140}

- The majority of annuities are currently purchased with a fund size of less than £20,000 and by those aged under 65.

- Falling long-term interest rates and increasing longevity have impacted on annuity rates in recent years. The financial crisis has also had a more recent impact: annuity rates for males aged 65 were 7.92 per cent in July 2008 and were 7.22 per cent at July 2009 (a fall of nine per cent).\textsuperscript{141}

\textsuperscript{138} ABI, 2008, Research paper No. 8, Pension Annuities.
\textsuperscript{139} \textit{ibid}.
\textsuperscript{140} ABI research.
\textsuperscript{141} Rate is for single-life, level annuity with a pension fund of £100,000. Annuity bureau, www.annuity-bureau.co.uk
9.2 Introduction

Upon reaching retirement, DC pension scheme members enter the ‘decumulation’ stage of the DC life-cycle. This is the process of converting the pension assets that a member has accumulated in their pension fund into a retirement income. There are legal restrictions on what people can use their accumulated pension pots for; these generally mean 75 per cent of the pot must be used to buy an annuity by age 75.

This chapter discusses the range of different choices available to DC members approaching retirement, including the different types of annuities and other decumulation products on offer. The chapter continues with a discussion of the availability and use of the OMO before briefly discussing size and segmentation of the UK annuities market, including the impact of the recent financial crisis on annuity rates.

9.3 Decumulation choice

Developments in decumulation are leading to an increasingly wide range of options available to DC pension members about to retire. Retirees can choose a life-time or short-term annuity which can be single or joint-life. Some retirees with a health problem or particular life-style can have access to an impaired annuity or enhanced annuity. Pension annuities can also be linked to investment – either unit-linked or with-profits. Retirees can also choose an income drawdown product.

Despite the range of products available, evidence suggests that most individuals still choose to purchase a single-life conventional life-time annuity. There are a number of possible reasons for this. Firstly, the low average value of a DC pension fund (see Section 9.5) can limit the availability and advantages of using more specialised pension products. Secondly, the wide range of choice of pension products and providers now available to consumers can lead to confusion, making decision making difficult (see Chapter 10) and result in people selecting the simplest option. Finally, current market conditions may also be affecting people’s appetites for investing in non-standard pension products which often have greater exposure to investment risk.

9.3.1 There is a wide range of different types of life-time annuities available and annuity pricing is becoming increasingly sophisticated

Most individuals purchase a life-time annuity with their pension fund when they retire. A life-time annuity is an investment which converts the capital accumulated into the individual’s pension fund into a taxable income stream which lasts for the rest of their life. There are a number of different variations to life-time annuities, discussed below:

---

142 ABI, 2008, Research paper No. 8, Pension Annuities.
Single and joint-life annuities

Life-time annuities can be single or joint-life. Single-life annuities will only pay out income throughout the annuitant’s life. Joint-life annuities continue to pay an income to the spouse or partner should the annuitant die.

The Association of British Insurers (ABI) found that 64 per cent of annuities sold (in volume terms) in 2006 were single-life and 36 per cent were joint-life.144 Figure 9.1 provides a breakdown of volumes and values of pension annuities sold between different types of product.

Guaranteed and not guaranteed annuities

If an individual dies soon after buying an annuity, the annuitant will have received little income from that annuity. A guaranteed annuity is one that will make payments for a minimum period even if the annuitant dies within that period. Guarantee periods are usually for five or ten years’ worth of income.

The ABI found that 71 per cent of annuities sold (in volume terms) in 2006 had a guarantee period and 29 per cent did not.145

Enhanced/impaired life annuities

Recent years have seen a progressively more sophisticated approach taken to the pricing of annuities. In particular, annuity rates are increasingly being linked with health and life-style factors. Such annuities are often referred to as ‘impaired’ or ‘enhanced’ annuities, and provide higher than standard rates to annuity purchasers with poorer life expectations. For example, people who smoke, are over-weight or who have relevant health problem may receive a higher rate. Some companies also offer higher annuity rates to people who have followed certain occupations or live in certain parts of the country.

Enhanced/impaired life annuities are not currently used widely yet evidence suggests that many more individuals could potentially qualify for them. ABI found that just five per cent of annuities sold (in volume terms) were enhanced/impaired life in 2006146 while Hargreaves Landsdown find that 40 per cent of consumers could qualify for an enhanced/impaired annuity.147

Investment-linked annuities

Investment-linked annuities link pension annuities to investments so that annuitants can continue to benefit from returns experienced from investing in the stockmarket, or otherwise, after retirement. With an investment-linked annuity retirement income is linked to the ups and downs of the underlying investment.

144 ABI, 2008, Research paper No. 8., Pension annuities.
145 ibid.
146 ibid.
147 Hargreaves Landsdown, 2008, The true cost of annuity purchase; why the open market option matters more than annual management charges.
rather than being pre-determined. These products typically have higher charges when compared to a traditional life-time annuity.

Investment-linked annuities can be either with-profits or unit-linked. In with-profits annuities, the pension annuity is invested in an insurance company’s with-profits fund. Premiums are pooled with other with-profits policy holders and everyone in the fund shares the profits and losses. In unit-linked annuities, the pension annuity is invested in units in investments. Income is linked directly to the performance of the assets invested in and annuitants can often choose the types of assets, depending on the level of risk and return sought.

The ABI found that just two per cent of annuities sold (in volume terms) in 2006 were unit-linked/with-profits.148

**Level and escalating annuities**

A further consideration when purchasing a pension annuity is whether to select a level or indexed (escalating) approach. Level annuities pay the same amount of income in cash terms (usually monthly) for the rest of the annuitant’s life and will therefore gradually decline in value in real terms due to inflation. Escalating annuities provide some protection to the annuitant from inflation and provide a lower initial annuity which then increases each year. There are two main choices of escalating annuities – fixed-rate escalating annuities (where income is guaranteed to increase at a fixed rate each year, say, by three per cent) and Retail Price Index (RPI) – linked annuities (where income is adjusted each year to reflect changes in the RPI).

The ABI found that only six per cent of annuities sold (in volume terms) were escalating in 2006 – see Figure 9.1.149

**Cash lump sums and trivial commutations**

Individuals may take up to a quarter of their pension fund as a tax-free cash lump sum. The rest of the fund must usually be used to purchase an annuity before the age of 75.

In addition, there are ‘trivial commutation’ rules in place which allow individuals with a modest pension fund to take the whole amount as a lump sum. There are a number of limits around the eligibility of trivial commutation including that the member must be over 60 but under 75 years of age, and that all pension funds must be converted to cash within a 12-month period.

Trivial commutation was originally introduced to save pension schemes the expense of administering very small benefits. In recent years there have been significant changes to the trivial commutation rules under the simplified tax regime for pensions introduced in April 2006 and, more recently, under the Finance Act

148 ABI, 2008, Research paper No. 8., *Pension annuities*.
149 *ibid.*
2008. This has resulted in trivial commutation becoming an option for a greater number of pension scheme members.

**Figure 9.1 Breakdown of pension annuities sales in 2006 by type of product (percentage volumes/percentage values)**

9.3.2 A wide range of income drawdown products is now available

Individuals who do not wish to purchase a life-time annuity at retirement have a number of options. Some of these are discussed below:

*Unsecured pensions using short-term annuities or income drawdown*

An unsecured pension allows an individual to draw income from their pension fund while keeping the remainder of the fund invested. Unsecured pensions can be combined with short-term annuities or income drawdown.

With a short-term annuity, part of the pension fund is used to buy a fixed short-term annuity and the rest of the fund remains invested. Short-term annuities can last for up to five years. At the end of the term of the annuity, individuals can buy another short-term annuity and can also combine income from a short-term annuity with income withdrawal.
Unsecured pension using income drawdown

With income drawdown (also sometimes referred to as ‘pension fund withdrawal’), individuals draw a flow of income from their pension fund while the remaining capital stays invested. The Government sets a limit on the maximum amount of income that can be taken from the fund.

A 2008 Financial Services Authority (FSA) survey of people found that 15 per cent of people who had purchased a decumulation product over the last five years were using income drawdown.\(^\text{150}\) The ABI estimate that at the end of 2007, there were 193,000 income drawdown policies in force, with funds under management totalling approximately £15.5 billion.\(^\text{151}\)

Alternatively secured pensions

Alternatively secured pensions (ASPs) work in similar ways to unsecured pensions but have different limits and rules. They are an alternative way that an individual can continue to invest their pension savings and draw an income from their fund at the same time.

Under ASPs, the income that can be drawn varies between 55 per cent and 90 per cent of limits set by the Government Actuary’s Department (GAD). The funds in ASPs are invested in a similar way to an unsecured pension arrangement and are therefore subject to investment risk.

9.4 Use of the open market option

9.4.1 Only a third of those purchasing an annuity do so on the open market

The Government introduced the OMO in 1978. This provides policyholders with the right to shop around for annuities and purchase from any provider in the market. To improve the effectiveness of the OMO, in September 2002, the FSA introduced new rules requiring pension providers to inform customers of their right to shop around before purchasing an annuity (the ‘wake-up’ letter).

Despite this, evidence suggests that large numbers of individuals still do not exercise their right to the OMO. In a 2008 survey conducted by the ABI, almost two-thirds of annuitants were found to have arranged their annuity ‘internally’ (through the provider of their private pension). ABI estimate that one-third of annuitants shop around then buy externally, one-third shop around then buy internally and one-third do not shop around (and buy internally).\(^\text{152}\)

\(^\text{150}\) FSA, 2008, Consumer research report No. 76, Consumer purchasing and outcomes survey.

\(^\text{151}\) ABI research.

\(^\text{152}\) ABI, 2008, Research paper No. 8, Pension Annuities. The survey was of 36 ABI member companies providing annuities, of which 26 responded to the survey representing 89 per cent of annuity contracts. ABI supplemented this with additional research using existing data form the ABI, the FSA comparative tables and elsewhere.
In a recent HM Treasury publication, the Government sets out its belief that annuities (or other products that provide an income until death) will meet consumer needs in retirement and that its long-term strategy will focus on educating savers on how to make the right choices, rather than changing the current rules.\(^\text{153}\) A key part of this strategy involves ensuring that the OMO is widely and properly applied. The Government has recognised that there are still improvements to be made in this area.\(^\text{154}\) To date, much of the focus has been on ensuring that consumers are aware of their right to shop around to select the provider of their annuity. However, that consumers purchase the right type of annuity or other decumulation product (as well as getting the best rates for these products) is also highly important. The Government has established the OMO Working Group which will work to improve the operation of the OMO for consumers involving input from the Department for Work and Pensions (DWP), HM Treasury and other stakeholders.

9.5 Size and segmentation of the annuities market

This section discusses the size and rate of growth of the UK annuities market. It also examines average fund sizes used to purchase an annuity and discusses how this varies by gender and age.

9.5.1 The UK annuities market has increased in size by at least 50 per cent (in volume terms) since 2004

The number of annuities sold in the UK increased by 50 per cent between 2004 and 2008 – from approximately 310,000 to 450,000, as illustrated in Figure 9.2.\(^\text{155}\) Despite the recent financial crisis, total annuity sales in the third and fourth quarter of 2008 and first and second quarter of 2009 kept pace with previous years – at approximately 115,000 annuities sold per quarter.

In 2006, there were 36 ABI member companies selling annuities, down from 42 in 2000. Of these 36, 14 firms had market shares of over one per cent, while the market share of the top ten firms accounted for 89 per cent of the market.\(^\text{156}\) DWP research into the competitiveness of the UK annuities market argues that while the number of annuity providers has declined significantly in recent years, monopoly power is not in operation.\(^\text{157}\)


\(^{154}\) HM Treasury, November 2008, *Open market option: an update on the review*.

\(^{155}\) ABI research. It should be noted that this data refers to the size of funds used to purchase an annuity – after any upfront cash lump sums have been taken.

\(^{156}\) *ibid*.

\(^{157}\) Cannon and Tonks, 2006, DWP research report No. 318.
Figure 9.2  Annuity sales by size of fund

The majority of annuities are purchased with a fund size of less than £20,000 and by those aged under 65

In 2008, 350,000 annuities (76 per cent of annuities sold) were purchased with a fund size of less than £30,000 while only 18,000 annuities (four per cent of annuities sold) were purchased with a fund size of £100,000 or above, see Figure 9.2.

Figure 9.3 shows the mean average fund size used to purchase an annuity over the period 2004 to 2008 (in nominal terms). In 2004, the average fund size used to purchase an annuity was £20,800 and this has risen in nominal terms to £26,000 at 2008. Despite the recent financial crisis, the average fund size grew between the third and fourth quarter of 2008 – from £25,200 to £27,900. Mean values of fund size may be a misleading indicator of the majority of fund sizes since they are likely to be skewed by a small number of annuitants who have very large pension funds. Analysis indicates that the majority of annuities purchased are done so with a fund value of less than £20,000.
Figure 9.4 shows annuity sales for 2007 broken down by age and gender of annuitant. Males purchased over twice the number of annuities than females in 2007 – 310,000 annuities purchased compared with 140,000 for females. Overall, 67 per cent of annuities are purchased when the annuitant is under the age of 65, with just 1.9 per cent purchased by those aged 74 or over. Men are more likely to delay purchasing an annuity than women – 40 per cent of men purchase an annuity post 65 compared with 16 per cent of women.

The impact of extending working life can have a significant impact on an individual’s pension fund. Life expectancy continues to increase and, although not true for all, many people who live longer do so in a healthy way which allows them to continue working to a later age. Extending working lives can have a dramatic impact on retirement income by extending the period over which pension contributions are made, extending the period over which the pension fund accrues returns and by allowing the individual to receive a better annuity rate (because the expected period over which they will receive retirement income before they die is reduced).

Figure 9.3  Mean average fund size used to purchase an annuity, 2004-2008, nominal-terms

Source: DWP calculations using ABI research data.
9.5.3 Falling long-term interest rates and increasing longevity have impacted on annuity rates

Annuity rates depend on a number of factors including the type of annuity purchased and the amount of money invested in the pension fund. Over the longer term, annuity prices are also linked to long-term interest rates and life expectancy. During the 2001 to 2003 market crash, the fall in equity prices was coupled with a decline in the long-term interest rate. This decline, combined with increasing life expectancy, led to a fall in annuity rates.158

More recently, the current financial crisis has also impacted on annuity rates. Annuity rates for males aged 65 were 7.92 per cent in July 2008 and are 7.22 per cent at July 2009 (a fall of nine per cent).159

Recent press coverage has also highlighted the impact that Solvency II may have on annuity rates. Solvency II is a fundamental review of the capital adequacy regime for the European insurance industry.160 Members of the pensions industry

---

159 Rate is for single-life, level annuity with a pension fund of £100,000. Annuity bureau, www.annuity-bureau.co.uk
have speculated that the new higher capital requirements needed to meet the risk management standards required by Solvency II will result in less attractive annuity rates for retirees in the UK.\textsuperscript{161} The European Commission has stated that it aims to have the new Solvency II framework in operation in 2012.\textsuperscript{162}

This chapter has discussed decumulation in DC. Chapter 10 will now discuss the financial capability, behaviour and attitudes of DC pension members.

\textsuperscript{161} Citywire, 7th July 2009, \textit{Solvency II proposals threaten annuity rates}.

\textsuperscript{162} European Commission, July 2007, \textit{Solvency II: Frequently asked questions}. 
10 Financial capability, behaviour and attitudes of defined contribution pension members

10.1 Summary

- A growing body of literature examining people’s perceptions and behaviour in relation to pensions exists and is well documented by the Pensions Commission and others.\textsuperscript{163}

- Many people have a poor understanding of pensions with investment risk and decumulation being particular areas of confusion.

- Many people are not saving sufficiently for retirement and, when they do save, will often make poor decisions – for example, by not diversifying, by being heavily influenced by default options and by following the market.

- Many factors may explain the tendency for individuals to make poor saving decisions. Such ‘barriers to saving’ can be broadly categorised as informational/attitudinal barriers, structural barriers and behavioural barriers.\textsuperscript{164}

- Pensions compete with alternative assets as a means of saving for the future but, according to National Association of Pensions Funds (NAPF) in 2009, are still the most popular choice of asset amongst those saving for retirement.

- Evidence suggests that confidence in defined contribution pension products has suffered in recent years on account of poor investment returns resulting from falling asset prices and a perception of low annuity rates.


10.2 Introduction

This chapter briefly reviews evidence regarding the financial capability, attitudes and behaviour of DC pension members. A growing body of literature examining people’s perceptions and behaviours in relation to pensions exists, and is well documented by the Pensions Commission and others – for example, see the DWP research paper ‘Incentives to save for retirement: understanding, perceptions and behaviour’. This chapter does not attempt to provide a full review of this literature, but rather summarises some of the key findings.

10.3 Financial capability

10.3.1 Many people have limited financial capability and understanding of pensions

Many people do not have a good understanding of pensions. The report, ‘Attitudes to pensions: The 2006 survey’ found that just five per cent of respondents felt that they had a ‘good’ knowledge of pension issues while 67 per cent of people agreed with the statement ‘I find all pensions confusing’.

The Pensions Commission described the UK pensions system as the most complex in the world. Consumers are faced with many different choices regarding their pensions over the course of their lives including whether to take a pension, the type of pension to take, how much to invest, when to annuitise, whether income drawdown is an option, and how to combine pension investment with other asset holdings. The fact that all of these choices can involve many different providers and products adds to the complexity.

Research has shown that even relatively basic subject areas create confusion for many when it comes to pensions. For example, a recent survey carried out by the Association of British Insurers (ABI) found that 45 per cent of people thought that a pension and an annuity were the same thing; while another survey found that 42 per cent of consumers were unaware that you can receive tax relief on pension contributions. Meanwhile, a Financial Services Authority (FSA) study found that only 31 per cent of those who were under the state retirement age knew what their state pension income might be.

ABI, 2005, Serious about Saving – Annuities: Bonus or Burden?
FSA, 2007, Finance in and at retirement – results of our review.
Understanding of investment risk and decumulation appear to be particular areas of difficulty. A recent study of 54 pension professionals by the Pension Institute at the Cass Business School found that, on average, survey respondents estimated that only ten to 15 per cent of DC scheme members understand the investment risks they face. Over half of survey respondents put the figure at ten per cent or less.171 In 2007, the FSA found that while knowledge around pre-retirement DC options appears to have improved, understanding of newer developments such as decumulation products including annuities, income drawdown and equity release172 remains poor.173

A range of sources provide information and advice on pensions including independent financial advisors (IFAs), employers and publicly available government information. However, there is evidence to suggest that people are not necessarily motivated to seek information about pensions and financial services, particularly amongst lower income groups.174 A recent study by the FSA found that, of a sample of consumers buying decumulation products, a relatively small number (19 per cent) had spoken to more than one adviser before deciding which product to buy.175

Where consumers do seek support, they tend to rely on IFAs, rather than carrying out their own research or benchmarking. The FSA found that seven out of ten purchasers of decumulation products cited IFAs as the only or most useful source they had consulted while company information was found to be the second most useful source.176

Evidence on the impact of financial education is not easy to measure and, as yet, there is limited UK evidence on its impact on individual’s subsequent financial decision-making.177 Nevertheless, a recent survey of members of mid-sized UK DC pension schemes found that individuals who received financial advice expressed a more realistic view of the amount that they needed to save in order to ensure an adequate retirement.178

Following the Thoresen review in 2008, the Government announced that the FSA would lead a two-year programme to set up a service offering free, impartial

171 Pensions Institute, 2007, Dealing with the reluctant investor: Innovation and governance in DC pension investment.

172 Equity release is a scheme which allows an individual to retain use of their home or other asset which has capital value while also obtaining a stream of income using the value of that asset.


175 FSA, 2008, Consumer purchasing and outcomes survey.

176 FSA, 2008, Consumer purchasing and outcomes survey.


178 Byrne, A., 2007, Employee Saving and Investment Decisions in Defined Contribution Pension Plans: Survey Evidence from the UK.
information and guidance on money matters to the public.\textsuperscript{179} This would draw on the FSA’s National Strategy for Financial Capability launched in 2006, which aims to ‘equip people to manage their money more confidently’.\textsuperscript{180} Recent FSA financial capability initiatives include Moneymadeclear, a dedicated website to help people manage their money and compare products, and the ‘make the most of your money initiative’, which provides financial education and information direct to employees in their place of work.

10.4 Behaviour

10.4.1 Poor pension decision making can be explained by informational/attitudinal, structural and behavioural factors

Many people are not saving sufficiently for retirement\textsuperscript{181} and, when they do save, will often make poor decisions – for example, by not diversifying, by being heavily influenced by default options and by following the market. This phenomenon is well recognised and has been examined in much of the behavioural economics literature, documented by the Pensions Commission\textsuperscript{182}, the Personal Accounts Delivery Authority (PADA)\textsuperscript{183} and others.\textsuperscript{184}

Many factors may explain the tendency for individuals to make poor saving decisions. Such ‘barriers to saving’ can be broadly categorised as informational/attitudinal barriers, structural barriers and behavioural barriers:\textsuperscript{185}

- **Informational/attitudinal barriers.** This relates to the low financial capability of consumers, and the lack of understanding about the need to engage in effective planning for retirement, leading to poor pension decision making. It also relates to poor perceptions people often have about saving, including lack of trust of the institutions that provide pensions, which reduce people’s

\textsuperscript{179} Thoresen, March 2008, *Thoresen review of generic financial advice: final report*.

\textsuperscript{180} FSA, March 2008, Press release, *FSA to lead ‘pathfinder project’ delivering a national money guidance service*.

\textsuperscript{181} In a recent study, PwC found that nearly 20 per cent of the working population are failing to ensure provision of a suitable pension. See Wicks, R. and Horack, S., 2008, DWP Research Report No. 562. Calculation based on ONS and DWP statistics.


\textsuperscript{183} PADA, 2009, Building Personal Accounts: designing and investment approach. A discussion paper to support consultation.

\textsuperscript{184} See, for example, Bernatzi who showed that people tend to follow the market and invest in assets that have recently been performing well, possibly showing little consideration to fundamentals and the likelihood of future performance. Bernantzi, S, 2004, *DWP ministerial seminar*.

incentives to save. Which? 2006 survey results showed that fewer than one-third of those questioned trusted financial institutions to run their pensions.\textsuperscript{186}

- **Structural barriers.** This includes the complexity of the UK private and state pension system which can overwhelm individuals and lead to decision fatigue. The Pensions Commission, reporting in 2004, argued that the private sector pension market under-provides for individuals on low to middle incomes making it more difficult for them to contribute to a private pension even if they wanted to.\textsuperscript{187}

- **Behavioural barriers.** A large number of behavioural/psychological factors are also cited in the literature as potential barriers to saving.\textsuperscript{188} For example, myopia is said to occur when people strongly discount the future and do not act in their long-term self-interest. ‘Hyperbolic discounting’ can occur where people do not discount the future at a constant rate so preferences for smaller pay-offs now over greater pay-offs later may be regretted. Inertia is linked to feelings of apathy, hopelessness and disinterest and is considered in the literature to be another major barrier to pension saving. Such apathy featured strongly in research conducted into employees on behalf of DWP where ‘the dominant attitude to emerge…was of considerable, often substantial, apathy and indifference with respect to pensions’.\textsuperscript{189}

The 2012 pension reforms are intended and expected to increase participation in pension schemes (see Box 2.1 for more information). Automatic enrolment is intended to overcome barriers to inertia, myopia and perceived complexity that have traditionally discouraged opt-in participation. Unlike commercially run pension providers who are not required to provide services to all employers who request them, the new Personal Accounts scheme will be available to all employers, thereby helping to improve access to pension provision. In addition, the financial incentives of tax relief and mandatory minimum contributions from employers are intended to persuade most of the auto-enrolled who are tempted to opt-out to resist and remain enrolled.


\textsuperscript{188} Wicks, R. and Horack, S., 2008, DWP Research Report No. 562.

10.5 Attitudes

10.5.1 The recent financial crisis may have made people more sceptical about pension saving

Pensions compete with alternative assets as a means of saving for the future. According to the National Association of Pension Funds (NAPF) in 2009, pensions were the most popular choice amongst those saving for retirement for 39 per cent of those surveyed, ahead of property (20 per cent) and ISAs (16 per cent).190 However, research carried out in 2008 showed that, in recent years, people have increasingly looked away from pensions to alternative savings or investments, such as property, as a source of funds for retirement. This research found that half of all employees saw property as a source of retirement income in 2008.191 It is likely that these opinions will change as market conditions change.

Further research finds that there are two popular (and negative) perceptions commonly related to DC pensions when compared with defined benefit (DB) pensions, that they will:

- leave people with lower incomes in retirement; and
- cause people to delay their retirement.192

The FSA has identified that confidence in DC pension products may have suffered in recent years on account of poor investment returns resulting from falling equity and asset prices and low annuity rates. The FSA concludes that savers may be more likely to place an increased premium on security of their savings in the future, to be reflected in a more conservative choice of investments, and investments backed by higher levels of compensation.193

DWP research published in summer 2007 found that half of respondents agreed that putting money into a pension is the safest way of saving for a retirement. Respondents were also asked how much they trusted or distrusted different types of organisation, when thinking about the pensions they have or might have in the future. Employers were the most trusted organisation, followed by a non-profit independent organisation, followed by the financial services industry, with the Government being least trusted.194

---

192 Smith, S., 2005, What do defined contribution pensions mean for retirement?
194 Kelly, M., Summer 2007-08, Trust and confidence in pensions and pensions providers, Research Summary.
Recent survey research conducted by the ABI in January 2009 finds that only seven per cent of respondents think the benefits of saving have gone up over the past 12 months, compared with 15 per cent of respondents in the third quarter of 2008. In contrast, the proportion of those who felt that there were now fewer benefits to saving increased by 20 percentage points from 53 per cent to 73 per cent between the third and fourth quarter of 2008. Government contributions and guaranteed returns on pension savings were found to be the most popular choice for inducing (non-retired) working respondents into saving more. Nevertheless, the number of people who said nothing would persuade them to increase pension saving was found to be at its highest level in more than three years.

This chapter has briefly summarised the growing body of literature that identifies a range of behavioural and attitudinal issues that create barriers to DC pensions saving.

---


196 Ibid.


ABI, (2008), Research paper No. 8., *Pension annuities.*


ABI, (2005), *Serious about Saving – Annuities: Bonus or Burden?*

ABI, (2005), *The pension annuity market: further research into supply and constraints.*


Byrne, A., (2007), *Employee saving and investment decisions in defined contribution pension plans: survey evidence from the UK,* University of Strathclyde.


Citywire, 7th July 2009, *Solvency II proposals threaten annuity rates,* citywire.co.uk


DWP, (December 2006), Personal accounts: a new way to save.

European Commission, July 2007, Solvency II: Frequently asked questions.

Financial Services Authority (FSA) (2009), Financial Risk Outlook.

FSA, (March 2008), Press release, FSA to lead ‘pathfinder project’ delivering a national money guidance service.

FSA, (2008), Consumer purchasing and outcomes survey.

FSA (2008), Consumer research report No. 76, Consumer purchasing and outcomes survey.

FSA, (2007), Finance in and at retirement – results of our review.

Hargreaves Lansdown, (2008), The true cost of annuity purchase; why the open market option matters more than annual management charges.

HM Treasury, (November 2008), Open market option: an update on the review.


Kelly, M., (Summer 2007-08), Trust and confidence in pensions and pensions providers, Research Summary.

Leston, J. and Watmough, M. (2005), Department for Work and Pensions Research Report No. 294, Providing pensions information and advice in the workplace where there is little or no employer contribution: Pilot evaluation findings based on survey and qualitative research.


National Association of Pension Funds (NAPF), (2009), Workplace Pensions Survey.

NAPF, (2008), Annual Survey.

Office for National Statistics (ONS), (2008-09), Pension Trends.

ONS, (1997 – 08), Annual Survey of Hours and Earnings.


Personal Accounts Delivery Authority (PADA), (May 2009), Building Personal Accounts: designing an investment approach. A discussion paper to support consultation.


Pensions Institute, (2007), *Dealing with the reluctant investor: Innovation and governance in DC pension investment*.


The Pension Protection Fund, 2009, *The PPF 7800 index*.


Thoresen, (March 2008), *Thoresen review of generic financial advice: final report*.

PricewaterhouseCoopers LLP (March 2009), Press release, *Two decades of underperformance for defined contribution schemes leaves employers and employees between a rock and a hard place*, http://www.ukmediacentre.pwc.com

Professional pensions, (March 2009), *Defined contribution schemes lost 10% in February*, http://www.professionalpensions.com/847021

Professional pensions, (2009), *DC disappointment blamed on lack of knowledge*, www.professionalpensions.com/846763


Watson Wyatt, (February 2009), *DC – reality bites: the impact of the financial crisis on DC pension provision*.


Wood, A., Leston, J. and Robertson, M., (July 2009), DWP Research Paper No. 591, *Current practices in the workplace personal pension market: Qualitative research with pension providers and intermediaries*.