TUC
Changing the world of work for good

Fixing the Retirement Lottery

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Section One

Introduction

At the heart of the Trades Union Congress's (TUC) approach to pensions is the belief that what people seek more than anything for their retirement is security and stability. And that for most of today's workers, their ability to provide for themselves in their old age is a lottery.

This report began life as a series of blogs on the TUC website. Feedback from readers from both within and without the trade union movements has confirmed a view that the prevailing pensions system is not delivering what members expect. Where differences of opinion lay is in the relative importance this work should give to improvements in state pension(s) versus enhancements to workplace provision.

Meanwhile, some of the policy options we explored have gained traction.

We suggested levying pension contributions from the first pound of earners. This was contained in the government's review of automatic enrolment and is pencilled in for implementation in the early 2020s.

We proposed lowering the starting age for contributions. That too, was endorsed in the review.

Meanwhile, the Royal Mail and CWU trade union have agreed the implementation of a Collective Defined Contribution scheme for 144,000 workers, including those currently enrolled in a conventional defined contribution scheme. By pooling savings together, a CDC scheme can prove more efficient, less volatile, and geared up to provide the income in retirement members say they need. The momentum for the creation for the necessary regulations could be aided by an inquiry by the Work and Pensions Select Committee into the topic.

But much more needs to be done to ensure workers receive decent pensions. This report maintains our primary focus on our system of workplace provision. It is here where government policy is unfinished. And it is here that there is the greatest potential for improvement.

That is not to say that the TUC is content with state pension provision. How can we be when the latest data from the OECD shows that our existing system is the least generous in the developed world? It remains the case that improvements to state provision are the most effective means to countering inequalities such as those between men and women. We will continue to lobby hard for an improved state pension. The maintenance of arrangements that ensure that this rises by at least 2.5 per cent a year – the triple lock - is one tool to gradually improve its value.

Workplace pensions is a venue of both considerable improvements for many workers while others face declining quality of provision. The roll-out of automatic enrolment, which

assumes workers will amass a pension unless they actively opt out, has given millions of people access to a retirement scheme with an employer contribution.

But despite the success of auto-enrolment, your chance of having a workplace pension still often depends on your workplace and earnings. And even once enrolled, the level of savings made, the growth of that pot and their ability to turn it into a sustainable replacement wage in retirement are largely outside the individual's control. Yet, for almost all savers, provision is still held to be primarily that individual's responsibility.

How did we get here?

Pension provision has evolved since the Second World War. The initial decades were characterised by relatively strong state and occupational pension provision, at least for men in full-time employment. The fruits of this are being harvested today. Four in five pensioner households now benefit from workplace pension income. It was less than half in 1977.

This system unravelled from the 1980s as the government favoured individualism. And employers increasingly reduced or abandoned support for workers' retirement provision. The result was a situation where, by 2012, a minority of private sector workers was enrolled in a pension scheme. The state pension dwindled in value.

Reforms rolled out from 2012 centred on automatic enrolment into workplace pensions, building on the work of the Pensions Commission that deliberated from 2002 to 2006. The body benefited from the input of commissioners with backgrounds in the trade union movement, business and academia.

By requiring workers to actively opt-out if they do not wish to save for retirement, as many as eight million more savers have been brought into workplace pensions with a compulsory employer contribution. A lid was put on charges levied on savers. And a state-backed provider NEST was established to not only ensure that all firms could find a pension provider but to pioneer standards across the pensions industry.

But while support for the initial Pension Commission proposals has been sustained, there has been little attempt to establish a fresh consensus on future reforms. For instance, appeals from the TUC and many others for a standing Pensions Commission to consider evidence for future pension policy initiatives, have been rebuffed.

Ministers have sometimes been diverted down other avenues that are at best irrelevant but in some cases greatly risk exacerbating the lottery elements of the current set-up. Where the Pensions Commission sought to utilise inertia to nudge people towards saving, innovations like the Lifetime ISA assume that the carrot of tax incentives is enough to encourage people to put money aside. There has yet to be much interest shown by savers. More dangerously, while workplace pension saving is driven by inertia, pensions freedom changes introduced in 2014 that allow a saver to cash in a pension at age 55 has placed decision-making, and responsibility if things go wrong, firmly on the shoulders of the individual.

This reports sets out the flaws in the current system:

- The employment lottery that means that workers in some sectors have decent provision, while in many others large numbers are excluded from pensions or receive very little.
- The investment lottery that means that someone who retires in a good year for investment markets can be many thousands of pounds a year better off than an otherwise identical saver who leaves in a bad year.
- The risks for individuals of a retirement income system that provides no clear route for securing a lifetime income.

We set out a range of policy options including:

- Greater urgency in implementing agreed reforms, such as the move to calculate pension contributions from the first pound of earnings.
- Bringing more low earners (notably women) into the pensions system by abolishing the £10,000 earnings trigger for automatic enrolment.
- The need for government to set out a route map to improve contribution rates over the long term.
- Changes to pensions regulation to make it easier for open defined benefit schemes to remain open.
- Introduction of regulations to allow Collective Defined Contribution pension schemes.
- A crackdown on costs in pension schemes by ensuring that charges are transparent and pension schemes have the scale and power to drive down prices.
- The introduction of default pathways at retirement, to make it easy for retirees to secure a good standard of living in old age.

Section 2

The employment lottery

Working people's ability to access a pension has improved enormously in recent years. As many as nine million more workers have been enrolled into a workplace pension scheme with employer contributions since automatic enrolment started to be rolled out in 2012. The provision of pensions (with an employer contribution), which dwindled to a minority of private sector workers, is now commonplace.

Yet around 8.8 million workers, around one in three employees, are not currently saving into a pension scheme, according to the Annual Survey of Hours and Earnings (ASHE). And this headline figure, while worrying in itself, disguises great inequalities in the UK workforce.

In some occupations up to 85 per cent of the lowest paid are not in a pension scheme, and are missing out on the employer contributions that better paid workers receive. Some industries, such as agriculture and wholesale and retail, also lag far behind the norm.

Workers want money in their pockets today from decent wages. But they also want security in old age. Households in receipt of private pensions enjoy 1.6 times the disposable income of those without. Those excluded are at great risk of a low standard of living in retirement.

TUC analysis, based on ASHE data, shows:

- Among highly-paid professionals earning more than £600 a week, nearly nine out of ten are saving into a pension.
- But, at the other end of the spectrum, 85.8 per cent of those in sales or customer service jobs paying £100 or less a week are not members of a scheme.
- Four in ten employees undertaking care, leisure and other service work (39.3 per cent) are not enrolled in a pension scheme, including nearly three quarters of the lowest paid (73.4 per cent).
- On an industry basis, agriculture performs worst, with two-thirds of workers in this sector without a pension.
- But in absolute numbers the wholesale and retail sector ranks at the bottom with nearly 1.9 million employees, some 44.7 per cent of those working in the industry, unpensioned.
- Meanwhile, the amount employers contribute to their workers' pensions varies dramatically from sector to sector.

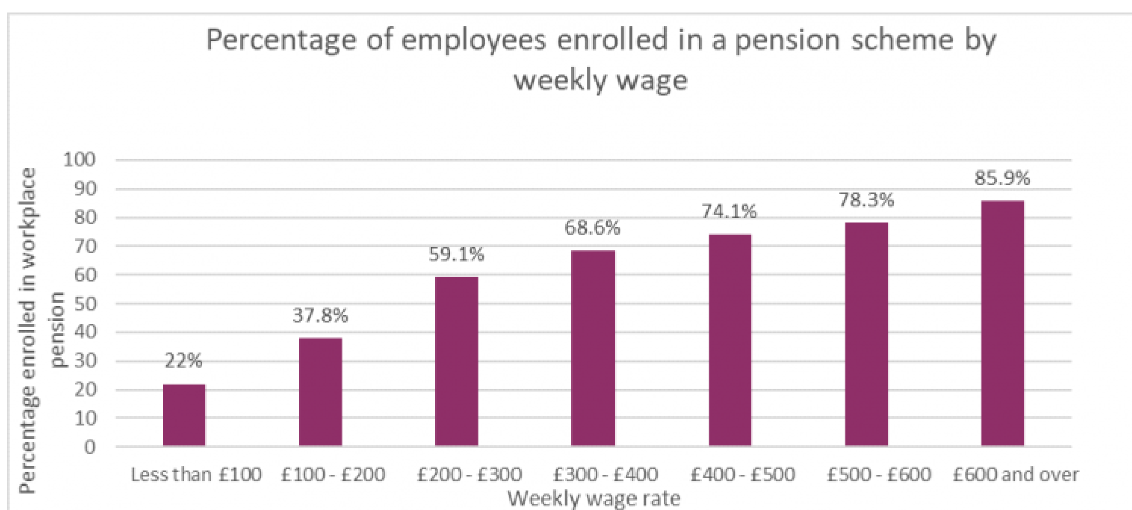
This suggests that the pensions system, as it is currently structured, risks leaving behind millions of workers.

It hardwires in inequality between low paid and better paid occupations. Those who earn under £10,000 do not have to be automatically enrolled into a workplace pension.

Many employers choose to enrol their entire workforce in a scheme. However, in some sectors, notably those without a recent history of making retirement provision for workers, firms are doing the minimum needed to comply with the law.

TUC analysis published in summer 2016 found that of the 26.4 million employees in the UK, 4.6 million (or 17.6 per cent) earn less than the £10,000 trigger level. A majority of these workers are women. The trigger has a particularly unfair impact on those 106,000 workers, (70 per cent of them women) who hold multiple jobs which combined would take them over the £10,000 threshold.

The lack of pension provision means that the pay gap is wider than at first apparent with low paid workers missing out on employer pension contributions. It also suggests that whatever gap in pay workers experience in their working lives could be amplified in retirement.



Source: ASHE

We therefore end up with industries that are pension blackspots. At the top of list is agriculture where nearly two-thirds of employees are without a pension. This includes more than 95 per cent of those earning less than £100 a week.

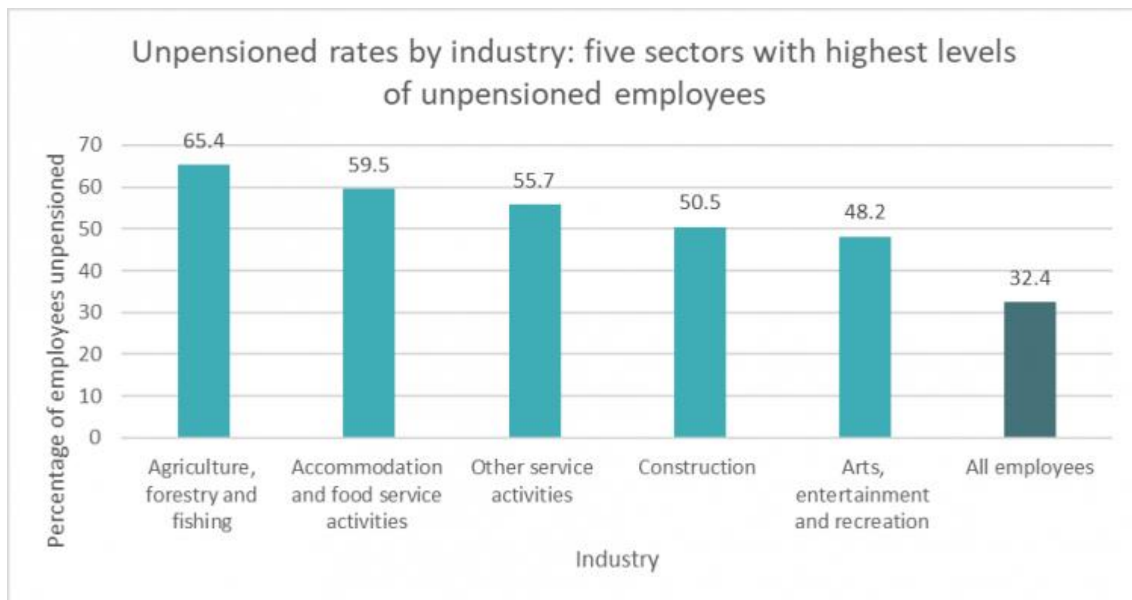
Other outliers include the large accommodation and food services sector where 900,000 people were unpensioned according to the latest figures, construction and arts, entertainment and recreation.

But in absolute numbers the wholesale and retail sector ranks at the bottom with nearly 1.9 million employees, some 44.7 per cent of those working in the industry, without pension provision.

Contrast this with those working in public administration, 93 per cent of whom are enrolled in a pension scheme. Or the financial and insurance sector, where only 13 per cent of employees are unpensioned.

In some of these sectors enrolment rates will have risen as automatic enrolment is extended to the smallest companies and members are captured in official data. However, it still reveals a worrying disparity between sectors.

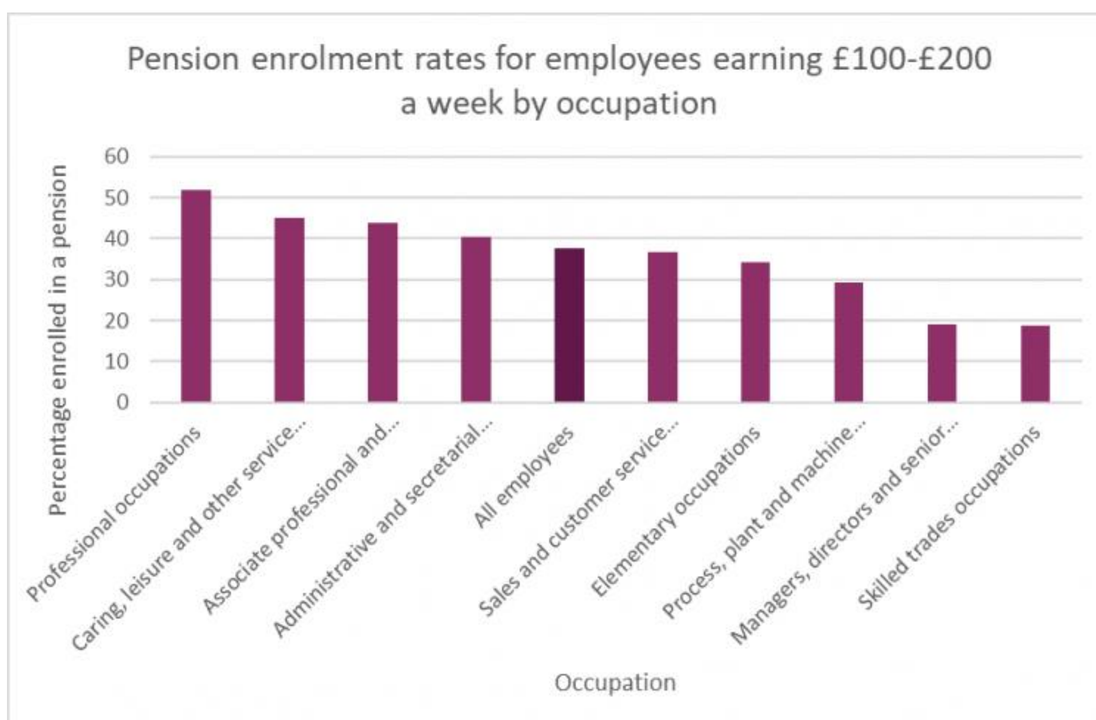
Many of these underpensioned sectors typically employ large numbers of women.



Source: ASHE

It is also clear that there is not a straightforward link between earnings and pension, with some occupations much better provided for, even when earnings are low. In sales and customer service roles, 85.8 per cent of those receiving less than £100 a week are not in a pension scheme. But when it comes to professionals, two in five in the same income bracket are having money put aside for their retirement.

Likewise, four out of five employees earning between £100 and £200 a week who are categorised as managers and directors, and a similar proportion in skilled trades are not in a pension scheme. But 45 per cent of those in caring, leisure and other service occupations are enrolled.



Source: ASHE

Meanwhile, 35.8 per cent of those in administration roles earning £200 to £300 a week are unpensioned, but 62.2 per cent of those in skilled trades are not saving.

The gaps in pension provision moderate among higher earners, those taking home more than £600 a week. However, professionals continue to outstrip the others, with nine out of ten of them enrolled in a pension. Occupations such as process, plant and machine operatives (enrolment rate of 80 per cent) lag behind.

This is evidence of differences in norms of pension provision between occupations and industries, particularly when it comes to the low paid. This suggests that further policy initiatives are required.

Contribution rates

It is not just whether an employer pays into a pension that matters, but also how much they pay. Our analysis shows that this also varies widely by sector.

The amount that an employer pays into a pension is a key determinant of whether the sums saved by a worker by retirement is sufficient for a decent standard of living.

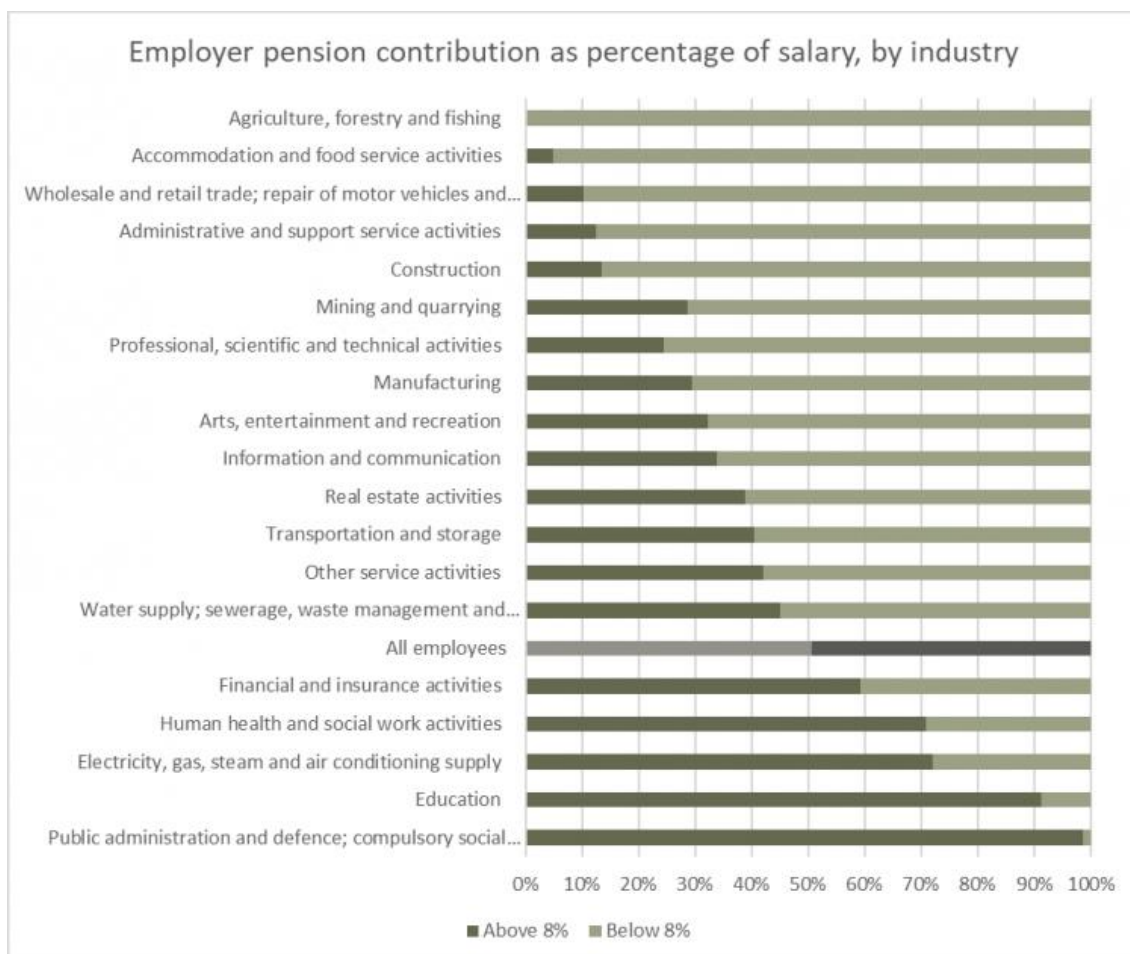
Average contributions to workplace pensions are tumbling. This shift is attributed to some extent to those employers being required to offer pension schemes for the first time, providing contributions at the legal minimum of just one per cent.

More than half of those enrolled in defined contribution schemes are receiving employer contributions of less than four per cent, according to official data. TUC analysis of ONS data shows that this includes some 88.4 per cent of pension scheme members in

accommodation and food services and three quarters of those in administrative or support service activities. But only 15.2 per cent of those in financial services have such low employer contributions.

Some of the diversity is down to a division between those sectors in which defined benefit schemes are commonplace, and those where they are not. When many employers closed defined benefit (DB) schemes they took the opportunity to slash the amount they contributed to workers' pensions. Meanwhile, regulatory pressure and rock-bottom gilt rates, which make funding schemes more expensive, mean that sponsors of many DB schemes are putting in growing amounts.

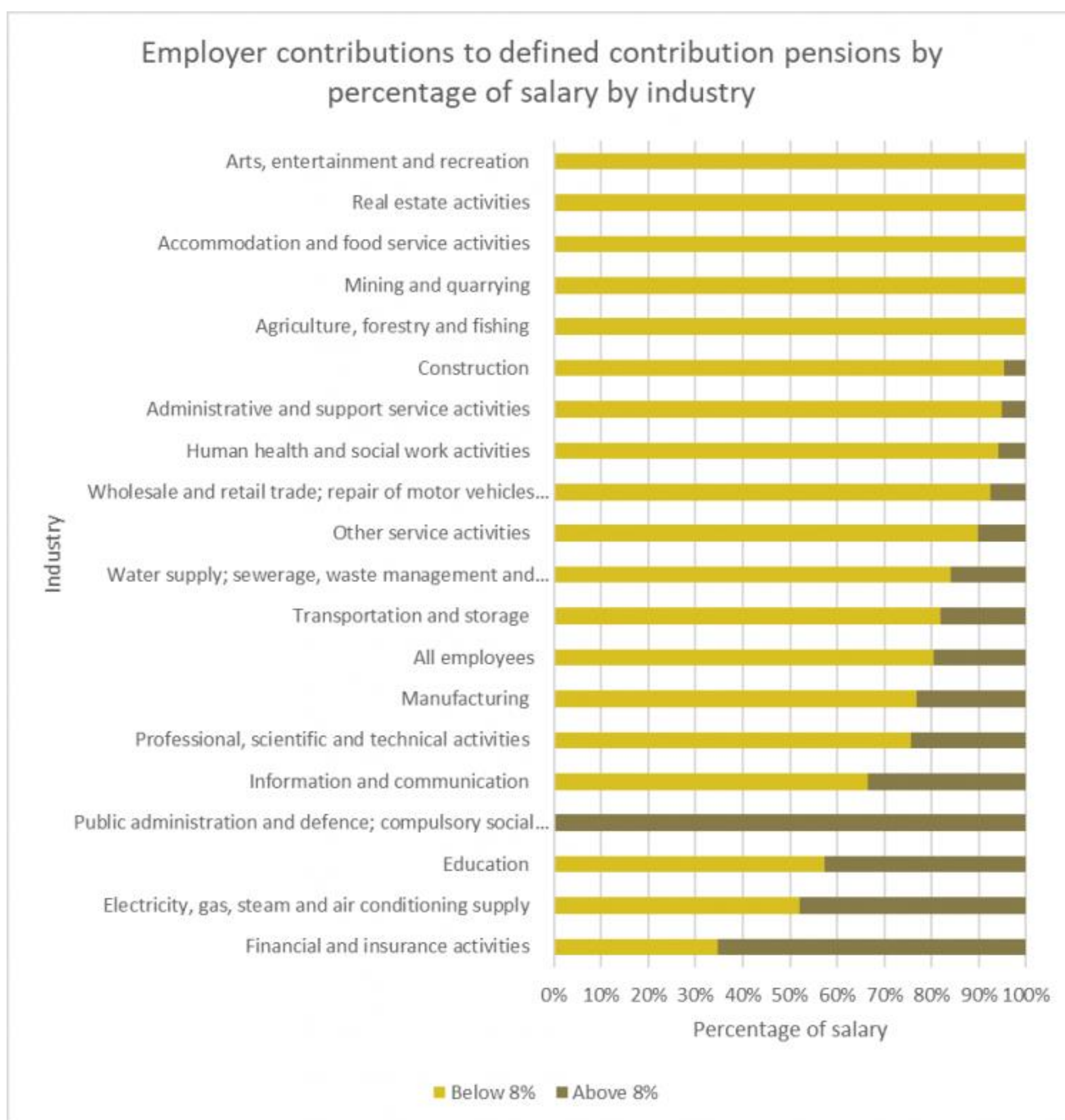
Nearly three quarters of those in administrative or support service activities receive less than four per cent in pension contributions from their employer. This contrasts with 15.2 per cent of those in financial services. Yet, more than one in five financial services workers receive employer pension contributions of more than 15 per cent. This is not a feature of a bias towards DB provision. Nearly two-thirds (64.9 per cent) of workers in this sector in defined contribution schemes receive employer contributions in excess of eight per cent.



Source: ASHE

It is evident that in many sectors low employer contributions to DC pensions are ubiquitous. Reasonable contribution rates are found largely in those industries with a history of high

quality DB provision (and a relatively large trade union presence). This includes the electricity and gas sector and manufacturing sectors.



Source: ASHE

Again, there is a structural problem with the pensions system that hinders contribution rates. For a start, legal minimum contributions are rock-bottom, at just one per cent each for employers (and employees). It will not be until 2019 that total contributions will reach eight per cent. This will be made up of three per cent from the employer, four per cent from the employee and one per cent from the government in the form of tax relief.

This situation is exacerbated by the decision to apply contributions to a band of earnings, rather than base them on a full salary. For 2017/18 the band of earnings was between £5,876 and £45,000.

So for someone on £10,000 a year, only £4,124 of their earnings are pensionable, and for them, 8 per cent of qualifying earnings actually means just 3.3% of their total salary is being contributed. The rate for a median earner on £27,000 will be just 6.3 per cent. This is far short of 8 per cent and way adrift of the sorts of rates needed to have a decent standard of living in retirement.

Section 3

The Investment Lottery

A typical worker could be £5,000 a year poorer in their old age if they retire after a bad spell for pension funds rather than in a good year.

Analysis of historic investment returns shows that a pension saver's pot size can vary by up to 40 per cent due to little more than luck.

A man on median pay who had saved for 40 years in a defined contribution pension before retiring at 65 in 2000 could expect a yearly workplace pension of £16,845. Yet, a colleague with an identical work history retiring two years later would have received £11,761 a year.

Differences are even wider if you consider the roll of the dice savers make on turning their pension pot into an income to live off. In recent years quantitative easing and a lacklustre economy have contributed to a surge in the cost of the traditional route of buying a guaranteed income through an annuity contract.

The retiree in 2000 could have enjoyed an annual income of £27,871 from his pension pot of £306,272, based on prevailing annuity rates. This is more than £12,000 a year extra for life than the £15,183 netted by the man retiring in 2003 with a £213,844 pot.

These huge differences matter because millions have a workplace pension for the first time thanks to rules that automatically enrol most workers into a pension scheme with a compulsory employer contribution.

Yet, defined benefit (DB) pensions, which aim to pay a retirement income based on your past wage and length of service, are increasingly rare in the private sector. In these schemes shortfalls in investment returns are not met directly by savers.

Instead, most current workers in a pension are enrolled into defined contribution (DC) schemes. With these, the final pension pot, and income that can be taken, is related to investment returns as well as the amount contributed. Savings are typically invested in a mixture of company shares and bonds. If returns are poor, this directly affects their standard of living in old age.

The TUC believe most workers want their pension to allow them a decent standard of living in retirement, not a high-stakes gamble on the markets.

These figures strongly suggest that workers should be enrolled in well-governed schemes with the scale and investment expertise to grow their savings while protecting them from the worst of the ups-and-downs of the markets.

Building up a pot

Data produced by the Pensions Policy Institute (PPI) for the TUC, reveals the extent to which investment returns add another layer of uncertainty and chance.

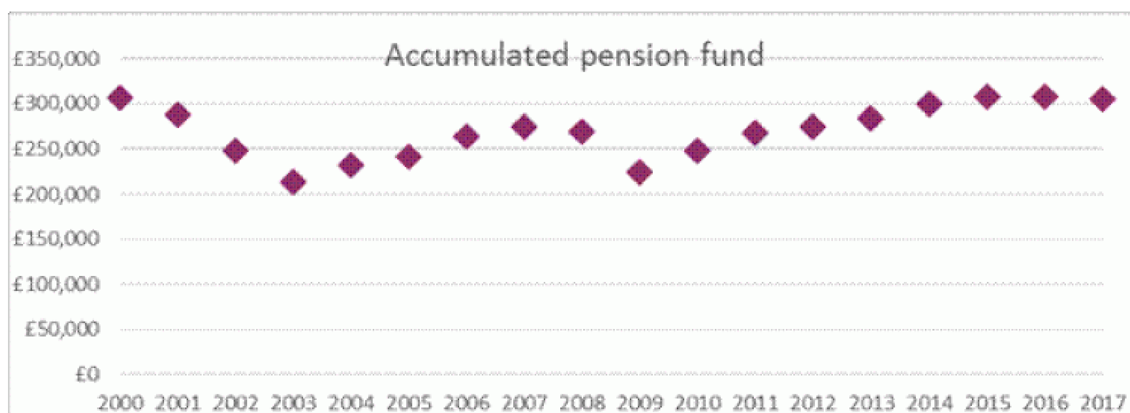
The PPI found that a man on median pay who had eight per cent of wages being applied to a typical defined contribution (DC) pension for 40 years, would have ended up with a pension pot of £306,272 if he had retired in 2000.

But just a year later, after the Dot.com bubble burst and technology shares plunged in value, 40 years of savings would have given him £18,000 less, some £288,372. The total would have fallen further to £213,844 if the individual retired in 2003.

Returns have subsequently bounced back thanks to recent strong stock markets. A median earning male retiring in 2017 would have netted a pension pot of £305,519.

The analysis is based on a typical DC scheme's default fund invested 60 per cent in equities and 40 per cent in bonds. The differences in outcome reflect the impact of financial crises where investments resulted in a loss, as well as having money invested in "good" years when overall returns were strong.

Defined contribution pension pot size at retirement for median-earning male in 2017 earnings terms by year of retirement



Source: Pensions Policy Institute

Turning that pot into an income

The size of pension pot affects the income a retiree can enjoy. Based on 2017 annuity rates for a 65-year-old, the saver retiring in 2000 would have enjoyed a yearly pension of £16,845 and someone retiring in 2016, £16,926.

Yet, the person whose 40 years of saving ended in 2002 would have received a comparatively small £11,761 a year. And a 2009 retiree would have picked up £12,285.

Take into account changes to annuity rates, which are linked to the price of bonds, and the difference is more stark.

The retiree in 2000 could have enjoyed an annual income of £27,871 based on prevailing rates. This is more than £12,000 a year extra for life than the £15,183 netted by the man retiring in 2003 with a £213,844 pot. And even the saver retiring in 2016 would have got just £14,464 a year having purchased a level single life annuity despite his £307,751 of retirement savings.

Defined contribution pot size and indicative income at retirement in 2017 earnings terms by year of retirement. Based on a male median earner-contributing for 40 years

Retirement year	Accumulated pension fund	Annual Income (£s) (2017 annuity rates)	Annual Income (£s) (Historical annuity rates)
2017	£305,519	£16,804	£16,804
2016	£307,751	£16,926	£14,464
2015	£307,265	£16,900	£17,821
2014	£299,893	£16,494	£18,593
2013	£284,417	£15,643	£16,496
2012	£274,989	£15,124	£15,674
2011	£268,149	£14,748	£16,893
2010	£248,570	£13,671	£16,654
2009	£223,357	£12,285	£16,082
2008	£268,785	£14,783	£20,428
2007	£275,212	£15,137	£20,366
2006	£264,299	£14,536	£19,030
2005	£240,999	£13,255	£17,111
2004	£231,333	£12,723	£16,656
2003	£213,844	£11,761	£15,183
2002	£248,496	£13,667	£18,140
2001	£288,372	£15,860	£23,070
2000	£306,272	£16,845	£27,871

The future

Just as investment returns in the past have been volatile, the outlook for future returns on people's pension saving is also highly uncertain.

The PPI modelled for the TUC a range of scenarios for median- and low-earning men and women with typical employment patterns. Again, this was based on a typical DC pension default fund invested 60% in equities and 40% in bonds.

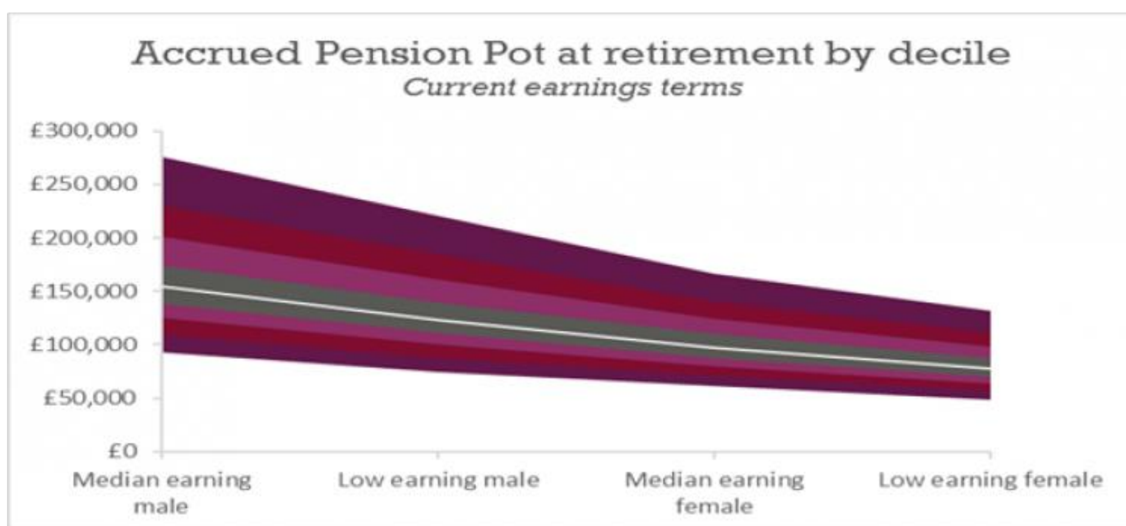
There was a huge range in the potential pot size, which are illustrated in the chart below. PPI simulations of future retirement income outcomes found that in the lowest 10 per cent of outcomes, a median-earning male might accrue a pot of £78,757.49 in 2017 terms,

enough to deliver a weekly income of £61.82. But in the highest 10 per cent of scenarios, the pot would be £353,123.42. This would pay out £277.19, if an income was bought today.

A median earning female, who it is assumed will take career breaks for caring responsibilities, sees her workplace pension income range from £44.02 in the bottom 10 per cent of outcomes (based on a pot of £56,076.57) to £160.10 for a pot of £203,959.32 at the other end.

And for a low-earning female, the range in weekly income from a private pension is from £35.14 to £126.10.

It is notable that in virtually all scenarios, the income a median or low earning woman receives from the state pension would dwarf what she would get from a private pension, no matter how well markets turned out for her. We will explore the value of the state pension in a future blog post.



Source: Pensions Policy Institute

Case for reform

It is notable that the implementation of so-called Pensions Freedom in 2015 means that DC savers are no longer obliged to buy an annuity. This potentially strips out some of problems around fluctuating annuity rates. The flipside is that little has come into its place that helps savers generate an income and protects them against the risk of their money running out in old age. Many savers will be more exposed to the vagaries of markets in retirement because their funds remain invested for longer.

This analysis does suggest that further consideration should be given to the implementation of Collective Defined Contribution pensions. In such schemes the risks (and benefits) of investments not turning out as expected are shared between scheme members. Like DB pensions all savings are paid into a pool, with all pensions paid from the same pool. But unlike DB there is no pensions promise from an employer. Instead, CDC pensions have a target pension that they seek to pay.

There is also the potential that if the government pursues the consolidation of workplace schemes this might deliver some of the potential benefits of CDC. The development of large-scale schemes would deliver benefits of scale with costs shared across a large number of members. They might also be better able to develop diversified investment mandates to reduce volatility by investing in a range of assets, including those that might be difficult to buy or sell quickly.

There are already signs that some of the big providers of automatic enrolment pensions are taking steps to diversify their investments, in part to smooth out returns for investors.

State-backed NEST states in its investment principles that “diversification is the key tool for managing risk”. Hitherto, this has resulted in limited moves, such as taking a position in emerging market bonds. But managers at the provider have talked of moving into areas such as commodities, infrastructure, global credit and private debt.

Likewise, it is expected that NEST’s main rivals will take similar steps as they grow rapidly in size.

If these promises are realised, then workplace pensions will be better placed to deliver to savers a good chance of a decent old age rather than a ticket to an investment lottery.

Section 4

The Retirement Lottery

Retirees are being increasingly faced with a blizzard of risks that are bringing new sources of uncertainty and chance into financial arrangements for old age.

Recent reforms have led to a slew of savers cashing in their pension or using potentially risky retirement products to manage their income in retirement. This leaves them vulnerable to the corrosive impact of inflation, sharp drops in investment returns (particularly in the early years of retirement) and, counter-intuitively, the hazard of living longer than they expected.

For many years, workplace pensions were provided through defined benefit pensions. Incomes were paid out based on length of service and salary. Often surviving spouses received benefits, too.

The increasing use of defined contribution (DC) pensions for workplace saving requires members to find a way of generating a replacement income in retirement.

Until 2015, most DC savers were effectively compelled to buy an annuity, a contract that paid a regular income until death. But many got a poor deal by sticking with their existing pension provider. Initiatives to encourage savers to shop around largely failed.

On top of this, low interest rates adopted to cope with the Global Financial Crisis, combined with rising longevity, forced up annuity prices.

But the so-called pension freedom reforms unexpectedly unveiled in the 2014 Budget blew up the old system without putting a new one in its place. From age 55 savers could take their money out of a DC pension scheme and do what they wanted with it.

No structures were put in place to help savers navigate their options. Auto-enrolment was a policy based on the lesson that complexity, disparities of information and behavioural biases mean that savers struggle to make good decisions and providers are not subject to competitive pressure. Part of the answer was ensuring that savers were enrolled in default options subject to minimum standards and governance when building up a retirement pot. But the pensions freedom reforms assumed that no such defaults were needed in the next phase – and the market would provide.

There were no requirements regarding governance of at-retirement products. So there are no trustees making sure members get a good deal.

Nor did it put in place requirements about pricing or quality.

All that was provided was the prospect of a Pension Wise guidance appointment, which few have taken up.

Two years in, and there are many reasons for concern, set out neatly in a recent report from the financial regulator:

There is evidence that cashing-in at least part of a pension long before retirement is becoming a cultural norm.

Complex, opaque charges are being levied on drawdown products used by increasing numbers of savers to access their pensions savings.

There is little evidence of savers "shopping around" for retirement products.

There is an absence of innovation by product providers that will enable consumers to protect themselves against outliving their savings.

There is also a worrying sign that some in good quality defined benefit schemes are being tempted to transfer out into DC schemes so they can then cash in their savings. This could leave them at risk of a poor standard of living in years to come if their money runs out, falls in value or, worst of all, is lost in a scam. A recent study by the financial regulator found evidence that less than half of transfers were suitable.

Cash and corrosion

Over one million defined contribution pension pots have been accessed since the pension freedom reforms.

Around half of savers have decided to fully withdraw their pension savings as a cash lump sum.

Yet most market observers are expecting cash will yield a negative real return over the next few years.

The Barclays Equity Gilt Study 2016 shows that the stock market has outperformed cash in 75pc of all the five-year periods since 1900, rising to 91pc of the 10-year periods.

Inflation has been particularly low in recent years. But it has ticked up in recent months. A sustained pick-up in prices could see people's savings significantly eroded.

A number of those cashing in their DC pensions appear to have (often inflation-linked) defined benefit pensions to fall back on. So they are cushioned from the impact of the falling real value of any DC pension pot they have stuck in a bank account.

But within the next few years, growing numbers of savers will rely entirely on DC pension pots. If they cash in at retirement (or even earlier from age 55), instead of generating an income or investing the money elsewhere, the consequences for their future prosperity could be very serious.

Investment dangers

Since the government removed the obligation on retirees to buy an annuity most people will remain exposed to this investment risk well into old age.

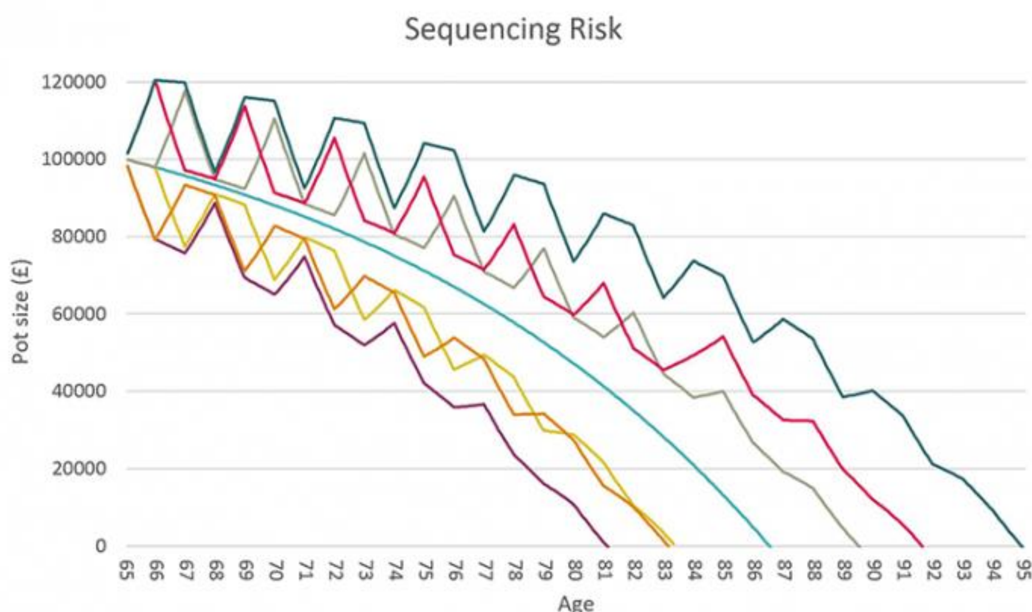
In the second quarter of 2017 just 13,800 annuities (which guarantee an income for life) were bought in the UK while 42,700 drawdown plans (which leave money invested in financial markets and let people take out a proportion each year) were opened. So just one in four DC retirees opted for the guaranteed income.

These drawdown products have their attractions. For instance, by keeping savers invested for longer, they give them the chance to build up a bigger pot and ward off inflation. But they are also riskier.

An asset manager might not make the expected returns, meaning retirement cash will run out sooner than expected. And even if the investments do perform as anticipated overall, pensioners still face a lottery if markets fluctuate from year to year. This is because the sequence of returns can have just as great an impact as the average level.

This effect – known as sequencing risk – can be seen in the graph below. It shows the age at which a retiree's £100,000 pot of cash will run out in a variety of scenarios.

In each scenario they draw down £750 a month and their investments achieve an average 7 per cent annual growth. The figures are illustrative and reflective of the approach employed by a key academic paper on the issue. However, the outcome illustrates the risks involved.



The central, turquoise line shows what happens when this return is achieved smoothly, at 7 per cent each year. The money runs out around age 86.

But if the returns are achieved on a three-year cycle of one good year (+27 per cent) one average year (7 per cent) and one poor year (-13 per cent) this varies significantly. The various combinations of these circumstances are also shown below.

In the worst scenario, the fund starts in a poor year, followed by an average year. The effect of future growth being generated from a smaller pot, plus the regular withdrawals, is that the stellar performance in year three still doesn't take the fund back to the 'average' level. As this is compounded over time, the fund runs dry five years earlier.

On the other hand, if the high returns come in year one of the cycle, the fund could last until age 95. So even in this simplified model, the same size fund, achieving the same average returns, with the same level of drawdown, could last anything from 16 to 30 years.

Living too long

Even if a saver could predict when a pot in drawdown would run out, this would not be particularly useful unless it was combined with an equally accurate prediction of how long they would live.

Research from Aviva has found 65-year-old men underestimate their life expectancy by 3.3 years on average.

But even if we were all a bit less pessimistic about our probable lifespan, in a system where the individual is responsible for managing their own longevity risk there is still a great deal of uncertainty.

As the Pensions Institute's Independent Review of Retirement Income points out: "Being told their life expectancy is a completely useless piece of information for someone who has just retired, since there is an approximately 50 per cent chance that a 65-year old man, for example, will live beyond his life expectancy of 86.7."

And around one in four will live to at least 93. Even at higher ages, the average life expectancy of an 85-year old man is 91.6 but one in three will reach 93 and one in twenty will live to 100.

Defined benefit schemes and insurance companies that sell annuities manage this challenge by pooling large numbers of people together. Those unfortunate people who die earlier than expected cross subsidise those who have an unexpectedly long life.

This means that every individual only has to save enough to last them the average lifespan. Without access to this pooling they are faced with a choice of significantly oversaving, or accepting a 50/50 chance that their money will run out while they still need it.

Conclusion

In granting savers "pensions freedom", there is growing evidence that retirees have had other freedoms taken away such freedom from making bewildering and complex choices and freedom from worry through retirement.

The potential negative consequences of these policy choices have been limited so far. Many retirees have secure DB pensions to fall back on. Meanwhile inflation has been relatively low and investment market returns have been high.

But this won't last forever. We need reforms today to bring increased stability into the retirement regime.

Section 5

What does a good retirement system look like?

Trade unions have a straightforward vision of what the pensions system should deliver. We believe that all workers should have the opportunity to enjoy a retirement free from poverty in a lifestyle similar to the one they had in their working lives.

What can we learn from overseas?

Good state pensions. The highest ranked retirement systems have state pensions that are much more generous on average than the UK. For people on low earnings, the net replacement rate (retirement income from the state pension and mandatory schemes as a percentage of pre-retirement income, after taxes) in 2014 was over 100 per cent in the Netherlands and Denmark, and almost 90 per cent in Australia, according to the OECD. In the UK the figure is just over 50 per cent. Those on average earnings in the Netherlands have a replacement rate of around 95 per cent, while in Denmark and Australia the figures are 66 per cent and 58 per cent. The UK the rate is just 29 per cent.

Decent contribution rates. The amount paid into funded pension arrangements – particularly by employers – tends to be much higher than in the UK. In the Netherlands contributions are generally around 20 per cent, with two thirds of that coming from employers. Compulsory employer contributions are 9.5 percent in Australia, and are set to rise to 12 per cent. Legal minimum contributions in the UK are set to rise to 8 per cent of band earnings (with 3 per cent coming from the employer), which works out at just 6.3 per cent for an average earner.

Scale. Countries with successful pensions systems have a small number of large schemes. While in the UK we have tens of thousands of schemes, in the Netherlands there are just 265 (and the number is shrinking – down from 422 five years ago – as the regulator nudges schemes with high costs to merge). In Australia there are around 500 superannuation funds. This means pension funds from these countries are generally very large and can use this scale to benefit their members.

Longevity protection/risk sharing. Most systems have an element of compulsory longevity risk protection that is missing from UK DC schemes. This means that savers cannot run out of money by living longer than they expected. Sector-wide collective DC schemes in the Netherlands, for example, provide a retirement income based on average earnings, but only give annual increases in line with inflation if the scheme is sufficiently well funded. The earnings-based element of the Danish state pension also offers conditional indexation: pensions increase in line with prices only if the scheme has sufficient funds.

High levels of coverage. The vast majority of workers in these countries save into a pension scheme, often because this is compulsory. In Australia employers must enrol all employees into a scheme (without the opt out available to UK workers). In the Netherlands sector-wide pension funds are generally mandatory, with employers only able to opt out if they offer more generous arrangements. More than 80 per cent of scheme members belong to this kind of scheme.

Looking at pensions in the UK, we know that radical change is possible. The Pensions Commission showed that by building the evidence base and consensus support to usher in a new system of workplace pension saving with compulsory pension contributions under automatic enrolment. The creation of state-backed provider NEST ensured that all workers would have access to a pension scheme. The imposition of minimum standards minimised some of the most egregious examples of rip-off behaviour.

These advances need to be defended, but also extended.

Section 6

The route to a more secure future

i) Abolish the earnings trigger with employer contributions paid from the first pound of earnings.

One of the biggest causes of exclusion is the earnings trigger. An employer only needs to enrol someone into a workplace scheme if they earn more than £10,000 for any single job. That means that millions of low-paid workers, most of them women, are excluded. The system is particularly unfair on those doing multiple jobs that together add up to £10,000 but currently receive nothing.

Abolishing the earnings trigger would instantly bring low earners into the system and remove any incentive there is for employers to keep wages below the trigger level.

We regard this as a more effective way of bringing those with multiple jobs into the system than seeking an arrangement to determine which employers might be responsible for contributions.

ii) Scrap the complicated qualifying earnings system.

Currently, pensions contributions only have to be levied on a band of earnings between £5,876 and £45,000.

If an employee earns £20,000 their qualifying earnings would be only £14,124 and the effect is even more disproportionate for people on lower incomes. For someone on £10,000 a year, only £4,124 of their earnings are pensionable. Even when minimum pension contributions rise to 8 per cent, just 3.3 per cent of their total salary would be contributed.

For someone on £10,000 a year, only £4,124 of their earnings are pensionable

Part time workers with more than one job are particularly affected because the qualifying earnings deduction applies to each job.

Levying contributions on the entirety of a worker's pay packet would simplify administration and boost saving.

The government has agreed that this should be reformed and contributions made from the first pound of earnings. However, implementation is not planned until the 2020s. This could leave many workers on inadequate contributions for a significant proportion of their career.

iii) Reduce the starting age for contributions.

The current arrangement, which only requires workers to be enrolled into a pension scheme from age 22, risks disadvantaging those who enter the workforce rather than pursuing

higher education. And starting to save earlier makes it more likely that an individual has sufficient pension for retirement. A lower starting age for auto-enrolment could simplify administration for employers. Those for whom saving is not appropriate or desirable can opt-out.

Again, the government has committed to reducing the starting age to 18, but implementation is not fixed.

iv) Set out a route map for raised contributions

There is widespread agreement that even when minimum pension contributions rise to 8 per cent from 2019, this will be inadequate for a decent retirement. Yet many employers, especially those who previously offered no pension scheme, pay in only enough to comply with the law. It is estimated that two thirds of those enrolled in pensions in 2030 will be on minimum contributions.

Trade unions have long supported the stance that pension contributions should be at least 15 per cent of salary, including 10 per cent from an employer and five per cent from the wage packet of an employee.

v) Maintain open defined benefit schemes

Too many good quality pension schemes were allowed to wither away from the 1980s onwards. Those defined benefit pensions, that pay a pension based on a member's salary and length of service, that remain are doing the job we need pension schemes to do. More than 90 per cent of people currently accruing benefits in DB schemes are likely to have a decent standard of living in retirement.

More than one in eight defined benefit schemes (13 per cent) remain open to new members, ensuring that both old and new workers can build up entitlement to good quality retirement provision. Maintaining these is a priority because they ensure that both younger and older workers have access to good quality pension entitlements.

More than 90 per cent of people currently accruing benefits in DB schemes are likely to have a decent standard of living in retirement.

There is a very strong case for a differentiated regulatory regime for open DB schemes. Such a regime might allow greater flexibility on valuations and greater scope for benefit changes as long as a scheme remains open to new entrants. This should be supported by adding to the Pensions Regulator's remit an objective of seeking to maintain and promote good quality DB pension schemes.

vi) Greater cost transparency

It is frequently claimed that low costs should not be pursued in pension saving at the expense of good returns. Yet the financial regulator has found quite categorically that higher charges are not a predictor of higher performance.

Yet, the cumulative effect of costs is enormous. A one per cent annual charge will consume nearly a quarter of a saver's pension pot over their working life.

And trading excessively can cost members money. There is evidence that if managers held onto their investment more, they could save as much as 20 per cent of the costs paid by members.

There have been moves to place higher requirements on fund managers to disclose the full range of costs and charges to pension schemes. These are still in their infancy.

There is a strong need for a data standard for collecting cost data from pension funds in the UK and from their providers (asset managers, custody banks, consultants and so on), overseen by an independent body that can verify the accuracy of the information supplied.

vii) Greater consolidation

But transparency is only of benefit if it leads to reduced charges.

There are upwards of 35,000 DC pension schemes in the UK. Many are too weak to negotiate a good deal from suppliers, such as fund managers. Transparency might be of little benefit to them.

A recent study of Dutch pensions found that a fund that has 10 times more assets under management, has on average 7.67 basis points lower annual investment costs. These economies of scale are solely driven by management costs.

International evidence also suggests a link between fund size and a more diversified portfolio. Translating this into improved performance can lead to big gains for investors. An increase of 1.5 percentage points in yearly investment returns would increase their pots by 46 per cent to 62 per cent.

The establishment of large investment funds, such as is occurring in defined benefit pensions with the Local Government Pension Scheme might help improve returns and cut costs if DC pensions were given access to such .

Some consolidation in workplace pensions is likely to come with automatic enrolment. The likes of state-backed NEST and People's Pension, while relatively small today, have the potential to become very large indeed. Almost half of those automatically enrolled have been enrolled into master trust schemes like these. This will be aided by increased regulation of schemes that could prompt some to close down.

But policy action will be required to accelerate this process.

One option is to strengthen requirements on the chairs of trust-based DC schemes. The government is currently considering moves to require the chairs of trustees of trust-based DC schemes to publish details of costs and charges in their annual statements.

Additionally, requiring them to justify whether the current size and scale of their scheme is sufficient to produce good value for members might hasten the consolidation of sub-scale schemes.

viii) Move to CDC

Collective Defined Contribution pensions are like traditional defined benefit pensions without a promise and without an employer guarantee.

Instead the risks (and benefits) of investments or longevity not turning out as expected are shared between scheme members.

Like DB pensions all savings are paid into a pool, with all pensions paid from the same pool.

Unlike DB there is no pensions promise. Instead, CDC pensions have a target pension that they seek to pay, though unlike most annuities the intention is that benefits are indexed.

There is a risk that pensions will not increase or might even decrease in bad years, but in practice in Holland and in modelling based on UK conditions this is both unusual and does not result in big cuts

Studies by organisations including the RSA and Aon have found considerable advantages:

- On a like-for-like comparison, a collective pension would on average have outperformed an individual pension by 33 per cent.
- That in 37 of the past 57 years, a collective pension would have outperformed the individual pension.
- That the variability of the pension, and thus the risk the saver would have taken, would be lower with a collective rather than an individual pension.

Primary legislation already provides for CDC in the UK. However, the regulations to bring it into operation are yet to be completed.

We agree with the Work and Pensions Committee that there is a strong case for encouraging the provision of schemes that retain some of the best features of company schemes in an age when many employers do not want the long-term commitment of providing a DB scheme.

ix) Retirement default pathways

The key to giving savers a better chance of good outcomes is for the establishment of default pathways. These would be well-researched, good value, securely governed solutions that would be suitable for most savers. Those who wished to pursue an alternative approach would be free to do so.

We see little appetite among most providers to be first movers in developing such products. Some will be understandably wary of setting a saver on default journeys that they might later say was not optimum for their circumstances. It is therefore the role of government and regulators to ensure that all savers have access to a default retirement pathway.

This would take the lessons from auto-enrolment in the accumulation stage - namely that inertia is a major driver of behaviour – and apply them to decumulation.

The likely shape of such pathways would match the combination of income drawdown and deferred annuities described by NEST in its retirement blueprint.

However, there could be a role for Collective Defined Contribution schemes to provide a mixture of longevity risk pooling and continued access to real returns.

Conclusion

Workplace pension reform in the UK is not complete. And it will not be finished in 2019 when minimum pension contributions reach eight per cent (of a proportion) of a worker's salary.

Pension provision needs to cover more workers, command higher employer contributions and, crucially, share risks more effectively.

Workers want a decent income in retirement. They don't want a ticket to a lottery.