TOUCH STONE EXTRAS

Third Time Lucky

Building a progressive pensions consensus

by Craig Berry and Nigel Stanley

Contents

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Touchstone Extra

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Introduction

Pensions policy is not like many other policy areas. Important decisions can take many years, even decades, to make a difference. Policy is inevitably complicated; not only are the details of how different pensions operate highly technical, but pensions policy areas interact with others. Decisions about the shape of state provision can have a major impact on the role that occupational pensions need to play.

Making progress that sticks is therefore hard without securing consensus. Perhaps once a generation major changes occur, sometimes progressive and sometimes not. Even with positive changes, unless they secure wide support there is the danger that they will be reversed before they have made much difference or had the opportunity to establish constituencies of support.

Consensus can be a slippery word. It does not mean an end to disagreement or debate. It is better to think of consensus as binding in enough people to set the bounds of the debate by delivering a wide agreement about the basic building blocks of a policy area. Sometimes unions are within the consensus, albeit always pushing for improvements. Sometimes we are outside, lacking influence.

Consensus need not be the lowest common denominator – splitting differences and leaving no-one happy. A good consensus is built on an active search for progress that can command wide support and meet enough of everyone's interests so that they also see the benefit of not achieving everything they desire.

The long-term nature of pensions policy makes some basic agreement about the structure of pensions and the basic role of the different players – the state, employers and individuals – necessary for progress. But this still leaves plenty of room for debate and disagreement. The minimum wage is a good example of such a consensus. It is not that long ago when it was extremely controversial, with strong opposition from employers and the Conservatives. Going even further back, some unions opposed it. But after a careful process of policy development and implementation almost everyone now accepts the principle of a national minimum wage, even if there remains intense debate about issues such as its level, rates for young people, and the role of a living wage on top.

The same goes for pensions for much of the time. We can have wide agreement about structure, but still disagree about how much to spend on pensions provision or the detailed regulation needed within the overall architecture.

Unions have a fairly simple approach to pensions. We believe they are a vital part of any civilised society. When people retire they should not face poverty, but enjoy a decent and secure standard of living that offers some continuity with the lifestyle they enjoyed before they retired. We want a pensions system that is based on equality, and treats people fairly. The state, employers and individuals all have to play a proper role in delivering such a system. Pensions are part of the social wage.

But there is no one way of delivering this. Other countries broadly meet this objective more so than the UK, but do so in different ways. We cannot simply import wholesale the best method from overseas as we must start from what we have, however messy and imperfect the existing system is. People at work have already built up different forms of pension entitlements, and decisions taken years ago are still making a difference.

Our belief is that the UK is now entering a period of a new pensions consensus – the third since the modern welfare state was established after the Second World War. Building this new consensus started with the recognition by the last government that our pensions system was breaking down, and that we needed to make changes. The Prime Minister set up the three-member Pensions Commission chaired by Adair (now Lord) Turner, with trade unionist Jeannie (now Baroness) Drake and academic John Hills as its other members.

Its report has since formed the basis of a series of pension reforms taken forward by both the previous and present governments. There is general acceptance that employers should have a legal obligation to enrol their staff and contribute into a decent pension scheme, and that it should not be left to individuals to make complex decisions about retirement planning. The Commission also outlined plans to simplify and increase the level of state pensions, to provide a solid platform for private saving, eliminate means-testing and move towards flat-rate state pension provision. The coalition government has gone further than the Commission anticipated in this regard by proposing a 'single-tier' state pension implemented from 2016.

For the most part, this adds up to progressive change – by no means perfect, but much better than what went before. Importantly these reforms also have a good chance of sticking, because they have achieved a wide degree of consensus across political parties and among the various pension interest groups. Unions played a significant part in first establishing that change was needed, and shaping the policies that emerged. We are proud of that role, if far from complacent about the need for further progress.

Consensus has secured agreement about the basic architecture of the pensions system. But there is still much to do to make it a reality and important ways that it can be made better within the structures and approach set by the Pensions Commission. This Touchstone Extra is an attempt to outline the shape of the new pensions consensus and the issues that trade unionists and others who share our desire to build a decent, comprehensive pensions system need to consider if we want to shape it in a positive direction for the future.

Table 1: Pensions policy consensus over time (summary)

	State	*Employers*	*Providers*
Collective provision (1950s to 1970s)	Social insurance	Employer benevolence	Arms-length management
Individualised pensions (1980s to early 2000s)	Safety net	Limited obligations	Direct sales to consumers
New consensus (mid-2000s onwards)	Savings foundation	Minimum contributions	Collaboration with employers

Much of our argument is based on understanding the differences between the three periods of pensions consensus that we identify, starting with what many see as the golden age in the decades following the second world war.

Understandably, some call for a return to this first pensions policy consensus, with generous state provision and employers voluntarily shouldering most of the risks of pensions saving. There are certainly legacies of that period that are as appropriate today in parts of the economy as they were then – such as quality defined benefit (DB) schemes in public and private sectors – and we defend them.

But going back to the kind of provision we enjoyed then is neither practical nor wholly progressive. It is impractical because the economy has changed beyond recognition with few companies exhibiting the stability and commitment to maintain the long-term commitment needed to guarantee DB promises. Indeed this was clear even in the 1960s when Barbara Castle went beyond Beveridge's original flat state pension by introducing earnings-related pensions for those not in good occupational schemes.

Nor, despite some attractions, is a wholesale return to the first consensus desirable. The key building block of both state and private pensions in the post-war years was the male breadwinner-led nuclear family. Even at the time that assumption did not cover everyone, but it is totally inappropriate now. Indeed providing women with adequate pensions in their own right has been a clear objective of recent pensions reforms.

But while the first consensus was progressive for its time, what came next was much less so. The second consensus started in the 1980s and lasted until the Pensions Commission wrote its obituary. It was based on 'individual responsibility' and a belief that a competitive pensions market would provide optimal outcomes, because that is what markets always do. Employers could thus withdraw from long-term pensions commitments, even if pension contributions would be encouraged by worker preferences within the labour market. The state could retreat to the role of providing a meagre basic pension with a 'safety net' for pensioners that had been unable to do better.

The second consensus evolved from the gradual collapse of the first. But while the first functioned reasonably well within in its own terms for many years, the second never delivered a pensions system that worked for the majority. As that became more and more obvious, the then government set up the Pensions Commission which delivered its blueprint for what we label the third consensus.

Our mission now is to fully realise the promise offered by this new approach, getting the structures right and putting enough money from individuals, employers and state into them to make them work. This requires, first, a full understanding of why the market oriented approach of the second period failed, and second, the construction of a new system that does not just meet union concerns, but also builds a sustainable consensus that can at least match the thirty years or so that the two previous periods have achieved.

Because the detail of pensions can get technical quickly, many people shy away from pensions policy. Of course we need technical experts, but the basic issues and choices we face need wide engagement. Pensions, more than many other policy areas, involve decisions about priorities and what trade-offs to make. It is right that there is the broadest engagement in these issues, particularly if we want solutions to stick. This is another reason we have developed our 'three period' analysis as we think it brings out the basic assumptions and trade-offs of the big picture.

We have written this pamphlet not only because we want to engage with the wider pensions policy world, but also to rescue discussion about pensions from the experts. So while we do consider many current policy issues and engage with them, our main purpose is to provide a pensions policy primer, unashamedly dealing with the big picture of policy making. We hope therefore that it will find an audience among non-pensions experts, particularly in the trade union movement, who want to understand the issues at stake. We do not deal with every pensions issue, such as how pension funds should invest savings and act as responsible owners of their investments. While this is an important issue – and done well does result in better pension returns – we concentrate on scheme design and other pension policy issues here.

One reason why unions were influential in the work of the Pensions Commission and in subsequent debates is that we have worked with allies and engaged with the other legitimate interests in the pensions debate. Consumer, advice and charity groups have a large shared agenda with unions, but we have also worked with good employers who have not wanted to be undercut by the bad.

Furthermore, while we are sometimes critical of the commercial pensions industry, there are many people within it who want to see good pension outcomes. The problem is that the second consensus structures too often incentivised them to behave badly. There is also a range of experts and professional bodies who have much to contribute, even if all sides of the debate need to be aware of the vested interests that almost all bring to the debate. But the more that unions can build progressive alliances, the more influential we will be and the more likely change is to occur and be sustained.

1 The first consensus: collective provision

The UK established a largely progressive pensions settlement after the Second World War, even if based on the then dominant social model of the male breadwinner and dependent wife and family.

Employees could build up a state retirement pension through their National Insurance contributions (NICs). In retirement NICs funded a state pension for most employees. Outcomes were based – as they remain today for the most part – on the length of time spent in work, and the benefit kept its value once in payment through being linked to rises in average earnings.

On top of this many people at work (or perhaps more accurately many men) had the opportunity to build up an occupational pension linked to their earnings, usually their final salary. This gave them, together with state provision, a good chance of getting a reasonable replacement income in retirement. Responsible employers saw it as their duty to provide such pensions.

In the 1960s, when occupational scheme membership was at its peak, Barbara Castle added to state provision a second pension for those with no access to an occupational pension through their work. This too was linked to earnings and was thus called SERPS – the state earnings-related pension system.

This created a system that gave most working people a chance to build up additional earnings-related provision on top of the 'basic' state pension (as it came to be known), either through their employer's scheme or SERPS. This combination of social insurance and occupational provision meant that the UK pensions system resided somewhere between the state-centric social democratic model common in Scandinavian countries, and the corporatist arrangements more common among our Western European neighbours.[1]

A key feature of SERPS was 'contracting out'. Employees in good workplace schemes did not need an earnings-related state pension, so they could forgo entitlement to SERPS, and in return both employee and employer paid less National Insurance. Contracting out was a largely progressive instrument, and helped to sustain defined benefit pension provision. But it was also a key cause of complexity in the state pension system and will be abolished by the coalition government's plans for a single-tier state pension, discussed below.

Of course, the system was never comprehensive. It was based on a social structure that bears no relation to modern life. Many fell through gaps, and significant numbers of pensioners have always faced poverty in retirement. Women in particular fared badly. Few would have had the chance to build up much occupational pension or SERPS. Many chose to pay reduced NICs (the so-called 'married woman's stamp') that have left them without a full state pension.

Yet this system still allowed many to retire with better pensions than their parents received. Given how long changes in pension policy can take to work their way through into practice, many current pensioners are still receiving pensions mainly built up on this first consensus model – and some are still retiring with good occupational pensions largely built up under this approach, even if their state retirement pension has subsequently reduced in value.

How the consensus unravelled

The immediate post-war period was marked by consensus not simply in pensions policy, but economic policy more generally. But this consensus started to break down in the late 1970s, when many of the social and economic institutions built up during and after the Second World War came under attack from a newly resurgent right. Both began to unravel in the late 1970s as an unprecedented period of sustained economic growth came to an end. One key dividing line in opinion was the extent to which state-backed social insurance pensions should make up for the absence of occupational provision, either for those workers in firms without a pension scheme, or workers who moved jobs too often to build up an occupational pension.

For example, while SERPS was genuinely progressive by nature, hugely popular and consistent with the principles underpinning the first consensus, it was targeted by Mrs Thatcher's government as soon as it came to power in 1979. SERPS had become ammunition for those who argued that the state was 'overloaded', one of the main claims of the new right. They argued that the state was encroaching onto the responsibility of individuals, and going beyond the limits of the state's fiscal and administrative capabilities.

Mrs Thatcher did not go as far as to abolish SERPS. Instead her government reduced its generosity by cutting the accrual rate. In addition they allowed individuals to opt out of SERPS in return for cash to invest in personal pensions. Their strong message, which turned out to be untrue for the vast majority, was that people would be better off in a personal 'defined contribution' (DC) pension, rather than in the DB-based SERPS system.

The Conservative government also broke the link between earnings and the level of the basic state pension, which had allowed pensioners' standard of living to keep up with society more broadly. The earnings link was replaced by indexing pension payments to price inflation, and therefore state pension provision reduced in value over time.

In addition the government allowed individuals to opt out of occupational schemes entirely. Up to that point employers had been able to – and often did – make membership of their scheme a contractual obligation. This was a key element of the social wage. These opt-outs led to a great mis-selling scandal as commission-hunting salespeople persuaded many – even in high quality DB schemes in the public sector – to move into poor quality DC schemes. Few pension companies escaped huge fines as a result, eventually, and this incident did much to undermine trust in the pensions industry and exposed the dangers of commission-based sales models.[2]

But not everyone in the pensions world was always enthusiastic about these changes, even if market forces brought them eventually into line. One insurance company, Prudential, sought to advise their own potential customers about the downside of these products, warning in a marketing brochure that 'if you are already a member of a company pension scheme or will soon be eligible to join one, you will probably feel it best to stay with your company scheme'. But the pensions industry was given a huge incentive to act against the interest of consumers by government policy. As we argue later, providing incentives for people to behave badly, and then trying to stop them doing so by a mix of regulation and appeals to conscience, was a key structural defect in the second consensus. Indeed in this case the government even accused Prudential of 'undermining [the government's] pensions policy'.[3]

Yet it was not simply the ideological agenda of the Thatcher government that led to the unravelling of the first consensus. The 1980s saw great industrial change, as manufacturing employment declined and the service sector started to grow. Trade and financial liberalisation began the process of globalisation. The UK had witnessed an enormous expansion of the workforce during the period of the first consensus. The public policy model of the male breadwinner heading a nuclear family had always failed to include many households, but higher living costs and a changing role for women in society meant that women needed to build up their own pension rather than rely on their husband's.

2 The second consensus: individualised pensions

The second consensus was, at least in its early days, much less secure than the first consensus had been. Policy-makers in the 1980s began to move responsibility away from the collectivised pensions provided by state or employer and put it on to on to individual employees.

There remained a role for the state, but it changed. The state pension was retained, but lost value. The state also began its long retreat from the provision or guarantee of earnings related retirement income, and instead concentrated on providing a means-tested 'safety net' for those who had not been able to secure a decent pension for themselves through occupational or individual saving. As the value of the state retirement pension declined, this would inevitably lead to greater numbers receiving means-tested benefits.

In addition the state incentivised pensions saving – through tax relief paid at the marginal rate of tax, thus helping high-earners far more than the low-paid. Many on the right would not see this as a cost to the state because of their philosophical attitude to tax, but this approach does not help public policy discussion. Tax relief equals tax revenue foregone – relieving a tax is the equivalent of spending public money.

Just as the state retreated from providing social insurance-based pensions, employers began to retreat from collective pension provision and risk-sharing, aided by the government encouragement of opt-outs from both occupational pensions and SERPS. This was when DC or 'money purchase' schemes began to become important. These are truly personal pensions. Each individual builds up their own pot; they bear all the investment risk and only pool longevity risk when they use their pension pot to buy an annuity (an annual pension income) at the point of retirement.

There had always been some role for personal pensions for groups such as the self-employed who could not join occupational pensions or gain access to SERPS, and for those wanting to save on top of their occupational pension. But this is when employers started to favour DC pensions for work-based provision. They were portable and therefore were meant to suit a mobile workforce and the end of 'jobs for life' – always a myth, but a strong belief of the time.

Despite the many advantages of DB provision, decline became established under the Thatcher government. There are many explanations for the decline of DB. Many rather glibly blame over-regulation and tax. Those who follow this line are often on the political right with an instinctive hostility to regulation and tax – but this does not quite fit with events. Much of the regulation flowed from the Conservative's 1995 Pensions Act and its well-intentioned measures to protect employees from bad employers. Robert Maxwell was not the only pensions villain.

The tax impact on pensions is also more complicated than some simple political narratives allow. In order to stop companies using pension contributions to avoid tax, the Conservatives in the 1980s penalised companies that 'over-funded' their pension schemes. This encouraged 'contribution holidays' when stock markets were booming. When economic times are good, however, it makes sense to build up a surplus – yet employers who did not want to take a contribution holiday faced a tax penalty for behaving responsibly. This stopped schemes building up the kind of surpluses that would have helped them weather the shocks caused by the 1990s recession and subsequent stock market volatility.

This has been forgotten by many who want to blame Labour's 1997 changes to the corporation tax regime that ended pension funds' favourable treatment. Active membership rates for private sector DB schemes have been falling steadily for many years. The rate of decline accelerated in the late-1980s and early 1990s, but remained constant in the period immediately before and following the 1997 change.[4]

Other factors have put pressure on DB schemes that are not the direct result of government policy. Longevity has increased, and investment returns have become more volatile. Changes in accounting standards – not set by the government – have made companies publish snapshot valuations of their pension scheme surplus or deficit which, while a poor measure of a scheme's long term ability to meet its liabilities, can certainly alarm investors and finance directors.

We do not think therefore that there is a single, simple explanation for the decline in DB in any of these accounts. Although we do not deny that all of these factors may well have had some impact, we would look to a wider account of how the economy has changed.

DB pensions are an efficient way to deliver retirement income, and their structures, contributions and benefits can evolve to deal with external changes such as increased longevity. But they depend on employers bearing much of the risk over many years. While this long timeframe gives employers the opportunity to absorb unexpected shocks, DB schemes can only work efficiently where there is what pensions jargon calls a strong and long-term covenant from the employer.

Yet this conflicts with the way that modern companies work. Since the 1980s the fashion has been to see companies as financial constructs whose purpose is to deliver short-term shareholder value.

Even those companies that have kept faith employ far fewer staff, due to productivity increases and the trend towards outsourcing services. There has been growth in the numbers employed in small and medium sized companies, which are less likely to provide access to a pension scheme. Some of this is due to long term increases in productivity, but is also due to the increased fashion for outsourcing and buying-in services that would once have been done in-house. Gone are the days when the cleaners and canteen staff were likely to be in the same pension scheme as those they served. There has also been, in more recent years, a hollowing out of jobs in the middle of the labour market, many of which would have been the skilled manufacturing jobs that would have attracted a decent DB pension in the 1960s.

Unions also became weaker during the 1980s and 1990s, and were thus less able to defend a key employee benefit, particularly one not always properly valued by members understandably more worried about the present and near-future than their retirement. However, unions have still been a positive force for pensions; many DB schemes have survived through union action, with sensible changes negotiated as an alternative to scheme closures.

Labour and the second consensus

When Labour came to power in 1997 it began by trying to implement a more progressive version of the second consensus. But by accepting its underlying structures and approaches it legitimised the basic architecture of the second consensus – at least until it too began to break down.

Labour's priority, justifiably, was to relieve pensioner poverty. It made means-tested benefits more generous, and attempted to reduce the stigma attached to claiming them. Income support for pensioners had become an increasingly important source of income for many people in the 1980s and 1990s, as pensioner poverty increased due the decline of occupational provision and changes to the state pension. Income support was effectively rebranded by Labour as the Minimum Income Guarantee in 1999, in advance of the introduction in 2003 of Pension Credit. Pension Credit was more generous but also far more complex. The Guarantee Credit element of Pension Credit helped to lift many pensioners out of poverty, but the benefit also included a Saving Credit element which rewarded poorer pensioners who had some income from savings or employment.

As such, even with a greatly expanded safety net, state provision under the second pensions policy consensus wanted to encourage responsible saving behaviour. However, although Pension Credit may have rewarded saving, arguably the state pension system in general did not do enough to encourage people to build up a savings pot in the first place. This is at least in part because the Guarantee Credit level was, by necessity, set far higher than the level of the basic state pension, and indexed to average earnings. Any additional saving would therefore lead to a loss of means-tested benefit entitlement.

While we endorse this analysis, which is widely shared among pensions experts, we also enter a note of caution. Too much of the explanation for the decline in saving is based on a market model where individuals make 'economically rational' decisions in which they compare the value of future income, viewed through an appropriate internal discount rate, against the value of spending given up today. Real people do not think like that. But such incentives do produce systems that affect attitudes. Getting them right is not sufficient, but is necessary to build a functioning pensions system.

The Labour government moved further against earnings-related provision in the state pension system, by replacing SERPS with the State Second Pensions (S2P) in 2002 and limiting the amount of earnings-related state pension that could be accrued. However, Labour's intention was progressive in some ways, as S2P enabled lower earners to accrue a higher pension than they had been able to under SERPS, and established a system of credits which meant that people could accrue S2P entitlements even if they were not working due, for instance, to caring responsibilities.

As well as the new Pension Credit safety net, the second pensions policy consensus was typified by the introduction of stakeholder pensions by the Labour government in 2001. This was an attempt to expand personal pensions to the mass market, through private sector-based provision, and not S2P. Labour envisaged this as the main way of extending earnings-related pensions to a wider number of people. Stakeholder pensions are now, somewhat inaccurately, seen as a forerunner to automatic enrolment, a key part of the third pensions policy consensus.

But the two policies are far apart in their ambitions. Through stakeholder pensions, employers with a workforce of more than five people had to offer a stakeholder pension to their staff. But there was no statutory minimum employer contribution, nor any obligation to enrol staff automatically. In addition stakeholder pensions were offered by insurance companies for profit; there was no market intervention to create a default, state-backed, not-for-profit scheme along the lines of what we now have with NEST.

Labour achieved a significant reduction in pensioner poverty by targeting benefits. But it did not challenge the fundamental building blocks of the second consensus – indeed it reinforced them in many ways. Labour was just as keen on pensions mobility and personal responsibility. Great efforts were put into encouraging people to save. Tax relief continued to be paid at the marginal rate, at an increasing cost to the state.

Of course we are imposing a narrative on what was a messy and sometimes slow process. The transition between first and second periods of consensus was not a sudden breach. Not everything done by either government neatly fits. Some institutions from the first consensus period – such as public sector and a significant number of private sector DB pensions remain. Much of the second consensus arrangements were not consciously planned but came about as elements of the first period declined, and it was left to the market to find solutions. The problem was that the market failed.

How the consensus unravelled (again)

The basis of the second consensus was a retreat by both employers and the state from providing post-retirement income. Individuals were meant to respond to market signals and take on responsibility for saving. The consensus broke down as it became clear that individuals did not respond and were not saving enough to plug the gap. The brave new world where pensioners drew on the personal pensions built up during their portfolio careers failed to materialise; workers simply stopped saving. The decline in DB pensions was steeper than the rise in DC pensions, meaning that by 2012 two in three of the private sector workforce were not saving in a workplace pension.[5]

The result was that increasing numbers had little to look forward to other than the state retirement pension – which no longer even lifted people above the poverty line. Reliance on means-testing was forecast to increase far more than had originally been expected by the Labour government.

Of course there were other pressures on pensions. The implications of increasing longevity began to be fully recognised by policy-makers and employers during these years. No-one can contest that people are living longer (although the better off have gained more than the poor), and that as the post-war baby boomers age there will be a steep rise in the retirement dependency ratio, that is, the proportion of people in retirement relative to the proportion of working-age people.

However, it is important to be precise about which bits of the pensions system are most affected by longevity. Second consensus private pension provision is mainly affected by longevity through its impact on annuities, the financial product used by most DC pension holders to secure a retirement income. The evidence of this impact is limited, but longevity does help to explain therefore why personal pensions did not deliver the alternative to traditional occupational pensions that the architects of the second consensus had envisaged.

Rather than looking for simple explanations, it is more appropriate to conclude that the second consensus unravelled because of a basic contradiction – everyone was expecting someone else to provide pensions. The UK's reliance on employer benevolence, a hangover from the first consensus, no longer worked. The state retreated, and individuals, increasingly left to fend for themselves in the DC marketplace, failed to take up the slack.

3 The birth of the third consensus

The failings of the second consensus, and continuing decline of first consensus occupational DB schemes, became ever more clear as Labour continued in government. What to do about it became one of new Labour's biggest, if least commented on, internal rows. While there was agreement about setting up a commission to look at the future of private pensions, the Treasury under Gordon Brown was opposed to any consideration of state pension provision. This was acceptable to neither Tony Blair, nor the members of the Pensions Commission who ultimately resolved the issue by extending their own terms of reference.[6]

This freedom to consider pensions policy in the round was crucial. It allowed the Commission to establish the basis for a break with the approach of the second consensus, and to lay the foundations for the emerging third consensus. The Commission, with members from a range of backgrounds including the trade union movement, proved to be an exemplar for consensus-building in policy development. It was careful to start by establishing an agreed research base so that its policies were rooted in evidence. It also set out to construct the best possible system that was politically realisable, recognising the need to keep important interests on board if its proposals were to be implemented.

Table 2: Pensions policy consensus over time

	State	*Employers*	*Providers*
Collective provision (1950s to 1970s)	**Social insurance** The state provides a generous contributory pension, but excludes groups without strong labour market record	**Employer benevolence** Large, stable employers see occupational pensions as part of a 'social wage', without formal compulsion	**Arms-length management** Schemes based on a single workplace or employer; investment and management often 'in-house'
Individualised pensions (1980s to early 2000s)	**Safety net** Value of state pensions undermined. Instead, state uses means-tested benefits to address pensioner poverty	**Limited obligations** Fewer employers recognise pensions as part of pay, but rather a perk often available only to highest earners	**Direct sales to consumers** Insurers develop risky personal pensions saving products, and offer 'group personal pensions' to some employers
New consensus (mid-2000s onwards)	**Savings foundation** Universally accessible state pension provision set above poverty threshold, to provide a platform for saving. The state also intervenes to ensure private provision operates effectively	**Minimum contributions** All employers are required to provide access to a workplace pension, and make contributions at or above statutory minimum. Firms must automatically enrol their staff into a pension scheme (with right to 'opt out')	**Collaboration with employers** Providers offer a wide range of product designs – some unique to individual employers, some large-scale off-the-shelf products. NEST acts as a default provider, focused on smaller firms with less buying power in marketplace

It did not provide a solution to every pensions policy problem in the UK or set out every important detail needed to implement its broad strategy. The Labour government in its third term, and the coalition government since 2010, have also been instrumental in developing key aspects of the new consensus. And it is vital to remember that the Commission deliberated before the financial crisis of 2008 – even if the bursting of the dot.com bubble in 2000 and symptoms of instability had already warned more enlightened pensions policy-makers of the danger of relying on the cult of shareholder value and dog-eat-dog capitalism to deliver decent pensions provision.

Perhaps the most important outcome of the Pensions Commission was a general acceptance that private sector pensions provision would be dominated by DC products in the future. The role of DC in workplace pensions has of course been inherited from the flawed second consensus – but progress would be impossible unless we start from where we are, and recognise the constraints inhibiting a resurgence of DB.

DC pensions essentially require that individuals shoulder the risk of investing in a pension scheme. Given the long-term nature of pensions saving, it of course makes sense that funds are invested, to attract investment returns, rather than simply attracting interest if held as cash in a regular savings product. But with increased returns go increased risk. In DB schemes, they can be underwritten by employers in the short-term and shared over the longer term. In DC, however, a failure to generate adequate returns directly hits retirement outcomes. In terms of longevity risk, DC savers generally pass this, on an individual basis, to insurance companies when they purchase annuities – but at significant cost, and with no certainty that the annuity rates when they reach retirement will provide the kind of income levels they had been expecting.

Later we will discuss how the design of DC pensions can be improved. What the Pensions Commission concentrated on, across three major reports, was the framework within which DC pensions operate: employer obligations, market structure, and the relationship with state pension provision.[7]

As such, the Commission gave us, first of all, automatic enrolment. For the first time, employers are required by law to establish and enrol their staff into a workplace pension scheme. Even more importantly, employers must contribute to their employees' pensions saving pot, with minimum contributions eventually reaching three per cent of a band of earnings (assuming that employees do not 'opt out' of contributing four per cent themselves). This was not the case when DC pensions originally emerged in the workplace, nor when Labour established stakeholder pensions. The vast majority of workers will be automatically enrolled into DC rather than DB schemes, but the requirement for employers to contribute, and the likelihood of individuals commencing pensions saving much earlier in their career than is now the case, should improve retirement outcomes.

Secondly, the Commission said that there had been a consistent market failure to provide quality pensions for low and medium earners and smaller firms. They thus advocated the scheme now known as NEST, established by government as a multi-employer, trust-based DC scheme designed to provide a low-cost savings vehicle predominantly for low-to-medium earners, and with an obligation to accept any employer however small. NEST has already shown the Commission was right. It has set a strong benchmark for the rest of the pensions industry in terms of both governance and cost structure, levelling up the kind of provision currently prevalent in the DC pensions marketplace (the difference between contract-based and trust-based pension schemes will be discussed below). The third consensus therefore incorporates a major attempt by the state to correct the market failure evident in the second consensus.

Thirdly, the Commission began to rescue the state pension from its long-term decline. In some ways, it sought to re-establish the value enjoyed by the state pension during the first consensus, by recommending that earnings indexation be restored. However, the state pension system was also made more accessible and generous for people without a full record of labour market engagement – a move particularly helpful for women with caring responsibilities.

The Commission recognised, however, that such measures, coupled with increased longevity, would increase the cost of state pension provision. It therefore recommended raising the state pension age, although on a very gradual timetable reaching 68 by 2046. We discuss this further in the next section.

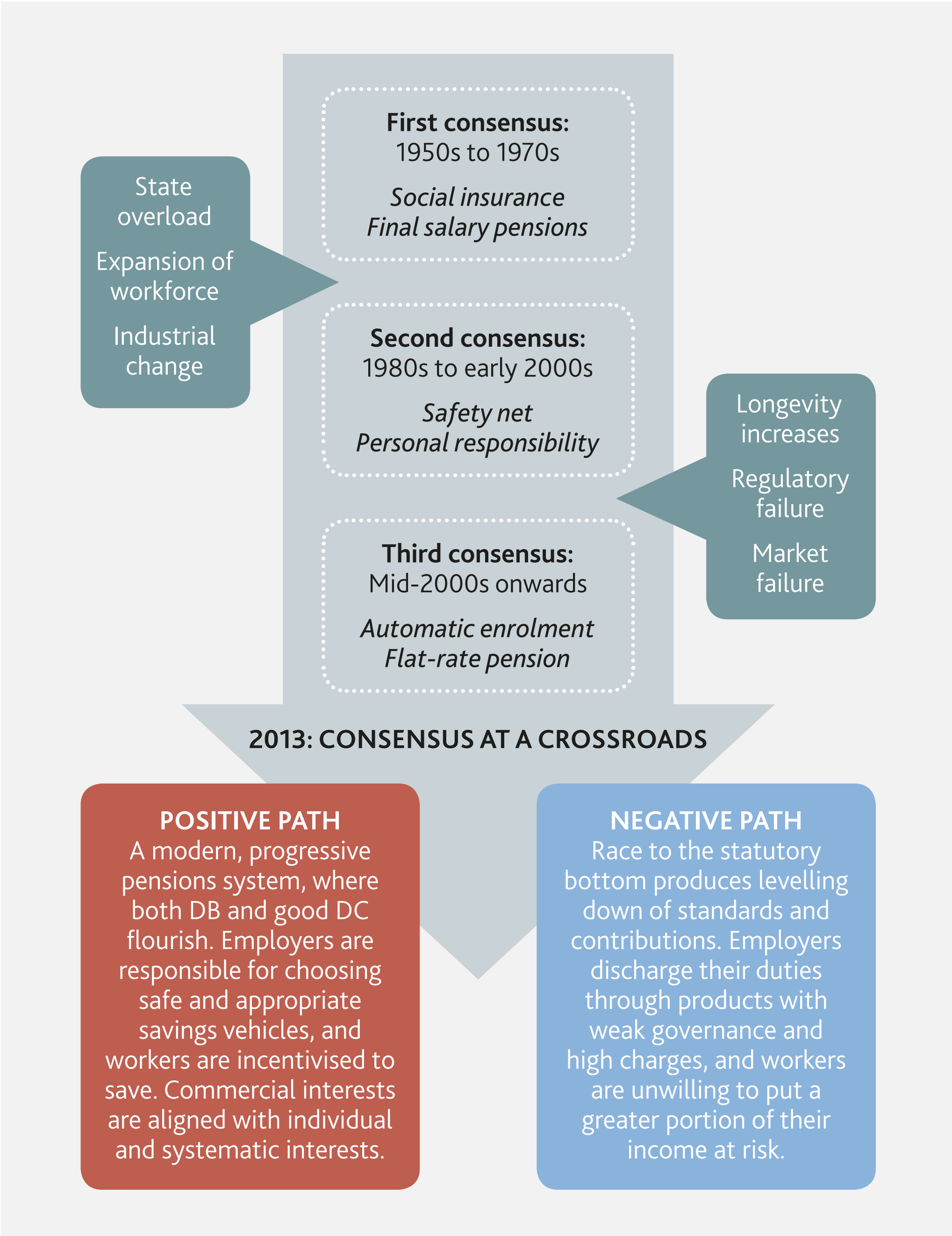
Crucially, the Commission also recognised that the state pension should provide a platform for private saving, most notably by providing an income for most recipients above the poverty threshold established by means-tested benefits. They shied away from abolition of S2P as they thought that getting from a two-tier system with opting out to a single-tier with no opting out was too difficult. But the coalition government's plan to create a single-tier pension that merges the basic state pension and the state second pension can be seen as a logical continuation of the Commission's intention that the state pension system should provide a flat-rate benefit over the long-term.

Personal responsibility – the key, and failed, driver of the second consensus – remains important. However, inertia will now deliver a minimal pension through a flat-rate state pension with an auto-enrolment pension on top, without the need for active engagement by individuals. But this will fall short of what most people would want from retirement income. To do better than this, people and their employers will have to contribute more than the minimum. They will also have to engage with what in pensions jargon is called the decumulation process – as discussed above, they will need to purchase an annuity in order to turn their pension pot into regular post-retirement income.

It is vital in the third consensus that we have a system where inertia delivers good outcomes. Of course we want people to actively engage with their pension, particularly to save more, but we should not require employees to engage to protect themselves from abuse or to deliver a reasonable income in retirement.

Automatic enrolment, statutory minimum contributions and stronger savings incentives mean that the burden on individuals is mitigated to some extent. Employers and the state will now take greater responsibility for delivering adequate retirement outcomes than during the second consensus. But there are two real challenges that need to be met to make the third consensus fully progressive. First it has to deliver higher pensions by increasing contributions and second it needs to ensure better pensions by ensuring the commercial interests of the private pensions industry are aligned with the interests of individuals.

Figure 1: Consensus at a crossroads



In the following sections we consider in more detail what the third consensus might look like in practice, and how it can be made more progressive. First we look at the state pension, and then at how defined contribution pensions could be improved. Finally we consider the government's plans for 'defined ambition' pensions which are designed to share risks between individuals and employers, and the future of traditional DB provision.

4 State pension reform

In the third consensus the state pension needs to provide a basic post-retirement income that lifts pensioners out of poverty. This should provide both a basic income floor, and the certainty that workplace and private pensions saving is worthwhile for all. Arguably, the coalition government's plan to introduce a single-tier state pension in 2016 is a return to the kind of state pension envisaged by William Beveridge at the birth of the welfare state (in stark contrast to their benefits agenda).

As we noted in the first section, the earnings-related state pension was only introduced later – Beveridge overlooked such a measure because most men were in occupational pension schemes in the post-war era. Auto-enrolment means we may be returning to this vision, with near-universal take-up of private pensions, albeit in a very different social and economic context. It is telling that the contributory principle has been retained: 35 years of NICs (or credits in lieu of NICs) will be required for a full single-tier pension – five years more than for the 30-year, woman-friendly record introduced as a result of the Pensions Commission. This, incidentally, seems to mark the death of a residence-based 'citizen's pension', which for a time had wide support including from the current pensions minister Steve Webb in opposition. But we agree that it is right to recognise the importance of the contributory principle in maintaining support for decent welfare provision when possible.

The government's proposals are a significant step towards a proper third consensus state pension. While the single-tier model borrows from the first consensus, it breaks sharply with second consensus provision. The state pension is no longer purely a safety net for those unable to save, but a platform for additional workplace and personal saving. The new state pension will be universal, with the vast majority getting a full state pension at retirement.

The argument for the single tier pension is that people need as much certainty as possible about the retirement income they can expect from the state in retirement. To do this it needs to be a single benefit. Everybody will get the state pension at the same level (or based on the same accrual rate), without having to worry about the complex interactions between different tiers of the state pension, means-tested benefits and workplace saving.

But it is always important to distinguish between structures and levels. A single-tier pension may be a logical structure for an ideal pension system, but if set at a low level will clearly be less popular and progressive than a complicated system that nevertheless delivers better income levels. Some argue that the government's proposals fall the wrong side of this test, as there will be undeserving losers, and in the long term the government intends to reduce spending on state pension provision.

Our view however is that the move to a single-tier pension can in principle be a good thing. If set at the right level, and working with a workplace pensions system which is run in the interests of savers and with proper minimum contributions, the third consensus can deliver a good and stable pensions system. This does not mean that we support the route chosen by this government; in particular, we believe the state pension needs to be set at a higher level.

But whether the current plans are implemented or better ones put in place, third consensus pensions also need good workplace pensions to provide the additional retirement income that will not just lift people out of poverty but provide some continuation with their pre-retirement standard of living. This will be the focus of our next section.

This government suggests that the new flat-rate pension, when it is introduced in 2016, will be set just above the level of the Pension Credit guarantee.[8] This has the benefit of minimising means-testing for future pensioners (with the quite significant exceptions of housing-related benefits). The vast majority of people can therefore know that they will keep every penny they save in workplace pensions or other savings vehicles. This may be an advance on current arrangements but a state pension set at the minimum income guarantee level is of course the bare minimum that should be expected from a single-tier state pension. The government's ostensible commitment to the cost-neutrality of reforms could become a significant barrier to realising the long-term benefits of the policy.

Trade unions will clearly want to press for higher state pension rates, not least because under the current, messy system, many people accrue state pension entitlements at a higher level than the new system will offer under government plans. While the third consensus accepts a pivotal role for private saving in retirement outcomes, this does not mean that the balance between state and private pensions should be set in stone. A higher state pension can aid the good design of workplace pensions, as the meaner the state pension the more risk averse savers will tend to be, but the harder we will need their pension pots to work.

As important as the initial level of the single-tier state pension is the method by which it will be uprated. With earnings indexation set by statute, the coalition government currently operates a 'triple lock' of earnings, prices or 2.5 per cent (whichever is highest) for uprating the basic state pension. Regrettably, the government has made this lock less secure by changing the measure of price inflation from RPI to CPI. But a double lock of the higher of earnings or CPI indexation is still a significant improvement from the second consensus, when the scrapping of the earnings link led to the long-term decline of the basic state pension.

The thorniest issue is how we get from where we are now to where we want to be. The difficulty of doing this fairly was why the Pensions Commission preferred, if perhaps reluctantly, a flat-rate second pension with a continuation of opt-out arrangements.

The argument against the government's current route remains that set out by the Pensions Commission. They were against a short-term introduction due to complexities around accrued rights to earnings-related pensions and contracting out. Instead they favoured gradually smoothing the differences between the basic state pension and other elements of state provision. The current government's plans effectively only accelerate this process. But in doing so, because of the need to respect accrued rights, the government (despite claiming to be acting to simplify the state pension) could create considerable uncertainty for many individuals, for decades to come, about what their state pension outcomes will be.

There will inevitably be losers and winners from implementing the reform more quickly than originally anticipated. The abolition of S2P, and as a consequence contracting out (which boosts private provision in DB schemes), means that many people could end up with a lower retirement income as a result of the change, just as many – such as the self-employed – gain from an earlier flat rate pension.

In contrast, the Pensions Commission's plans would have kept the basic architecture of the current system in place, but altered methods of future accrual for the different elements, minimising the possibility of individuals receiving state pension outcomes significantly different to those they were expecting towards the beginning of their career. It is entirely possible to support a single-tier state pension while rejecting the government's proposed timetable for reform – especially if they insist on maintaining an initial cost-neutrality that flows into reduced pension spending in the long-term.

Budget 2013 accelerated the implementation timetable, by confirming the implementation date as 2016. The white paper had indicated implementation in 2017 'at the earliest'. Introducing a new state pension system while male and female state pension ages are still unequal creates a complex 'cliff edge' issue for the government. It is estimated that around 430,000 women would not be entitled to the single-tier state pension while men born on the same day would be – because these men would reach state pension age before April 2017. Most importantly, around 80,000 of these women had already had their state pension age increased by the coalition government, when it accelerated the equalisation timetable after coming to office in 2010.

By implementing the reforms a year earlier, the 80,000 will now have access to the single-tier state pension – their state pension will be the higher of their entitlement under the old system, or their entitlement under the new system. Gender inequality remains for the remaining 350,000, although many of these would be no worse off under the outgoing system anyway. The government cited the circumstances of the 80,000 as a rationale for the earlier implementation. But it is also worth noting that an earlier abolition of the state second pension means that National Insurance revenue will increase by around £6 billion from 2016/17 onwards, as rebates associated with contracting out are discontinued. Budget 2013 committed some of this additional revenue to new initiatives such as the Dilnot reforms to social care finance, and the Employment Allowance for small businesses.[9]

State pension age

The previous government implemented Pensions Commission recommendations to increase state pension age to 68 between 2024 and 2046, following equalisation of male and female state pension ages at 65 in 2020. The current government has already accelerated the timetable for equalisation, and brought forward by six years the date that both male and female state pension ages will reach 66. It has also proposed to bring forward by eight years the increase to 67.[10] Table 4 compares planned pensionable ages across 34 OECD countries. By 2050, the OECD34 average male state pension age will be 65.6 – below what the UK's state pension age will be by 2020. Only a handful of countries have plans to raise pensionable ages in line with or faster than the UK.

Table 3: Male pensionable ages across 34 OECD countries, 2020–2050

	2020	*2030*	*2040*	*2050*
Australia	66	67	67	67
Austria	65	65	65	65
Belgium	65	65	65	65
Canada	65	65	65	65
Chile	65	65	65	65
Czech Republic	62.2	63.5	66.7	68.2
Denmark	65	67	67.9	68.8
Estonia	64	65	65	65
Finland	65	65	65	65
France	62	62	62	62
Germany	66.1	67	67	67
Greece	65	65.8	66.5	67.1
Hungary	64.5	65	65	65
Iceland	67	67	67	67
Ireland	66	68	68	68
Israel	67	67	67	67
Italy	61	67.3	68	68.7
Japan	65	65	65	65
Korea	60	62	64	65
Luxembourg	60	60	60	60
Mexico	65	65	65	65
Netherlands	65	65	65	65
New Zealand	65	65	65	65
Norway	67	67	67	67
Poland	65	65	65	65
Portugal	65	65	65	65
Slovak Republic	62	62	62	62
Slovenia	63	63	63	63
Spain	67	67	67	67
Sweden	65	65	65	65
Switzerland	65	65	65	65
Turkey	48.6	53.1	57.7	65
United Kingdom	66	67	67	68
United States	66	67	67	67
OECD34 average	***64.1***	***64.8***	***65.2***	***65.6***

Source: OECD Pensions Outlook 2012

Trade unions have justifiably opposed increases in the state pension age, and in particular the current government's changes to the Pensions Commission timetable. As explored earlier, increased longevity means that people will be retired for a greater proportion of their life, and that society's 'old age dependency ratio' will increase, meaning there will be proportionately fewer taxpayers for every person in retirement. But it does not follow automatically that state pensions are unaffordable. The UK already spends a lower proportion of GDP on the state pension than most comparable countries so we face smaller state pensions paid for fewer years than citizens in similar countries. Increasing the number of working-age people in decently paid jobs will be a much fairer and effective way of reducing public expenditure and increasing tax revenues.

Society has not shared equally in the longevity dividend, meaning increased state pension ages have a disproportionate impact on those with lower life expectancy (LE) and disability-free life expectancy (DFLE). The difference in LE at 65 between the most and least deprived local authority areas in England is 3.8 years for men, and 4.6 years for women. The difference between the local authority areas with the highest and lowest levels of disability-free life expectancy (DFLE) at 65 is 12.1 years for men, and 12.3 years for women.[11] Variations in LE mean that more affluent groups spend a greater proportion of their life in retirement than more deprived groups, and increasing state pension age is only likely to exacerbate this inequality. Those with the shortest life expectancy are likely to be those with the longest contribution records as they are likely to have entered the labour market younger than the longer living and better educated. If the state pension is to provide the kind of platform for private saving required by the third pensions policy consensus, it must be equitable as well as sustainable.

While we oppose further increases in the state pension age given its rapid increase in recent years, we support the idea of an independent commission – based on the Pensions Commission model – to decide pension age. Decisions about state pension age should be based on an independent assessment of evidence on life expectancy and healthy life expectancy inequalities, rather than taken by a chancellor wanting to look tough on spending in a budget. The government has partially adopted this approach by, as part of the single-tier state pension reforms, proposing the creation of an 'independently-led advisory body' to advise ministers on state pension age. However, this body will operate separately to the Government Actuary Department, which will report directly to ministers on average life expectancy increases.

In general, the problem we face is that pension policy now expects people to work longer, but neither labour market policy nor employer practice is responding adequately.[12]

This is a bit of a social policy conjuring trick. Raising the state pension age does not in itself keep anyone working longer. Many already stop work before state retirement age. While some are the affluent taking early retirement through choice, many stop working either because they cannot find a job or because their health does not allow them to work. With a working age benefits system that is increasingly mean and judgemental, defining a non-working 65-year-old as a work-shy scrounger rather than a pensioner may reduce the job to be done by pensions policy but hardly counts as social progress.

While we continue to oppose unjustified and rapid increases in the state pension age we campaigned for, and strongly support, the coalition's abolition of a compulsory retirement age. It should be a matter of choice whether people retire as long as they are still capable of doing their job – not something forced by employers, state or poverty – and more options for flexible working would enable people to stay in work in later life in way that they would choose.

5. Improving defined contribution pensions

In the third consensus, workplace pensions should lift retirees from a basic standard of living above the poverty line provided by a flat-rate pension, to one that provides some continuity with pre-retirement living standards. Those still in first consensus DB pensions can do this straightforwardly, but people with the DC pensions that will dominate third generation provision in the private sector will struggle.

There are three main areas where change is necessary:

- **Contributions:** individuals and their employers must pay more into DC pension pots.
- **Market structure:** we need well-governed and large-scale pensions saving vehicles.
- **Decumulation:** pensions savers should be protected against the risk of making the wrong decision when they reach retirement.[13]

Contributions

The level and consistency of contributions will always be the most important determinant of retirement incomes in DC pension schemes. Smarter scheme design can help people's savings work harder, but the basic equation in any DC pension will always be the more you put in, the more you get out.

There may be some danger that setting minimum contribution standards implies that this is all that is needed to achieve post retirement goals, but this is a price worth paying to ensure that (almost) everyone starts to save. And we recognise that if minimum employee contributions had been set too high, then there is a danger that opt out rates would be higher. Many in the pensions industry are so used to serving better-off clients that they do not understand just how hard it can be for families on modest incomes to make ends meet or lift horizons beyond each week's budget.

But we need over time, especially if we cannot secure a decent increase in the basic state pension, to move to higher employer and employee contributions, even though it was right to start auto-enrolment with low minimum contributions levels, given the radical shift from second to third consensus approaches. Yet it is worth detailing just how low the statutory minimum contributions are.

Media coverage that talks of eight per cent contributions – based on three per cent from the employer, four per cent from the employee and one per cent in tax relief – may be understandable shorthand, but is misleading.

It first forgets that auto-enrolment is phased in very slowly (finishing in 2017), and secondly that statutory minimum levels are based not on full salary, but rather a band of earnings, which from April 2013 will be set between £5,668 and £41,450. For a full-time worker earning around the minimum wage, the employer contribution will therefore only be just above 1.5 per cent. Even an individual with a salary that puts them precisely at the top of the earnings band, who will therefore have the highest statutory minimum, employer contributions will be only 2.6 per cent of salary.

It is also worth noting that employees earning less than £9,440 (or the 'earnings trigger') will not be automatically enrolled at all, and will therefore not be eligible to receive employer pension contributions (although they can 'opt in' if they earn more than £5,688). Figure 2 shows total pensions contributions as a percentage of pay using current levels for the bands and trigger, but with the full contributions payable as at the end of staging and phasing process in 2017. It shows just how short most people, particularly the lowest earners, fall of enjoying eight per cent contributions.

Figure 2: Impact of earnings band and earnings trigger on minimum contributions

Even at the end of the phasing process, statutory minimum contributions will therefore remain low. DC contributions tend to be lower than those in DB pensions, as they have normally been introduced as part of the cost saving that drove many second consensus changes. But as DC is less efficient than DB, and employees can argue that they should be compensated for shouldering the risk that employers abandon as they give up DB, a sustainable third consensus requires higher contributions.

We should start by encouraging voluntary higher contributions by both employees and employers, although the current squeeze on living standards does not encourage this. Pensions are deferred pay, so the key source of increased contributions has to be the employer. In Australia, where pensions compulsion has been successfully introduced, only employers are compelled to contribute at a rate of nine per cent (of whole earnings). In the long-term (and of course, as in Australia, there would need to be phasing) this is a reasonable aspiration.

One good way of increasing savings is through 'save more tomorrow' schemes where employees agree to put part of future pay rises into their pension scheme. For example, someone might agree to increase their contributions by one per cent at the time of each annual pay increase for the next five years. As long as their pay goes up by more than one per cent they will still see a cash increase in their wage packet, making this a relatively painless way to boost savings. If employers match these additional contributions, as many do, then this provides an even bigger boost to pension outcomes using some smart behavioural economics or 'nudge'. However, this approach only works when people get reasonable pay settlements – and any system of matching contributions must be progressively structured so as not to unduly penalise individuals less able to increase their contribution rate.

Box 1: Pensions tax relief

Alongside contributions policy, it is also necessary to reconsider pensions tax relief arrangements. Currently tax relief on pensions is skewed towards higher rate tax payers, as relief is provided at an individual's marginal rate. This means that it costs an ordinary employee paying standard rate tax 80p to save a pensions pound (as they no longer have to pay 20p tax on that pound of their pay.) But for the highest earners, who now pay tax at 50p, this system means that it only costs them 50p to put a pound into their pension (although total relief is now capped.)

Encouraging people to save into a pension is a reasonable public policy objective. If they didn't, poverty would increase and the state would pay higher means-tested benefits. But it is much harder to justify encouraging well-off people, who may already be assured of a comfortable retirement, to save more – especially with more generous incentives than their lower paid colleagues.

While the current government deserves praise for largely taking forward the pension reforms drawn up under the last government, their policy on contributions has been disappointing. We did not support the introduction of an earnings trigger for auto-enrolment set above the bottom of the earnings band. But we recognise that there is a reasonable argument to be made that it stops people making tiny contributions if they earn just above the bottom of the earnings band.

But because the trigger is linked to the income tax personal allowance, an unintended consequence of this government's decision to keep raising the personal allowance is that fewer people will now be auto-enrolled. This means that the level of earnings at which anyone is auto-enrolled into a pension is moving from the bottom of the earnings band, which the Pensions Commission expected to be about £5,000, to the government's chosen income tax allowance, which will reach £10,000 in 2014.

The original rationale for the earnings band was to stop the lowest paid building up a small pension that they would lose through interaction with means-tested benefits. But if we move to a flat-rate pension set above means-testing levels then this argument no longer applies.

We would therefore argue for a rethink of the earnings band and trigger point. Rather than simply raising the percentages paid on the current band of earnings, the first stage of any reform should be to start reducing both the bottom of the earnings band and the trigger level for earnings so that contributions are eventually paid on the first pound of earnings. It would be possible to stage this in the first few years by both reducing the overall contribution rate and the bottom of the earnings band in a way that ensures people at the top of the earnings band contribute the same percentage but everyone earning less than this contributes more.[14] Once everyone is getting contributions on the first pound of their pay, then we should start to raise percentage contributions.

Governance and scale

The only way to get markedly improved post-retirement income is to save more, but improvements in the structure and governance of pension schemes can help each pension pound saved deliver a better return and increase confidence in pensions saving.

Governance is an area where the full implications of third consensus thinking have not yet been thought through and it requires urgent fixing. For instance, this issue was largely absent from the government's recent 'Reinvigorating Workplace Pensions' strategy document.[15]

Essentially there are two types of workplace DC pension scheme: trust-based and contract-based (all DB schemes must be trust-based). Trust-based schemes are governed by a board of trustees whose only task is to protect the benefits of pension scheme members (although this of course involves a wide and complex range of functions). Legally speaking, only trust-based schemes qualify as 'occupational' pensions, which is why the additional term 'workplace' pensions has entered the pensions lexicon.

Contract-based schemes generally have no formal scheme-level governance, but involve merely a contract of service between member and provider, usually an insurance company. Where employers adopt a contract-based product for a portion of their workforce, this single product is known as a 'group personal pension' – an individual pension for each member of staff bought collectively by the employer.

It is not implausible to suggest that contract-based defined contribution pensions are so far removed from the collective risk-sharing nature of a true pension, that they are not pensions at all, but individual savings accounts. Campaign group FairPensions (now ShareAction) make the persuasive argument that contract-based pensions are 'fundamentally at odds with the mechanics of auto-enrolment'. The absence of trustees means that 'the saver is assumed to be an active consumer making informed decisions in a well-functioning market', but in a complex investment chain involving employers, advisers, insurance companies and (internal and external) asset managers, 'the saver is the only person in this chain who exercises virtually no influence over any key decisions'.[16]

In contract-based provision, almost none of the conditions for a market to function properly exist. Customers know very little about the product they buy, as demonstrated by the pensions mis-selling scandals. Under auto-enrolment the customer – the employer – does not directly benefit from the product they buy on behalf of their staff. While many big employers make such decisions with real care, smaller employers will not have the expertise to evaluate rival products even if they wanted to. Instead they will be interested in how easy the product is to integrate with their systems and ensuring they meet their often-resented regulatory requirements.

When incentives are not aligned and markets cannot function you need strong regulation to protect the consumer interest. FairPensions have suggested a greater role for fiduciary duties within contract-based provision, which would see providers playing a role similar to trustees. But regulation is always second best when it is used to stop people behaving in their self-interest – better to construct a system where good outcomes are produced by basic structures, not despite them.

If neither the bulk of employers nor individual savers can play a proper part as customers in a pensions market place, then we need more fundamental reform. As such, the *Kay Review of UK Equity Markets and Long-Term Decision Making,* despite advocating fiduciary duties, insisted that 'the establishment of market structures which provide appropriate incentives', rather than simply 'attempt[ing] to control behaviour in the face of inappropriate commercial incentives' was the correct approach.[17]

This is why we advocate non-profit, trust-based governance for workplace pension schemes. Trustees have a single interest: their members. Of course they may need to purchase services run for a profit such as scheme administration and investment, but they can be intelligent customers in a reasonably efficient market. Trustees will want the lowest possible charges. For-profit companies will charge what a (non-functioning) market will bear.

Box 2: Costs and charges

In combination, scale and good governance have the potential to produce very low cost schemes. Schemes like NEST, and those that would qualify as super trusts, can spread their fixed costs across a large membership, and also have the buying power to buy services cheaply – benefits that can be passed to members in the form of low charges.

Although we recognise that it is not possible to run cost-free pension schemes, DC pension charges continue to be controversial issue. While the last government capped stakeholder pensions at 1.25 per cent annual management charge, the Pensions Commission aimed for DC pensions charging 0.3 per cent. NEST has a charge structure offering 0.5 per cent over the long term, and this seems to have established a low cost benchmark for auto-enrolment. While some large employers have been able to do better than this, this is unlikely to apply to the long tail of smaller employers who are less attractive to commercial providers.

As the work of David Pitt-Watson and Hari Mann (2012) in the RSA's Tomorrow's Investor project has shown, differences in charges can make a significant difference to pension outcomes. In an admittedly simplified example, Pitt-Watson shows that, after saving for 25 years, someone who pays no fees gets a 60 per cent higher pension than someone who pays 1.5 per cent. It is therefore extremely worrying that many employers – who are the people who 'buy' pensions for their staff under auto-enrolment – do not understand charges (IFF, 2012).

Continued on page 31

Box 2: Costs and charges *(continued from page 30)*

Direct charges to members, such as annual management charges (AMCs) can at least be made more visible – various industry initiatives have supported this cause to varying degrees. This is not however the extent of the issue, because these direct charges do not necessarily capture all costs to schemes. Some may well be hidden – particularly the costs of investment – within lower investment returns. This is unacceptable; the asset management industry has recently strengthened its guidelines on disclosure, but there is more work to be done.

Pension scheme members now also face the prospect of 'consultancy charging'. This is an extra charge levied on scheme members to pay for services from a consultant working for their employer. The defence for this is that if the employer chooses the right pension then that is good for members or that advisers can provide services direct to members such as better communication materials. But these are thin arguments. It is more honest to see consultancy charging as no more than the employer passing on the costs of the employer meeting their legal obligation onto reduced staff pensions. The costs of meeting other legal obligations – such as equal pay – are not then passed off onto staff who benefit.

Consultancy charging is a hang-over from second consensus, commission-driven sales models and should be outlawed. NEST has said that it will not facilitate it, and other providers understand its potential to damage the reputation of auto-enrolment.

David Pitt-Watson & Hari Mann (2012) *Seeing Through British Pensions,* RSA, available at www.rsa.org /_data/assets/pdf_file/0004/635917/Seeing_Through_British_Pensions_-_How_to_Increase_Cost_Transparency_in_UK_Pension_Schemes.PDF

IFF (2012) *Telling Employers About DC Pension Charges,* NAPF and B&CE, available at www.napf.co.uk/PolicyandResearch/DocumentLibrary/0261-Telling-Employers-about-DC-Pension-Charges-Research-Conducted-by-IFF-for-NAPF-and-BandCE.aspx

This does not mean that contract-based pensions could not be governed more effectively. Greater accountability of insurance companies (the main providers) to policy-holders would help. Many employers with group personal pension schemes have also established 'management committees'. These committees can serve as useful sources of information and a degree of representation for scheme members. However, they have no formal oversight duties, and owe their existence to the discretion of employers (although the third consensus no longer assumes employer benevolence). There is very little guidance on how to organise a committee from the Department for Work and Pensions (DWP), the Pensions Regulator (TPR) or the Financial Services Authority (FSA, which regulates the individual contracts, but not the actual schemes). And they are only ever likely to work well in large employers with bespoke schemes.

The issue of how DC pension schemes are governed cannot and should not be divorced from issues around the scale of provision. Scale is a necessary condition for quality DC provision; like good governance, it can also help to ensure that charges faced by members are low – see Box 1. It also opens the possibility of risk-sharing in ways that we discuss in the next section.

Large-scale scheme design and good governance do not necessarily go hand-in-hand. There is certainly a correlation, especially within DC provision, as documented in the Pensions Regulator's scheme governance survey.[18] Scale is particularly important for not-for-profit, trust-based approaches as large schemes can attract the kind of well-qualified trustees and managers that can ensure high performance. It also gives them the ability to strike good deals with companies providing them services such as investment.

NEST, established by the government as a key element of the third consensus, is not the only example, but is the best known large-scale, trust-based DC provider with low charges, strong governance arrangements and an innovative member-centred approach.

Although subject to a recent government consultation, NEST is currently constrained by two key restrictions: an annual contribution cap of £4,200 and the prohibition of transfers in and out of the scheme. The reason given for the restrictions was to ensure that NEST concentrated on the needs of low to medium earners, but had as much, if not more, to do with keeping the pensions industry onboard with the auto-enrolment consensus.

Now that NEST has clearly established itself and shown in its approach to investment and communications a distinctive emphasis on the needs of its target group, the ostensible reason for the restrictions has gone. But they hit both employers – many of whom cannot use NEST as a single supplier because of its inability to serve high earners – and employees, who find themselves members of the only pension scheme that cannot accept transfers or contributions above a relatively modest limit.

Removing these measures would give NEST even more scope to develop as a model large-scale scheme that can drive standards and innovate on behalf of DC savers.[19]

The paradox, however, is that while scale can lead to good governance, it can also create a significant governance risk for members. Scale is only ever a means to an end. Some pension companies have set up multi-employer trust-based schemes in the run-up to automatic enrolment (so-called 'master trusts'). But they have been set up mostly to exploit the legal loophole that only allows trust-based schemes to offer 'short-service refunds' for staff who are scheme members for less than two years. This is highly advantageous for employers with high-churn workforces as they get the employer contribution back.

It is hard to see how the trustees of schemes set up by commercial providers such as insurance companies can exercise the strong, independent governance exclusively in the interests of members that should be the basis of our preferred model, but even if as part of what can best be seen as 'regulatory arbitrage' they introduce a degree of collectivism and scrutiny that is different from a standard contract-based pension scheme product. We are interested therefore in whether they can be used as a route to our ideal. By encouraging providers to place more of their products into master trust structures – which they have now demonstrated is perfectly possible – and then ensuring that those master trusts move to genuinely independent governance there may be a gradualist route to what has been called the 'super trust' model.

Partly in response to the inadequacies of commercial master trust products, the National Association of Pension Funds (NAPF) has long advocated super trusts as a way of achieving scale in defined contribution provision. Super trusts would be similar to the NEST model – multi-employer master trusts, but with strong governance arrangements completely independent from investment or other service providers.

Unlike existing master trusts offered by commercial providers, super trusts would operate under licence from the Pensions Regulator, and as such would be required to meet qualifying criteria to function. NAPF envisages that most super trusts would operate regionally or sectorally, or be established by trade and affinity associations. Only around 20 licences would be issued – this does not preclude other forms of multi-employer schemes existing, but would send a signal to employers and consumers about scheme quality. The scale inherent in super trusts would offer a 'regulatory dividend', that is, 'a reduction in the overall costs of regulation as the regulator focuses more efficiently on fewer, larger schemes'.[20] Scale also allows schemes to better manage investment risk.

Box 3: Transfers and small pots

The fact that millions of people will be auto-enrolled into a DC pension in the next few years has an implication for the number of separate pots that people will build up. It is estimated that individuals will change employer 11 times throughout their career. Government modelling suggests that auto-enrolment will create around 370,000 pension pots valued at under £2,000 each year after 2017. Indeed, there are already around one million small pots in the system (DWP, 2012).

Building up a large number of small, fragmented DC pension pots is not an efficient way to save for retirement, and the government is right to seek a solution to this problem. They decided on a 'pot follows member' approach where, when an employee moves jobs, their pensions saving would usually be automatically transferred into their new employers' scheme.

We argued – as did the majority of responses – for an 'aggregator' approach as the default, whereby deferred pots transfer to a central scheme (TUC, Age UK & Which?, 2012). This is the best way that pots can be guaranteed to end up in a good, well-governed, low-cost scheme. Pot follows member runs the risk of funds being transferred to a scheme that is significantly inferior. We also worry that at least some highly mobile workers in casualised sectors could end up with significant costs if their pension pot moves frequently. In order to make this system acceptable, the government needs to ensure that all DC schemes are low-cost and high-quality.

DWP (2012) *Meeting Future Workplace Pension Challenges: Improving Transfers and Dealing with Small Pension Pots,* available at www.dwp.gov.uk/consultations/2011/small-pension-pots.shtml

TUC, Age UK and Which? (2012) *Pensions consumer groups unite in concern at pensions minister's small pots approach,* available at www.tuc.org.uk/economy/tuc-21231-f0.cfm

Decumulation

In DC pension schemes, unlike DB, retirement incomes are provided not by the scheme but through the purchase of an annuity. Generally speaking, at retirement, individuals pass on the savings they have built up in their pension pot to an insurance company, in return for a regular income until they die. Of course, this is a hugely complex process, with an array of providers and products available – and the process by which annuity rates are calculated will be incomprehensible to most pension savers.

It is vital that all annuitants get the best deal that they can. This also means that those individuals who have lower life expectancy due to health conditions are able to access 'enhanced' annuity products, which will offer a better rate because, on average, the provider will be paying the annuity for a shorter period. But how do we get there? Generally speaking, annuity rates have been deteriorating for around a decade (average rates are around half of what they were in the mid-1990s).[21] Insurance companies will argue, ultimately, that annuity rates will be determined by conditions beyond their control, such as gilt returns and increasing life expectancy. However, the absence of policy-holder representatives within insurance company decision-making might be part of the story too.

One option is to increase competition among annuity providers, by increasing the number of people exercising the 'open market option'. Everybody with a DC pension has the right to purchase an annuity from an insurance company other than the one that provides their pension product. However, only a third choose to do so, providing further proof of just how dysfunctional markets are in financial services. Annuities should be easier to compare than pensions savings products – and are not about benefits many years in the future – but still people do not act as informed consumers

Of course anything that leads to better pension outcomes is to be welcome. Competitive market dynamics may not be the full answer, but there is scope to make current arrangements work better. To this end, in early 2012 the Association of British Insurers (ABI) published a code of conduct for its members on dealing with consumers approaching retirement, which will promote the open market option and make the process of annuitisation much more transparent. The ABI also recently consulted on plans to compel insurers to publish actual annuity rates available, to develop consumer awareness of how the market operates.[22]

But it is hard to see how a 'consumer choice and involvement' model will work, given the mounting evidence that is does not work in financial services. We should therefore recognise the limits to competition given the inherent complexity of annuitisation and the underlying structures of the financial sector.

Automatic enrolment is designed to minimise the necessity of complex decision-making by individuals. Improving annuities may depend instead, therefore, on improving governance and increasing scale in DC provision. Again, NEST provides a useful model: NEST has chosen a panel of five providers who will offer annuities to NEST savers in different circumstances. Individuals will not be shopping around (although they retain this option) but will be able to make a relatively straightforward choice offered to them via a transparent process with significant safeguards to ensure members' interests have priority. If individuals trust the governance procedures of their scheme, and if schemes are large-scale enough to attract competitive offers, people should be able to get a good annuities deal without navigating the open market (although that option should always remain open). It should be clear that trustees have a duty to ensure good retirement income, not simply a pension pot when they leave the scheme.

6. Risk-sharing and the third consensus

If the third consensus is based on a big extension of pensions saving, mostly into auto-enrolment DC pensions where risks are largely individualised, does that mean that employers are no longer expected to share the risks inherent in saving for retirement?

We have to acknowledge that many employers today are neither willing nor able to shoulder significant risks in this regard. DC pensions provision under the automatic enrolment rules is certainly better than no pensions provision, and as the previous section explored, there are ways to improve both the structure of the DC market, and the design of specific schemes.

However, auto-enrolled DC with no more than the legally-required minimum contributions is merely the bare minimum. The existence of a minimum wage, for instance, does not stop employers generally paying more.

Pensions are similarly an important and legitimate part of remuneration for their staff. Employers should therefore look to make their schemes more secure and generous, in order to recruit and retain the most capable workers. Unions, of course, also have an important role in negotiating better pensions; while we do not ever expect individuals to fully 'value' pension pots in the way they value current income, the introduction of auto-enrolment and more transparency of contributions may well make pensions a more valued part of the remuneration package.

This could well lead therefore to a renewed interest in risk-sharing arrangements. This is why we welcomed the coalition government's 'Reinvigorating Workplace Pensions' strategy, which agrees that employers can do better. They have outlined ideas for 'defined ambition' pensions, a catch-all term covering almost any approach which is neither pure DC nor traditional final salary DB; or as we might say, neither a first nor second consensus approach to occupational pensions.[23]

The best way to understand the different approaches is to start by thinking about the different risks in pensions. The three main ones usually identified are:

- **Investment risk** – returns from investments are inherently risky. In DB schemes employers bear the risk – although contributions will increase if returns are consistently low, rather than merely volatile.
- **Longevity risk** – the basic difficulty for anyone saving for their retirement is not knowing how long they will live. Almost all pensions pool this risk in some way – either through annuities in DC schemes or through an employer guarantee in DB schemes – indeed this is perhaps a good definition of what differentiates a pension

from other savings vehicles. In addition all risk pooling vehicles face the risk that average longevity will increase – it is relatively easy to pool individual longevity risk if you know how long people will live on average, but harder when this average increases in unpredictable ways.

- **Inflation risk** – future inflation is unknowable. How pensions deal with inflation varies considerably. In some DB schemes pensions in payment are indexed to price inflation – either the RPI or CPI measure. In many DB schemes pensions are indexed by the legal minimum – this is price inflation up to a maximum of 2.5 per cent. In DC schemes annuities are available that range from a fixed annual payment, to uncapped indexation in line with RPI inflation.

These risks can be borne in different ways. In DB schemes they can all be carried by the scheme, with the sponsoring employer as the ultimate guarantor, although contributions or benefit rates are likely to be changed when costs mount. In DC schemes each individual bears nearly all the risk (though pooling some longevity risk during decumulation through annuitisation).

Risks can also be managed in different ways. Some pension schemes invest in riskier assets seeking higher returns. Others invest more conservatively but would need higher contributions on average for the same pension payments. It is fair to say that many DC default funds have not been invested in a very sophisticated way. This is why we welcome the innovation that NEST is bringing to DC investment in ways that seek decent returns, reduce volatility and minimise the risk of poor performance over the life-time of a pension. In many ways its approach sets out to achieve many of the objectives set by the defined ambition agenda, yet within a DC framework.

The defined ambition agenda is about innovative ways of managing or sharing these risks. The government has organised options into 'DC plus' or 'DB minus' models. DC plus options could include:

- **Insurance-based products that guarantee that savers will get at least the value of their contributions back.** This appears to be the option favoured by the government. More generous version of this would include the value of employer contributions too, or the real costs of contributions rather than simply their cash value. The argument for this approach is that a 'no cash loss' guarantee would encourage risk-averse savers to contribute to pensions. The argument against is that such a loss is very unlikely in a well-managed pension scheme – large-scale, pure DC schemes will almost always ensure there is no meaningful loss, at a lower cost, so the real challenge is establishing sound governance so that individuals are willing to invest more in their pension schemes.24,25

- **Employer-funded 'smoothing funds' that provide guarantees via mutualised funds.** This model would offer limited investment return guarantees, which would increase certainty over outcomes for individual savers without necessitating potentially complex decisions about the value for money of a member-funded insurance product. We find this option more appealing, because it is more likely to represent value for money for individual savers. But it would radically increase complexity within scheme management, and require significant regulatory change.

> The increase in cost volatility for employers – because they would have to make sure the smoothing fund is adequately funded – makes it highly unlikely many employers will voluntary adopt this model. It is far from certain that the drawbacks outweigh the likely benefits.

DC plus options should be explored – but as part of a wider strategy for improving DC pensions. It is likely that the benefits of well-governed, large-scale DC schemes means there already exists an approach to DC provision that can deliver most of the benefits of DC plus, without increasing complexity or regulatory burdens. We believe that if the government is going to embark on reforming the regulatory regime for risk-sharing in DC pensions, it should strongly consider introducing 'collective DC' into the UK – see Box 4.

Box 4: Collective defined contribution

The most promising candidate for the defined ambition agenda is what is known as 'collective defined contribution' (CDC) provision. This is common in both Denmark and the Netherlands, countries that have similar pensions systems to the UK but much stronger traditions of social partnership bringing together unions and employers in the delivery of public policy.

Under these schemes, members do not have an individual pot – although a pot may be designated in a nominal sense – instead members of the scheme invest collectively and share investment successes and failures. This is a form of risk-sharing between members, not between the member and their employer. Sharing risk between members is economically efficient; transaction and management costs are lower, and investment returns tend to be higher as there is less need to de-risk investment upon the approach to retirement, as in pure DC (see Pitt-Watson & Mann, 2012).

In this way, CDC schemes resemble DB provision. CDC schemes aim for a target pension payment, which they pay from own funds rather than requiring members to annuitise. Unlike DB schemes, however, there is no employer as funder of last resort, so the target cannot be guaranteed. While historically Dutch pensions have generally met their targets, in recent years they have not, which understandably has created disappointed members.

The need to pay pensions in payment out of the collective pot, however, requires funds to have a wider life than a single employer, and to be able to recruit new members constantly (automatic enrolment makes this highly likely, but does not guarantee it). CDC can only therefore take place in well-governed, large scale and multi-employer schemes (of the kind we advocate for DC in general).

Continued on page 38

Box 4: Collective defined contribution *(continued from page 37)*

The difficult judgements involved in balancing the interests of pensioners and contributing members are clearly challenging. Retirement outcomes for current retirees will always be funded by subsequent generations. If investment conditions worsen, or if the demographic balance within the scheme shifts significantly towards retired rather than active members, future generations could end up with worse retirement outcomes (despite making contributions at the same rate) as accrual rates (i.e. the nominal investment return) or annuity rates are reduced in turn.

But despite these challenges, it is important that every pound a hard-pressed employee contributes to their pension works as hard as possible to deliver retirement income, and in ways that reduce volatility and particularly the risk of poor outcomes. CDC may be part of delivering this. The potential for intergenerational unfairness is real but should not be exaggerated. In pure DC, it is also the case that people could make the same contributions for the same number of years, but end up with very different pension outcomes, because they retire at different times because of differences in investment returns, annuity rates and longevity between generations. This is just as much intergenerational unfairness, albeit one flowing invisibly through the whole economy rather than through the accounts of a single pension scheme.

None of these issues is straightforward, but that should not stop us working through them. There are real gains to be had from making pension schemes that are better designed and run.

David Pitt-Watson and Hari Mann (2012) *Collective Pensions in the UK,* RSA, available at www.thersa.org/__data/assets/pdf_file/0020/750161/Collective-Pensions-in-the-UK.pdf

DB minus options could include:

- **Removing the need for the indexation of benefits.** We would strongly oppose such a move because it would destroy one of the key elements of DB provision. Pensions that are not indexed see an erosion in value over time, leading to a declining standard of living in retirement, exacerbated by the tendency for living costs to rise with age. There is no evidence that indexation contributes disproportionately to the cost or cost volatility of DB provision. The switch to CPI-based indexation, although regrettable, reinforces this point; indexation requirements have already been significantly relaxed.
- **DB active, DC deferred.** This is a variant of a hybrid approach in which people gain DB benefits while employed, but these are turned into a DC pension pot (based on a valuation of the DB benefits) when they leave the employer. This sounds attractive at one level, as it is easy to see why an employer could feel more responsible for current members of staff than ones who have left. But it also seems to provide a big incentive for an employer to get rid of staff before their DC benefits gets crystallised into a DB pension. This would not be good for older workers. The conversion method would also represent a key risk to employees – one which they are highly unlikely to be able to understand.

The argument for any form of DB minus is that it will encourage employers to keep DB schemes open, rather than switch to pure DC. We are not convinced by this, as most employers have already closed DB schemes to new members. There are already flexibilities within DB provision that enable employers to reduce both costs and cost volatility. For example, Morrisons recently introduced a 'cash balance' DB scheme, which minimises employer liabilities, and many schemes, including the public sector, have adopted a 'career average' rather than 'final salary' approach.[26]

Most of the DB minus models outlined in the document would be highly complex to operate, undermining their attractiveness to employers. They would also be very difficult to explain to employees or prospective employees, therefore undermining their value as retention and recruitment tools. The reinvigoration strategy fails to provide an account of the levers that are likely to encourage employers to take-up DB minus options. The most likely outcome is that employers that remain committed to DB in some form would simply take advantage of deregulation to reduce the generosity of their schemes.

Of course we would wish to see employers take back some of the risk that has been moved onto individual DC scheme members in recent years, which is why we appreciate the theoretical attractiveness of DB minus models over pure DC. We remain strong advocates of DB pensions, and do not accept that they have no place in the private sector. Certainly, unions press for their retention while being prepared to negotiate justified changes as part of their bargaining agenda with employers.

But such arrangements – even with a significant increase in prevalence – would still, in all likelihood, only cover a minority of employees. Not only is it difficult to persuade smaller companies that putting pension risk on their balance sheet is a good idea, risk bearing has to be long-term.

For this reason, most of the options for DB minus or DC plus that involve risk-sharing with employers are unlikely to be taken up in the short-term. There are not many big, stable employers who can guarantee to be around in their current form long enough to provide support decades into the future. We can make much more progress by supporting existing DB and encouraging large-scale, well-governed DC schemes with good levels of employer contribution – the efficiency of the latter will be the factor that determines the likelihood of risk-sharing re-emerging as a significant feature of the UK private pensions system.

Clearly, different kinds of workplace pension provision will be appropriate for different kinds of employers. An obvious example is the public sector. Short perhaps of an asteroid strike, the state can provide a long-term covenant to underpin defined benefit provision, and should therefore provide its employees with the best pensions that it can.

As long as there is a strong employer covenant, as Con Keating reminds us, DB pensions are economically efficient.[27] Analysis by Chris Sier of Stonefish Consulting also details how investment management costs could be much lower if, just as in DC schemes, DB schemes could benefit from greater scale.[28] And perhaps the biggest danger of the defined ambition debate – important and interesting though it is – is that it detracts from the real pensions challenge of increasing saving. Even the best run and most efficient pension scheme will not pay a decent retirement income without adequate and consistent contributions.

Conclusion

First consensus pensions provision was of its time. Elements of it were exclusionary for some groups, but in general it offered decent and secure pensions to millions. It shared the strengths and weaknesses of Britain's post-war settlement, rooted in a social democracy forged through the experience of war. While elements of it stubbornly – and rightly – hang on today (showing their fundamental strengths), much of it was fatally wounded by the oil shock and other events that heralded the end of that era, and ushered in the harsher world of market fundamentalism, that in its turn collapsed with Lehman Brothers in 2008.

The second consensus was perhaps even more in tune with its era. The retreat of the state and employer responsibility left individuals to cater for their own well-being. And as long as the state stood out of their way, it was expected that they would make 'rational' economic decisions to plan for their retirement. Pension provision, just like anything else, was best provided by competitive markets in which providers' search for profits delivered good products for savers.

Ironically the early years of new Labour ended up legitimising this approach, albeit by attempting to make it less harsh. They accepted the reduction in the value of the state pension but sought to universalise access to the provision that remained. They accepted the centrality of 'personal responsibility' but sought to ensure that simpler and cheaper products were available in workplace pensions. Perhaps most notably, they boosted the safety net for those left behind by the private pensions system.

But the second consensus, despite these changes, was never going to last. It bumped up against the unfortunate reality that, no matter what the incentives or encouragement provided by the government are, people are not inclined to defer consumption today to save for income tomorrow, especially in a confusing, complex system riddled by mis-selling scandals. The result was a steady decline not just in state and employer provision, but employee saving too.

The Pensions Commission was the midwife of what we have called the third pensions consensus, which is spluttering into existence as auto-enrolment starts and the state pension is linked once again to earnings. Unlike the second consensus, which both emerged by default and excluded consumer voices from its design, the third consensus has been carefully constructed by recognising the legitimate interests of different groups.

The shift to this new approach is undoubtedly a highly progressive move. The TUC and unions can take pride in both leading the campaign that said our pensions system was failing, and playing a crucial role, with our consumer lobby allies, in shaping the implementation of a new system.

This system, based on a simpler state pension set above means-tested benefit levels on which people can build further retirement income from a workplace pension, is undoubtedly a viable pensions architecture.

But this needs to be seen as a starting point, not the last word. To abuse the metaphor, good architecture is needed, but it is what you do in the building that counts. There are three main challenges that need to be met to make the third consensus truly successful.

First, contributions need to be higher. We recognise that this will need to be phased and that the middle of a living standards slump is not the best time to start, but there can be no doubt that the best pensions saving system in the world can only deliver good pensions if enough is saved in the first place.

Second, we need more efficient and better designed pension systems that are run in the interests of members, not employers or pension providers. This is where there is too much hang-over from the second consensus as products developed for that era are being stretched in ways that do not quite work to fulfil the different purposes of the third consensus.

The biggest problem is the misalignment of interests that continues. A key problem in the second consensus was that individuals never played the role assigned to them as intelligent, economically rational and informed consumers. Auto-enrolment and the accreditation of schemes goes some way to remedy this, but does not properly replace the role that consumers should, but are not qualified or motivated, to play.

In some ways this responsibility is passed to employers when they choose an auto-enrolment scheme, but their interests are not the same as those of their staff (although we recognise that many approach this role responsibly). Employers make a one-off decision to choose a supplier; after that their formal role in scheme governance ends – unless they choose to exercise this, ideally with strong member involvement.

In good trust-based schemes, trustees have the sole duty of serving scheme members. They can play the role market forces were expected, but failed, to play in the second consensus. With scale comes the ability for trust-based schemes to fund what is needed for good governance. Of course they will still need to purchase many services from traditional pensions providers, but large-scale trusts provide the kind of smart customers that can drive a good bargain for their members.

Of course not every trust-based scheme is run well: some are too small, and some do not have committed or competent trustees. These are problems that need to be dealt with through regulation. But overall, in trust-based schemes there is not the fundamental misalignment of interests that occur when, as in contract-based schemes, member welfare is sub-contracted to a company running the scheme, however well, to provide a return for their shareholders. Even those more inclined than us to trust markets increasingly recognise this problem in pensions provision.

For example, Michael Johnson, a Research Fellow at right-of-centre think-tank the Centre for Policy Studies has argued, "the industry knows that it has to radically change its behaviour, not least because some within it have finally realised that the pursuit of their own self-interest, at the expense of their customers, may ultimately prove to be the industry's nemesis." We fully share Johnson's conclusion that "a leap of faith is required by the industry, because whilst profits may diminish in the short term, the long-term outcome could be a rejuvenated reputation… and business growth". In our view, the industry would benefit from a progressive approach to the third consensus, even if many in the industry, wedded to second consensus policies and products, have yet to recognise this.[29]

Johnson continues, "change would be more lasting if it were driven by the industry itself, rather than through state intervention." There is merit in this, and trade unions have offered support to various efforts of industry trade bodies to establish self-regulation. But the juxtaposition between self-regulation and 'state intervention' is too simplistic. The third consensus needs the state: to guarantee a retirement free from poverty, irrespective of private saving; to make the workplace pensions market operate fairly and effectively; and to make sure pensions saving is always worthwhile. Individuals need to be incentivised to save more for a pension, but employers and industry can also be incentivised by the state to provide decent pensions savings products.

Moving to large scale, trust-based provision for the bulk of DC provision also opens up the possibility of innovation in pension design that can benefit from new approaches to risk-sharing such as some of the variants of collective DC. The traditional DC scheme in which each individual bears the risk and then purchases an annuity is very much a second consensus individualised ideal, even if they can be run in a way more appropriate in the third consensus era by good trusts.

Our third issue is state provision. While there are many issues of concern about how we move from the current system to a flat-rate model, there is undoubtedly a progressive case for changing the structure. But just as with workplace pensions, just as big a question is how generous the new scheme will be. The current government's projections show the share of GDP going to state retirement pensions falling in the long term under their plans, partly because many workers will not get such high earnings-related pensions, and partly because of the increase in the state retirement age.

But a fall in pensions spending is not a necessary consequence of a flat rate in itself. Future governments can make it as generous or mean as they wish. But it does show that there is potential for a more generous state pension that could move some of the way towards the much better pensions enjoyed in many of our European partners.

But without progress on any of our three calls for change, even the better structures in the third consensus run the risk of a race to the statutory bottom. Employers could discharge their new obligations with relatively limited fuss, by handing over control of their workplace pension schemes to providers such as insurance companies, offering products with limited cost and administrative complexity to the employer, but higher costs and fewer safeguards for the actual savers and keeping contributions at the current minimum levels in perpetuity.

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