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# HOW THE UK SAVES

## ESSENTIALS • OF • THE • UK • RETIREMENT • SYSTEM

LONDONDERRY MERIONETHSHIRE MIDDLESEX
MIDLOTHIAN MONMOUTHSHIRE MONTGOMERYSHIRE
MORAYSHIRE NAIRNSHIRE NORFOLK NORTHAMPTONSHIRE
NORTHUMBERLAND NOTTINGHAMSHIRE ORKNEY OXFORDSHIRE
PEEBLESSHIRE PEMBROKESHIRE PERTHSHIRE
RADNORSHIRE RENFREWSHIRE ROSS-SHIRE ROXBURGHSHIRE
RUTLAND SELKIRKSHIRE SHETLAND SHROPSHIRE
SOMERSET STAFFORDSHIRE STIRLINGSHIRE SUFFOLK
SURREY SUSSEX SUTHERLAND TYRONE WARWICKSHIRE
WESTLOTHIAN WESTMORLAND WIGTOWNSHIRE
WILTSHIRE WORCESTERSHIRE YORKSHIRE

**The 92 historic counties listed are sourced from the Association of British Counties as at October 2019.**

# Contents

| | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| UK Prime Ministers | John Major, Conservative | | | | | | Tony Blair, Labour | | | | | | |
| Secretaries of State with responsibility for pensions | | Peter Lilley, Conservative | | | | | Harriet Harman | Alistair Darling | | | | Andrew | |

**Major events**

- Government announces that BSE, or 'mad cow disease', can be transmitted to humans
- Death of Diana, Princess of Wales
- Referendums in Scotland and Wales back the creation of separate assemblies
- Good Friday Agreement on a political settlement for Northern Ireland
- War in Yugoslavia and Kosovo
- September – 9/11
- Air strikes on targets in Afghanistan
- UK joins US-led military campaign against Iraq

**Industry/regulatory milestones**

- Welfare Reform and Pensions Act introduces Stakeholder Pensions and pension sharing on divorce
- Child Support, Pensions and Social Security Act replaces SERPS with the State Second Pension (S2P)
- Pension Credit Act replaces income support for people aged 60+ with a guaranteed minimum income
- Pensions Act, one of the most influential pieces of primary legislation for pensions, provides a stronger regulatory framework for private pensions and increases the State Pension Age for women from 60 to 65 between 2010 and 2020

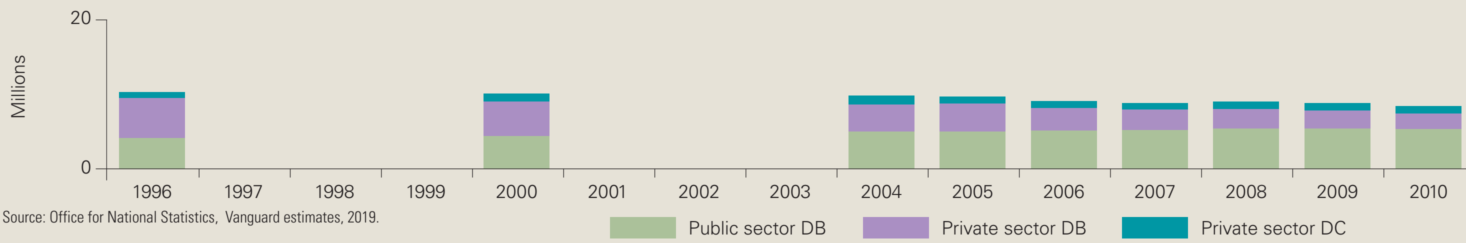
**Mandatory minimum contribution rates to UK defined contribution schemes**

Member / Employer / Total

| | 2012 | | | 2013 | | | 2014 | | | 2015 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Member | Employer | Total | Member | Employer | Total | Member | Employer | Total | Member | Employer | Total | Member |
| | 1.0 | 1.0 | 2.0 | 1.0 | 1.0 | 2.0 | 1.0 | 1.0 | 2.0 | 1.0 | 1.0 | 2.0 | 1.0 |

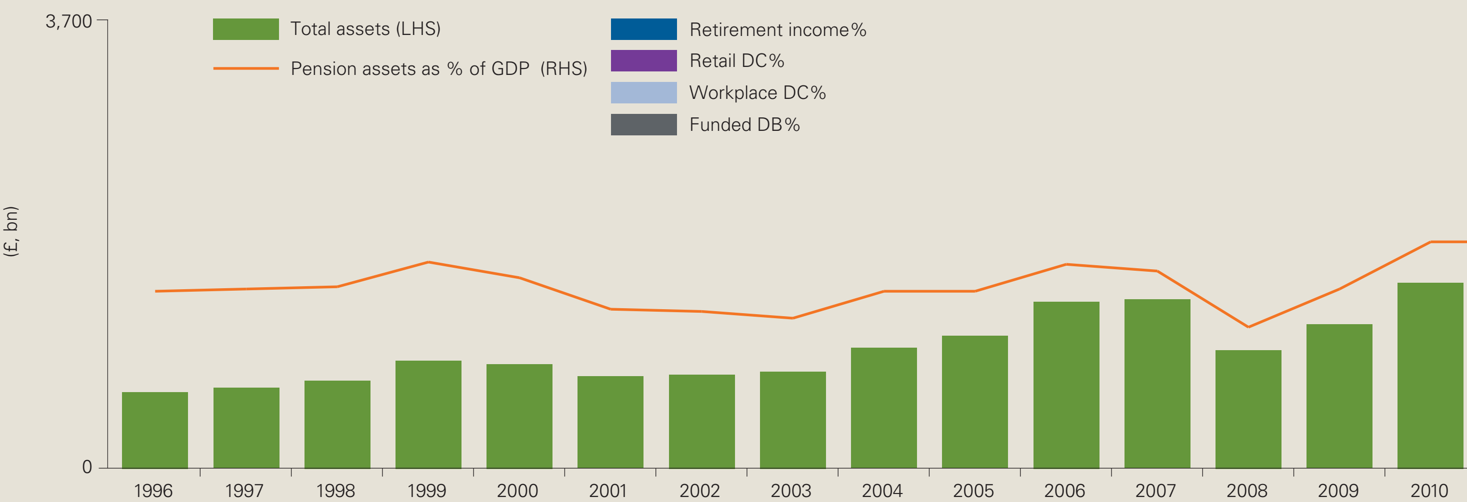
Source: Office for National Statistics, the Pensions Regulator, Vanguard estimates, 2019.

**Number of active members of occupational pension schemes (millions)**




Source: Office for National Statistics, Vanguard estimates, 2019.

**Industry Growth**




Source: Willis Towers Watson Global Asset Study, IMF, Hymans Robertson, Spence Johnson, NMG, Vanguard estimates, 2019.

2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018 2019

Gordon Brown
Labour

David Cameron (Conservative)
and Nick Clegg (Lib Dem)
(Coalition (Cameron–Clegg) 2010-15)

David
Cameron
Con.

Theresa May
Conservative

Boris
Johnson

Smith | John Hutton | James Purnell | Yvette Cooper | Iain Duncan Smith | Damian Green | Esther McVey | Amber Rudd

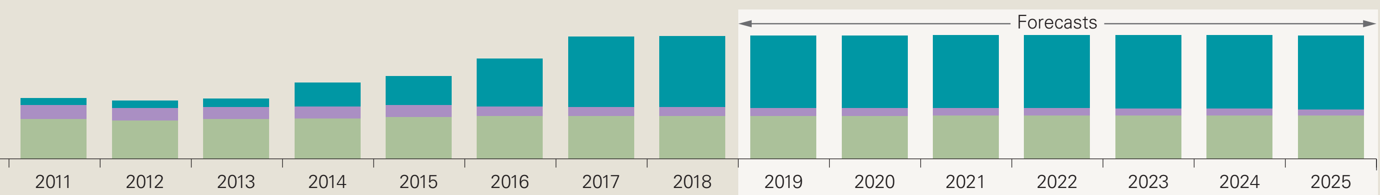
Alan Johnson | David Blunkett | Peter Hain | Stephen Crabb | David Gauke | Thérèse Coffey

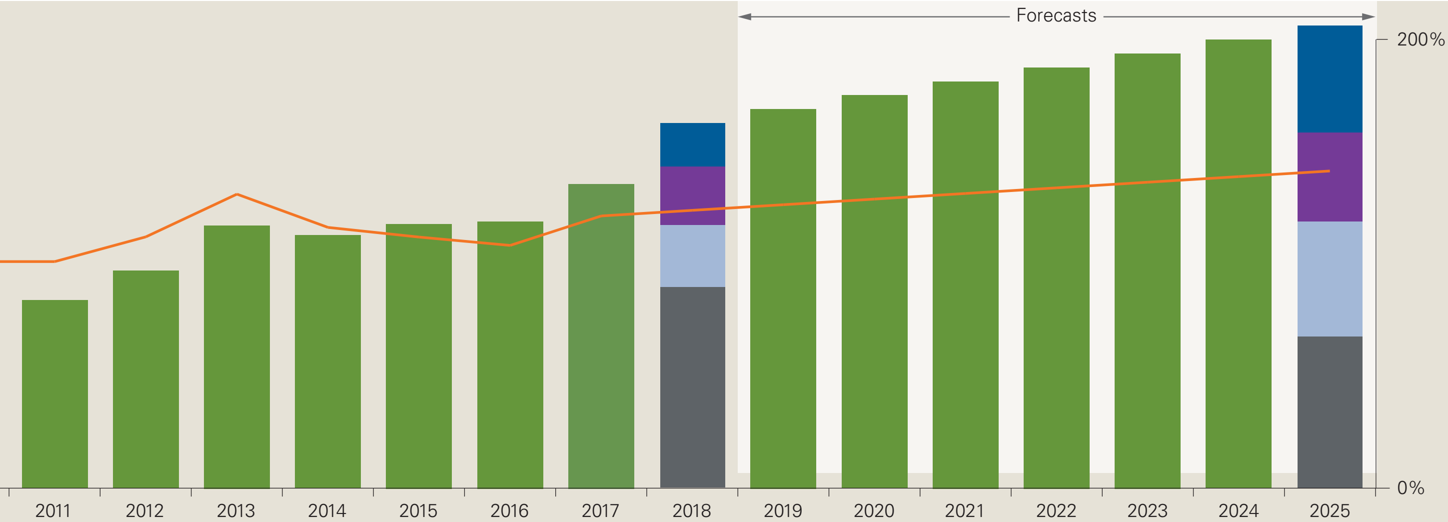
- UK government part-nationalises three leading banks following the global "credit crunch"
- Article 50 deadline for leaving the European Union extended to October 31, 2019
- Britain withdraws bulk of its remaining troops in Iraq
- Suicide bomb attacks on London's transport network
- Large-scale public spending cuts aimed at reducing UK's budget deficit
- International intervention in the conflict in Libya
- Irish Republican Army (IRA) announces formal end to its armed campaign
- David Cameron proposes a referendum on whether to leave the European Union
- London hosts the 2012 Summer Olympics and Paralympics
- Birth of Prince George of Cambridge, who is third in line to the throne
- Voters in a referendum in Scotland reject independence, by 55% to 45%
- UK voters in a referendum opt to quit the European Union. David Cameron resigns
- Formal negotiations begin to end Britain's membership of the European Union

- Pensions Act introduces workplace pensions reform including requirement for auto enrolment from 2012
- FCA introduces a ban on differential charging and DC commissions in workplace personal pension schemes
- Pensions Act establishes a new Pensions Regulator and Pension Protection Fund
- Employment Equality (Age) Regulations prohibit unjustified direct and indirect age discrimination
- Finance Act simplifies tax regimes for pensions
- Pensions Act increases state pensions age for men and women to 66 by 2020, and amends elements of 2008 Pensions Act
- Finance Act changes rules on annual contribution and lifetime balance allowances, annuities and income drawdown rules
- Budget Statement introduces "Pensions Freedoms" from 2015, allowing individuals to withdraw money from pension schemes as they please, and requires advice for DB to DC transfers
- Deadline for Master Trust authorisation applications, March 2019
- Pension Schemes Act establishes a new regulatory regime for Master Trusts that includes an authorisation requirement

Percentages

| | | | |
|---|---|---|---|
| 2016 | | 1.0 | 2.0 |
| 2017 | 1.0 | 1.0 | 2.0 |
| 2018 | 3.0 | 2.0 | 5.0 |
| 2019 | 5.0 | 3.0 | 8.0 |
| 2020 | 5.0 | 3.0 | 8.0 |
| 2021 | 5.0 | 3.0 | 8.0 |
| 2022 | 5.0 | 3.0 | 8.0 |
| 2023 | 5.0 | 3.0 | 8.0 |
| 2024 | 5.0 | 3.0 | 8.0 |
| 2025 | 5.0 | 3.0 | 8.0 |



# Essentials of the UK pension system

To provide context for both domestic and international readers of our UK retirement research, this publication summarises the structure of the UK retirement system and its recent evolution. We recommend that this piece should be considered alongside publications such as *How the UK Saves 2019: Member experience from the National Employment Savings Trust* to provide background around the UK pension and retirement system as a whole.

## The global retirement savings challenge

Ageing populations, driven by declining birth rates and longer life expectancy, are shifting the balance between those of working age and retirees. People are working longer, but not by enough to maintain the balance between those who are net producers of wealth and those who depend on the wealth produced by others.

Few workers can now expect the traditional pattern of 40 years of work for an established employer, with income steadily increasing over time. New forms and patterns of work are emerging – for example, around five million UK workers are now in some form of self-employment.

Meanwhile, the outlook for retirement security is challenged by low expected investment returns alongside weaker economic and productivity growth.

## The challenge in a UK context

The UK system has traditionally relied on a mix of taxpayer-financed, pay-as-you-go elements and funded provision. The latter comprises a blend of both workplace and personal provision across pension and non-pension saving. The main components of the system have historically been:

- The State Pension, comprising a basic flat-rate element and, at times, earnings-related supplementary elements;
- Voluntary occupational pension schemes, traditionally final-salary defined benefit (DB) schemes covering a large but declining portion of the workforce, as illustrated in the industry milestones infographic on pages 4 and 5.

This system has come under increasing pressure in recent decades:

- The basic State Pension, even though linked to inflation, has become progressively less generous relative to earnings;
- A variety of earnings-linked additional benefits have suffered from many revisions to their underlying calculations, leading to complexity;
- Means-tested "minimum income" benefits have proved an effective way of targeting pensioner poverty, despite their complexity. However, eligibility criteria have led to a reduction in the value of pensioners' savings and have been seen as a disincentive to save;
- Funding pressures, revisions to actuarial assumptions and regulatory changes have made guaranteed pension incomes more costly. Employers have moved away from offering DB in favour of defined contribution (DC);
- Uptake of personal pensions has risen significantly. Bundled as "group personal pensions" (GPPs), these have increasingly been used by employers to step away from occupational provision, allowing employers to outsource pure DC provision.

The parallel decline in worker participation in both occupational and personal plans may have been a consequence of these changes, or it may have contributed to them. Provision was concentrated among employees of larger firms and workers on relatively high incomes – with many schemes including service or income eligibility rules – but, by the turn of the millennium, it was in decline across all groups.

By the early 2000s, the situation was becoming critical. The government brought forward measures to improve access to workplace pensions by requiring employers to designate a pension for employees. They sought to address complexity and cost through the introduction of "stakeholder pensions", a simple, price-capped personal or group personal pension product. While expanding access, these measures were largely unsuccessful in expanding coverage.

In 2002, the government set up the independent Pensions Commission to consider the case for introducing compulsory retirement saving. In 2005, the Commission brought forward a comprehensive set of recommendations, which were largely adopted by the government and implemented from 2010. The key features of this programme of reforms were:

### First pillar

To ensure that a simple State Pension would retain its value and act as a stable foundation for supplementary saving, at a sustainable cost to taxpayers, the Commission recommended:

- Simplifications to the State Pension to make it a flat-rate, near-universal benefit indexed to earnings.
- Changes to the age of eligibility for the State Pension to ensure the pension age would move broadly in line with future increases in life expectancy, alongside an existing plan to align male and female State Pension Age by 2025. Thereafter the age of entitlement would increase by one year in every ten, reaching 68 by 2045.

### Second pillar

- Introduction of mandatory auto enrolment, requiring all employers regardless of size to enrol eligible workers into a qualifying workplace pension. Employees would retain the right to opt out but, where they did not exercise that right, employers would be required to make a minimum contribution towards their employees' pensions.
- Creation of the National Employment Savings Trust (Nest) – a qualifying workplace pension scheme with a statutory obligation to accept any employer wishing to use it to meet its auto-enrolment obligations. Nest was designed to ensure that a high-quality, low-cost option was available to everyone irrespective of their commercial "value" to pension providers.

## Subsequent reforms: 2008-2019

While implementing the Pensions Commission's proposed reforms, two further changes were made:

- The government underpinned the value of the State Pension with the "triple lock", which ensures that State Pensions are indexed to the better of prices, earnings or a minimum annual increase.

- The 2015 "freedom and choice" agenda abolished the previous regime which effectively imposed annuitisation on DC savers by age 75. This allowed them to instead gain access to their money in whatever form they preferred ten years prior to their State Pension Age.

## Establishing Nest

Nest is a trust-based, occupational pension scheme, set up by act of Parliament and run by a non-departmental public body. As an occupational trust, Nest is governed by a body of independent trustees, though it is also accountable to Parliament through the Secretary of State for Work and Pensions. Uniquely, Nest's constitution places on it a public service obligation to provide a qualifying plan to any employer and to accept any eligible worker that the employer enrols. As a consequence, its growth has been significant, as can be seen from the statistics in Nest annual reports and *How the UK Saves* publications from Vanguard and Nest Insight. The scheme will ultimately be self-funded through member charges but, until that point, it receives an interest-bearing loan from the government.

## The system as at 2019

Using the updated World Bank "five pillars" conceptual framework, the core components of the UK's retirement system are as follows[1]:

### Zero pillar

In addition to the reformed State Pension, some situation-specific, means-tested benefits such as housing benefit and council-tax benefit remain available to pensioners. For individuals whose total income in retirement is below £167.25 per week (£255.25 for couples), Pension Credit is available to bring their income up to this level.

### First pillar

Since 2016, those reaching retirement do so under the new flat-rate system. Eligibility is based on retirees' years of National Insurance contributions or credits. To receive the full State Pension, a retiree must have accrued 35 qualifying years.

The full State Pension amount is currently £168.60 per week, equating to £8,767.20 per year, which is approximately 35% of median earnings. Any individual can increase their entitlement by deferring their claim: an increase of 1% for every nine weeks deferred, plus any indexation during the deferral period, to a maximum of five years.

Eligibility for the State Pension was equalised for men and women at age 65 in November 2018. State Pension Age for both men and women is increasing, and is due to reach 66 by October 2020. The next proposed increase in the State Pension Age, to 67 for both men and women, will take place between 2026-28. Finally, under current legislation, the State Pension Age is due to increase to 68 between 2044-46, however the government has proposed a plan – currently under parliamentary review – to bring this timetable forward to between 2037-39.

## Worker eligibility and contribution levels

Worker eligibility is a function of age and income, as depicted in **Figure 1**, with the following main categories of worker allowed for within the regulations (figures shown are for the 2019-2020 tax year):

*Eligible jobholder:* Workers aged between 22 and State Pension Age, with pro-rated annual earnings of at least £10,000, must be enrolled automatically in a qualifying workplace scheme. Where the worker chooses to stay enrolled, the employer must make on their behalf a contribution totalling at least 8% of their earnings, subject to minimum and maximum earnings levels that are £6,136 and £50,000 respectively. At least 3% of this contribution must come from the employer. Individual contributions are made on an exempt-exempt-taxed (EET) basis, meaning that the contributions made by individuals are partly offset by tax relief. As a result, in the minimally compliant case, contribution rates will effectively be 3% employer, 4% employee and 1% from the government as tax relief

*Non-eligible jobholder or opt-in worker:* These workers fall into one of three categories;

- Aged between 16 and 21 with pro-rated annual earnings of at least £10,000;
- Aged above State Pension Age with pro-rated annual earnings of at least £10,000; or
- Aged between 16 and 74 with pro-rated annual earnings between £6,136 and £10,000.

The employer must enrol the worker if asked to. It must also make the same contributions as though the worker had been auto enrolled.

*Workers without qualifying earnings or entitled workers:* Aged between 16 and 74 with pro-rated annual earnings no higher than £6,136. Employers do not have to enrol these workers automatically, but they do have to enrol them if they ask to join. Employers are not obliged to make contributions on behalf of these workers, though they can choose to.

### Qualifying scheme rules

Qualifying workplace pension schemes must meet the following conditions[2]:

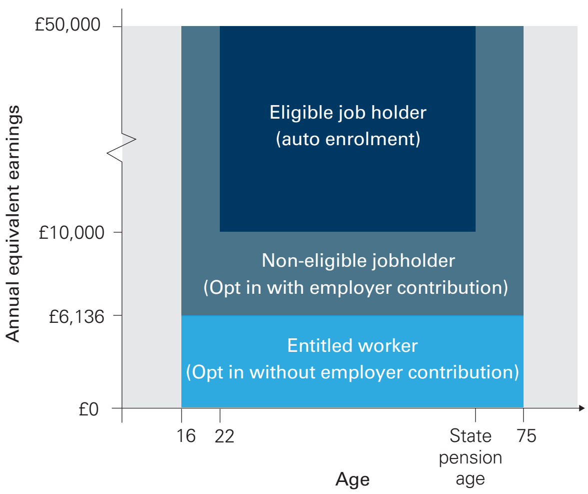
- Use auto enrolment and offer a default fund so that no active choice is required by the saver to begin saving for retirement;
- Offer contributions consistent with the minimum contribution rules;
- Have annual management charges no higher than 0.75% or equivalent;
- Comply with relevant regulatory criteria, dependent upon scheme structure.

1 *Old Age Income Support in the 21st Century: An International Perspective on Pension Systems and Reform,* World Bank, 2005 and subsequent enhancement *The World Bank Pension Conceptual Framework,* World Bank 2008.

2 The Pensions Regulator, *Detailed Guidance for Employers vol. 4*

3 Exempt-exempt-taxed (EET), a term describing the UK's system of pensions tax relief, in which the three letters correspond to the three stages in the taxation of pension schemes. The first E relates to the contributions stage, the second E to the investments stage and the T to the taking benefits stage.

Figure 1. Auto-enrolment eligibility




Source: the Pensions Regulator 2019.

### Second pillar

There is no compulsory funded/occupational tier in the UK. Workplace pension saving is voluntary for individuals, but subject to a mandate on employers to enrol eligible workers in a qualifying scheme automatically. Employers are also obliged to make contributions on behalf of any employee who remains enrolled. Workers who have opted out of saving are auto enrolled again on a three-year cycle.

### Third pillar

Individuals are entitled to make additional contributions to their workplace pension scheme. They can also separately open a personal pension (such as a Self-Invested Personal Pension or SIPP) and make contributions to that, subject to tax constraints. In addition, various other products exist that can be considered as contributing to retirement provision in a third pillar:

- Stocks and shares Individual Savings Accounts (ISAs) offer a tax-incentivised wrapper for investments. These accounts are structured on a taxed-exempt-exempt (TEE) model – i.e. savers contribute from post-tax income, but returns and withdrawals are tax free. Individuals can currently save up to £20,000 in an ISA per tax year.
- Lifetime ISA (LISA) launched in 2017 to help people either saving to purchase a first home or supplementing retirement savings. LISAs have an annual contribution limit of £4,000 and include a 25% match from the government. They are open to those aged between age 18 and 40 and, once started, investors can contribute every year up to the age of 50. Withdrawals can be made to fund a first home purchase at any time from one year after opening, or for any reason from age 60 onwards. Withdrawals at any other time are subject to a 25% penalty (in effect, removing the matching incentive). Contributions to a lifetime ISA count towards the overall annual ISA limit.

## Pensions taxation

All pension saving in the UK is done on an EET basis[3]. Contributions are made from pre-tax income, so are subject to tax relief. Investment growth is also tax free. From age 55, savers are also eligible to take 25% of their retirement savings tax free. All other withdrawals are subject to the marginal rate of income tax.

Contributions subject to tax relief in a given year are capped at £40,000. This annual limit also applies to the value of benefits accrued in a DB plan. Above that limit, contributions no longer attract tax relief and a charge may be due. Once an individual accrues benefits worth £1.055m (the "lifetime allowance" limit), they can no longer make additional contributions without triggering a tax charge.

Unlike in some other systems – for example, the Roth IRA in the USA – there is no TEE retirement product in the UK, although ISAs work on a similar basis and lifetime ISAs even more so.

## The shape of the UK retirement saving market

The legacy of DB schemes still dominates for many of those approaching or recently having entered retirement, with only 10% of those currently reaching retirement relying solely on DC provision[4]. Moreover, the majority of UK retirement system assets are still in DB schemes.

However, the UK has a higher proportion of its assets in DC than many other developed nations: a recent study[5] found it to be the third-largest DC system globally by AUM. In April 2019, when minimum auto-enrolled contributions rose to 8%, total annual contributions to DC schemes are expected to have increased by £17 billion[6] per year.

With almost all active contributions to workplace pensions in the private sector now going to DC, and with most DB schemes closed to new members, the balance in the UK should now shift considerably towards DC.

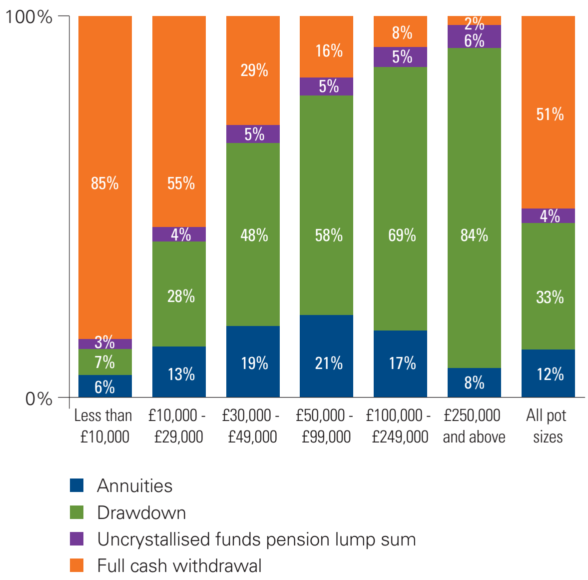
Compliance with the requirement to auto enrol eligible employees has been extremely high – at the last regulator's report[7], the figure for small employers was 95% – so scheme access is near-universal at the employer level. As can be seen from the infographic on pages 4 and 5 the impact on workers saving for pensions has been profound.

Government estimates suggest that the auto-enrolment mandate covers around ten million eligible jobs, and the growth in this number during the roll-out of auto enrolment has also frequently been used to represent the number of people auto enrolled. In practice, with a 5.5-year roll-out, job churn within the eligible population means that enrolment events in this period will have been much higher. Opt-out rates have been consistently low across the industry at less than 10%, and so a reasonable estimate is that, as a result of auto enrolment, around nine million people at any given moment are saving for their retirement who might not otherwise have been doing so.

## The at-retirement market

Since the "freedom and choice" agenda came into effect on 6 April 2015, drawdown plans have gained significantly in popularity. Based on latest data available from the regulator[8] in **Figure 2**, nearly three times as many pots are moving into drawdown as into annuities.

**Figure 2.** Composition of product purchases made between October and March 2018, by account size (%)




Source: FCA, data bulletin issue 14, September 2018

4 Pensions Policy Institute (2018): The evolving retirement landscape at http://www.pensionspolicyinstitute.org.uk/publications/reports/the-evolving-retirement-landscape

5 Willis Tower Watson (2017) Global Pension Assets study 2017 at https://www.willistowerswatson.com/-/media/WTW/PDF/Insights/2017/01/global-pensions-asset-study-2017.pdf

6 DWP (2016) *Workplace pensions: update of analysis on auto enrolment 2016*. At https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_ data/file/560356/workplace-pensions-update-analysis-auto-enrolment-2016.pdf

7 See *High compliance rates underpin success of auto enrolment* at http://www.thepensionsregulator.gov.uk/press/pn16-39.aspx

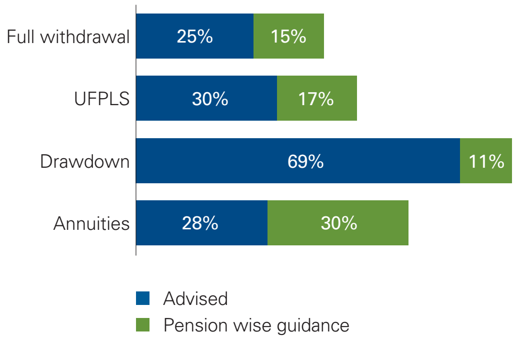
8 Financial Conduct Authority (FCA), *data bulletin issue 14, September 2018* https://www.fca.org.uk/publication/data/data-bulletin-issue-14.pdf

It remains too early to assess the "normal" behaviours that may emerge after the early demand to take advantage of pension freedoms subsides. However, initial observations are:

- Accessing pots early is still attractive: 72% of pots had been accessed by consumers under the age of 65, with most taking lump sums.
- 51% of pots accessed have been fully withdrawn, with the vast majority of these being under £30,000. Many pots were moved into other savings or investments rather than spent outright.
- Many of those withdrawing pension pots had other forms of retirement income – often including DB pensions providing a guaranteed income in retirement.

**Figure 3.** Breakdown of purchases and withdrawals with advice or guidance

Where recorded by provider between October 2017 and March 2018




UFPLS: Uncrystallised funds pension lump sum
Source: FCA, data bulletin issue 14, September 2018

The new landscape has presented several challenges for policymakers and the pensions industry:

- A perceived underlying lack of trust in pensions;
- The low propensity to shop around that was a feature of the annuity market also characterises the drawdown market. Member inertia means that many are taking drawdown from their existing provider;
- As shown in Figure 3, the tendency for many (31%) customers to buy drawdown plans without formal advice raises concerns about their ability to maintain their income throughout retirement. While the majority of annuity purchases continues to be single-life, level payments policies without formal advice (72%), a concern is the sustainability of customers' spending power in retirement.

The decline in DB incomes is coming alongside a decline in home ownership in the UK which together will limit the savings and pension assets available to those retiring in future. There is therefore a need for further innovation in the UK retirement sector. This may come in the form of "guided retirement pathways" available to support good member outcomes, and lower-cost advice solutions. It is likely that the UK at-retirement market will remain in a state of flux for some time as these challenges are addressed.

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