

we can't carry on like this!

policy solutions for the
under-pensioned: perspectives
from key players in the sector

Edited by Rachel Reeves MP





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policy solutions for the under-pensioned: perspectives from key players in the sector

This excellent and timely publication forms part of the Smith Institute's ongoing programme of work on policies for a fairer society. With falling real wages for many, rising levels of personal debt, an ageing population and a bleak economic outlook, the number of people who are "under-pensioned" is set to increase. The contributors to this collection highlight the scale and scope of the problem and offer a range of practical policy solutions. It is the responsibility of today's politicians and policy makers to ensure that our pensions system is fit for purpose and can meet the demands of tomorrow's pensioners. We hope that this report pushes the debate forward so that the necessary long-term decisions can be made with cross-party support.

The Smith Institute thanks Rachel Reeves MP (shadow pensions minister) for editing this publication and offers its thanks to all the authors for their excellent contributions. We also gratefully acknowledge the support of Aviva and the National Association of Pension Funds for this publication and the associated seminar.

Paul Hackett, Director of the Smith Institute

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Introduction

Rachel Reeves MP, Shadow Pensions Minister

The UK has one of the oldest and most complex pensions systems in the world. The Northumberland & Durham Miners' Permanent Relief Society, set up in 1862, had 140,000 members by 1899 and was offering a pension of four shillings a week for members over 60, while the London & Birmingham Railway sold left luggage to finance pensions for staff in the 1840s.

Through the development of pensions, the government has been a partner to companies, insurers and pension funds in building savings and delivering retirement income. The evolution of the UK's state pension system, as examined in more detail in chapter 4, began with the introduction by Lloyd George of the old age pension in 1908; then came the state pension in 1948, following the Beveridge report; then graduated retirement benefits; Barbara Castle's SERPS system; the state second pension; and pension credit. The development of pension policy over the years has covered a lot of ground. The Coalition has since kept up the pace of reform.

One result of government engagement by the last Labour government is that pensioner poverty is now at its lowest level since records began, and the current generation of retirees are benefiting from generous occupational pensions as well.

Challenges

But, despite some successes, we have a problem. We are under-saving – not only under-saving for a rainy day, but most of all under-saving for the average of 20 or more years that we spend in retirement.

The numbers tell a stark story. A huge 51% of people are not making adequate provision for their retirement, and 20% are not saving at all. The problem gets worse as we move down the income scale. While 77% of people earning upwards of £31,000 have private pension savings, only 56% of people on average earnings of £25,000 a year do. Just 44% of people earning below average incomes have any savings put aside, and as we move down the income scale, the sufficiency of those savings falls too.

Those are the numbers as things stand now, but we know that in the current economic climate finding money to put into a savings account or pension is particularly difficult. With household incomes falling by 3.8% last year, inflation running high and wages stagnating, it is difficult for many families to put money aside. This book is about those challenges, and the solutions to boost pension savings going forward.

Under-saving is inevitably linked to disposable incomes, but also reflects the design of the system and is exacerbated by the increasing trend in life expectancy.

Many of the chapters in this pamphlet refer to the complexity of the pensions system – and its failure to keep up with the changes in the labour market. Many features of today's pensions system are rooted in the realities of the 1940s. When the state pension began, in 1948, men made up 70% of the workforce, part-time workers just 4%, and most people could expect a job for life. Today, the situation is significantly different – 71% of women are economically active, part-time work is much more common, and we can expect to have, on average, 11 jobs in our working lives. The state pension and occupational pensions were designed for a world of work that no longer exists, and pensions policy has not kept pace.

Add to the system design the increase in life expectancy, and the growing challenge of under-saving worsens. While men reaching 65 in 1950 could expect to live for 12 years, a male retiree at 65 can now expect to live for 20 years. These changes demand innovative solutions from government, pension providers and individuals, if expectations of a decent life in retirement are to be realised and the pensions system to remain affordable.

The chapters that follow set out some of the opportunities that exist to tackle the challenges, as well as identifying some key groups for whom the problems of under-saving are most acute and, in many cases, growing.

Opportunities

Perhaps the biggest opportunity ahead is the introduction of automatic enrolment, rolled out from 2012. The result of the post-Turner Commission consensus, auto-enrolment represents a continuation of the historic partnership between state, employer and individual in delivering pensions. By automatically getting workers saving for their retirement, it is designed to get up to 7 million more people saving, and ensure that more people do not have to rely just on state support when they come to retire. It harnesses our inertia when it comes to savings – taking advantage of the tendency that people have to put off until tomorrow what should be done today.

The 2012 reforms mean that this pamphlet is incredibly timely. The spirit of partnership and consensus, which was responsible for the auto-enrolment settlement, was evident in the formation of this book, for which the Smith Institute, Aviva and the National Association of Pension Funds deserve significant thanks. Ensuring that auto-enrolment gets as many people saving as possible is the task for policy makers now, and this

collection of essays from key players and experts across the pensions industry offers important insights into the biggest challenge we face: under-saving. It proposes a variety of innovative policy solutions for how we can ensure that we do not, indeed, carry on like this. But as Age UK argues, auto-enrolment needs to be made to work effectively: it is not the panacea to all our problems.

Three of the key priorities to address the problem of under-saving are: ensuring that savings can provide a decent and certain retirement income; building a structure of pension schemes and tax fit for today's world of work; and rebuilding trust in the pensions system in the wake of the damage done by past scandals.

A decent and certain retirement income

The first challenge is one of a certain and predictable income stream in retirement.

When planning for their retirement, people are put off by the complexity of the system and uncertainty about what they will be entitled to. Auto-enrolment is designed to harness inertia and build a habit of saving, but there is more that government can do.

The flat-rate pension proposed in a recent government green paper is welcomed by Oliver Heald MP, in chapter 3. He sees it as a tool for increasing the predictability of pensions, and making sure people know what they will retire on. Simpler state provision will open the eyes of savers to the reality of what their retirement income is likely to be, and is welcomed by Age UK in chapter 9. In chapter 8 Otto Thoreson of the Association of British Insurers makes a powerful case for the role of government in making retirement incomes clear to younger savers. In chapter 4 Nikki Cleal of the Pensions Policy Institute looks at how current government policy may contribute to the target of simplicity and speculates that state pension policy may well go full circle, back towards the flat-rate system envisaged by Beveridge.

Chapter 1 makes clear the value of financial education. It is true that the application of nudge theories "can only go so far", and even with a simplified pension system there will be a pressing need for advisory support for savers, particularly young savers. This is particularly important among certain groups: younger savers with a "plasma screen today rather than pension tomorrow" attitude; women like Yvonne, featured in Diana Holland's chapter 5; and ethnic-minority groups who may have poorer financial awareness and are less likely to seek out financial advice, as highlighted by Runnymede in chapter 7.

Auto-enrolment and beyond

Along with auto-enrolment, the entry of the National Employment Savings Trust (NEST)

into the market as a provider of pensions to any firm automatically enrolling its employees has altered the range of options open to individuals saving and companies choosing products for savings. Any policy that changes the structure of pension provision needs to be handled carefully. That is why NEST was designed with a contribution cap to protect existing providers. Even before it is operational, however, Oliver Heald has joined a number of commentators in highlighting the importance of removing the contributions cap. Joanne Segars at the National Association of Pension Funds sets out in chapter 2 a persuasive case for the establishment of super trusts – “large, not-for-profit, multi-employer pension schemes” that would have the aim of limiting risk and bringing down costs for savers.

Any policy solution must reflect the needs of employers and the realities of the labour market. NEST needs to work closely with small and medium-sized enterprises to make sure that employers of all sizes are in a position to help their employees to save for the future. Small businesses employ 58% of the private-sector workforce, and are an important part of solving the problems we face, as highlighted by the Federation of Small Businesses in chapter 6.

We know that people work in an average of 11 jobs in their lifetime, and are increasingly mixing periods of work, training and education, and doing a variety of full-time and part-time work throughout the course of a working life. Aviva highlights the possibility of a feeder system running alongside ISAs to target a younger generation of savers, and Oliver Heald suggests the lifetime savings account. This links to a recent survey conducted by Aviva, which indicated that eight out of 10 people would be more likely to save if financial products were more flexible and easier to understand. Such options would substantially alter the format of occupational and personal pensions, and deserve analysis as possible ways to increase savings rates, especially given uncertainties in the labour market.

In addition, in times of fiscal constraint, policy makers must ensure that the tax system supports pensions fairly and efficiently. Currently, two-thirds of tax relief for pensions and savings goes to higher-rate tax-payers, according to HMRC. There are potentially better and more equitable ways to spend the £20 billion of pensions tax relief, and rectifying the skewed system should be a priority. At present, it costs £600 for someone on 40% tax to save £1,000 in their pension. Those earning more than £150,000 only need to put away £500. People on basic rate, on the other hand, need to build up £800 to get the same benefit. The government can and should do more to encourage people on lower incomes to save through the tax system.

Inspiring trust and confidence

In addition to increasing simplicity and changing the structures of the system, part of the solution must lie in tackling the lack of confidence among the public that "it pays to save". After the Maxwell scandal, the collapse of Equitable Life, and the financial crisis, there are common concerns that a lifetime of contributions could vanish overnight. Despite the introduction of the Pension Protection Fund and the protection this offers, these scandals have cast a long shadow and undoubtedly are contributing to under-saving.

This is a theme highlighted by Aviva in chapter 1, while the Association of British Insurers in chapter 8 rightly says that "we can't let older generations' disappointment and disillusion with their pensions distort the opportunities open to young people". Partnership and co-operation are vital to tackling the lack of trust and confidence. Employers, particularly small employers, need the correct support and guidance, as auto-enrolment is introduced, to pick the best scheme for their employees, a point made forcefully by the Federation of Small Businesses in chapter 6.

Closely related to trust and confidence is the question of the fees and charges associated with pension savings. An average pension pot can be hit by enormous charges, running into thousands of pounds. The difference between an annual management charge of 0.5% and one of 1.5% can ultimately alter the value of a pension pot by as much as 30%. As well as looking at capping fees and charges, as was done with stakeholder pensions, the effect that super trusts could have on annual management charges is worth examining. Government and industry need to analyse (particularly with the advent of auto-enrolment) how small pots are annuitised and how to combine small pots built around different jobs. As a Pensions Policy Institute report has highlighted, 44% of annuities purchased between 2001 and 2009 were worth less than £10,000, and yet the returns on small pots are far inferior to those on larger pension pots. Making small pots more valuable as annuities is an important part of the solution.

Conclusion

The experts' views that follow make the size of the challenge clear, but also offer a variety of innovative solutions. Going forward and making sure that auto-enrolment is a success demands that policy makers inspire confidence in a simplified system. It demands that individuals think more about putting something away for their retirement, and that their employers help them to do so. It demands that the pensions industry designs and is allowed to create products that meet people's needs and reflect the changing world of work. More than anything, we must make sure that it pays to save, and that people believe it pays to save as well.

Achieving that requires a partnership between state, industry and individuals. Making policy with consensus and coherence is a challenge, especially as reforms built on other reforms often result in a confused and confusing landscape. We have come a long way from financing railway workers' pensions through the sale of lost luggage. But the challenges that remain in the system are large, and will require application of the innovative thinking that is contained in this pamphlet.

Chapter 1

Rebuilding trust in savings

Paul Goodwin, Workplace Savings Director at Aviva

Rebuilding trust in savings

Only 30 years ago it was still common for people on modest incomes to save small amounts each month or week to fund their longer-term requirements. Often this was with a life company; they knew the company's representative personally and, perhaps because of this, they trusted the company to look after their money. Of course, this wasn't a golden age. But rebuilding that level of trust in savings and pension providers is essential to restoring a savings culture and closing the "pensions gap". Trust cannot be conjured out of thin air, so this will be a gradual process. But the prize is great for providers and for the government, and, above all, for customers.

Where are we now? The scale of the challenges

In September 2010, Aviva published its *Mind the Gap* study with Deloitte. This researched the European pensions gap – the extra amount people need to save each year in order to generate a comfortable income in retirement, which the OECD recommends should be 70% of the average person's pre-retirement income. The study found that the UK has the biggest shortfall per person in Europe. This is largely due to higher final salaries before retirement and a relatively low level of state pension compared with many other countries. But it also emphasises that most people in the UK are simply not saving enough.

The UK's pensions gap is £318 billion, equivalent to an average of £10,300 per person for *each year* between now and retirement. In other words, to close the gap, each person would need to invest an average of £10,300 a year *more* than they do now, with or without help from their employer.

This startling figure is an average based on the 31 million UK adults due to retire between 2011 and 2051. For older people who have less time to make good *their* personal shortfall, and those on lower incomes for whom it might be difficult to put money aside, the picture is particularly worrying. However, the data is skewed by the significant shortfall that those approaching 65 in the next few years face – the average figure for all individuals retiring between 2011 and 2015 is much higher than for people aged 50 and below.

This is important because it emphasises that the earlier people can be encouraged to start saving, the greater the longer-term impact and the easier it should be for them to overcome the shortfall.

Figure 1 breaks down how the pensions gap varies by age group.

Figure 1: UK pensions gap by age group

Extra amount that individuals need to save each year to close the gap between current and required pension saving

All individuals retiring 2011-51 up to age 65	Age in 2010			
	50 years	40 years	30 years	20 years
£10,300 pa	£6,200 pa	£3,100 pa	£1,900 pa	£1,300 pa

It is good news that the UK is already taking steps to reinvigorate retirement savings through automatic enrolment into a pension scheme. In fact, for people in their 20s with an annual shortfall of £1,300, an 8% contribution of the average national income of £25,900¹ would lead to a combined annual contribution (from employee and employer) of £2,072. However, it would be foolish to assume that this was "mission accomplished". Many people in their 20s earn far less than this. And many will have their pension contributions based on "banded" earnings, which will mean a significantly lower contribution amount. Some, for various reasons, may choose to opt out. So the big question remains: how can we encourage saving habits in everyone, especially the young and those never likely to meet the national average? In this it is important that we do not limit ourselves to pension plans only but acknowledge that encouraging saving in general is more likely to lead to higher levels of pension saving in particular.

Affordability is the main barrier ... but not the only one

At Aviva we regularly ask customers about their concerns and attitudes. Unsurprisingly, our *Family Finances* report, published in May 2011, shows that many are very worried about their immediate security.

The typical UK family's top three fears – the rising cost of living (60%), redundancy (48%) and unexpected expenses (39%) – stayed consistent between January 2011 and May 2011. However, as inflation began to bite, people had by May 2011 become marginally more worried than previously about the rising cost of living (up from 57% in January 2011) and redundancy (up from 45% in January 2011).

When asked to select their top three fears for the next five years (rather than the immediate future), the families surveyed remained downbeat, citing significant

¹ statistics.gov.uk, April 2010

increases to the basic cost of necessities (58%), redundancy (51%) and unexpected expenses (39%).

How does all this affect people's attitudes towards saving for retirement? One major hurdle that families see as stopping them from contributing to a pension is that the rising cost of living is squeezing their disposable income. Indeed, 4% of UK families claim that, after living expenses, they have *no* additional money.

But – and this is a very big “but” – 96% of ordinary UK families do have some additional cash. Some choose to take positive financial action with this surplus and pay down unsecured debts (32%), put it into a savings account (23%) or a long-term savings vehicle (8%), or pay down their mortgage (7%).

Crucially, just 10% look to put this surplus into some form of retirement savings product.

Although Aviva's research has highlighted affordability as the main barrier to saving, this is only part of the story: the financial services industry, when developing solutions, needs to focus much more on people's attitudes and motivations rather than thinking in terms of products only. So we must also address the following issues:

- There is a lack of trust in financial services companies.
- The complexity of savings, investment and pension products and legislation makes them difficult for most people to understand and engage with.
- Most people are very risk-averse when it comes to saving or investing money. As far as possible they want certainty *and* flexibility.

That briefly covers the scale of the challenges. Against this background, what can the financial services industry do to engage better with consumers and encourage retirement saving? There are no easy solutions, but there are several ways of making a positive impact.

Meeting the challenges

Targeting a new market ...

As mentioned above, 96% of ordinary UK families do have sufficient cash to spend on other expenses. But money is tight.

One approach would be to persuade people that even if they cannot plug their entire "pensions gap", moderate levels of saving can still make a meaningful improvement to their retirement lifestyle. For instance, an additional income of £150 a year might be enough to pay for a daily newspaper, or the subscription to a couple of societies, or a visit to the cinema once or twice a month. More emphasis should be placed on pension savings as a means of enriching retirement, not as a way of replicating all pre-retirement activities.

Of course, people who are living hand-to-mouth genuinely cannot afford to contribute to a pension plan or any other form of savings, and should not be forced to. In retirement they need a safety net from the state, and it is to be hoped that proposed improvements to the basic state pension will deliver this.

Ultimately it is up to each person to decide what to do with their own money. Where we need to have much more of an impact is in ensuring they are well informed enough to understand the consequences of "under-saving" or not saving at all. They should be able to make an informed choice and see clearly that there is a trade-off inherent in their choice between immediate and longer-term gratification.

The most common products that families use to save are a basic building society or bank savings account (80%), followed by a cash/share ISA (34%) or premium bonds (22%). But, as mentioned earlier, Aviva's research already shows a shift towards seeking more security, so providing for a more comfortable retirement, which constitutes long-term security, should become a natural part of this trend. Auto-enrolment will undoubtedly help people get the longer-term savings habit (compulsion should be considered only if there are unsustainably high numbers of opt-outs).

Relying on improved promotion alone will not be enough. Most people do not directly link saving today with a better standard of living tomorrow, especially when their retirement is far off. Particularly in today's challenging economic times, we need to find innovative ways of helping people start to build small, short-term savings pots, which over time can be combined into more traditional forms of retirement savings.

At the start of this chapter it was mentioned how important it is to encourage the savings habit early. To many people in their 20s, retirement will seem a very long way off, and often they will have very pressing and much shorter-term financial issues, such as dealing with student debt or saving for a deposit for a property. Products that cater for these concerns will be particularly suited to them, which is why Aviva supports the introduction of a workplace ISA feeder product, with employer contributions, as a

useful bridge to longer-term saving. This product would direct contributions into an ISA initially until a certain fund size was achieved; thereafter the contributions would be invested in a pension plan.

This would help young people get into the habit of saving by offering them a product designed to meet their needs – as well as offering them something extra from their employer. It would also give them flexibility, with the knowledge that the cash could be used to fund a house purchase or other spending rather than be locked away for up to 40 years. A feeder fund model allows the pension and ISA systems to sit side by side, with limited changes to either regulatory regime.

But to encourage a savings culture much more widely, especially into pensions, the industry needs to go further than this and focus on people we have ignored in the past. Yes, it is still vital to support the "high net worth" advice market, but we also need to meet the needs of customers on lower incomes – customers that pension and investment providers have largely ignored. This target market is different from those customers that we and other product providers would continue to serve through intermediaries. These new customers will require a direct approach, with simple savings products that are easy to understand and fulfil their basic requirements. In this regard, the Simple Products/ FSA Product Intervention Paper² is definitely a step in the right direction.

Direct is the chosen distribution route because the cost of advice will prevent most of the targeted customers from going to an intermediary, and providers must still be able to make a profit on such products – which the cost of distribution through intermediaries would make impossible. This requires simple, regular savings products with a low charge; contribution levels that are affordable for the target market; and restricted investment options, including a default fund with a targeted or guaranteed return, whose aim would just be to outperform the return on a competitive, higher-rate bank or building society account.

We know from our research that the great majority of customers in this new target market have a negative attitude to risk. For instance, in our Consumer Attitudes to Saving Survey³ in the fourth quarter of 2010, Aviva asked people whether they agreed with the statement: "I am prepared to accept a higher level of risk for some of my savings/investments in return for a higher possible return." Among the respondents, 46% disagreed or strongly disagreed, with 28% neither agreeing or disagreeing. These

2 DP11/1: *Product Intervention*, discussion paper (2011) (http://www.fsa.gov.uk/pages/Library/Policy/DP/2011/11_01.shtml)

3 <http://www.aviva.com/customers/consumer-attitudes-survey/>

people want steady, secure growth and have no requirement for a wide fund choice. We also know that they want less, not more, information, and limiting the fund choice helps achieve this.

Lower regulatory requirements would decrease the costs of engagement with consumers. And the simple, restricted approach outlined above should increase customers' trust in providers, who will be more easily able to show they are delivering what they have promised to deliver.

If several of the ideas outlined above for encouraging savings echo the approach that the National Employment Savings Trust (NEST) is taking, that is no coincidence since what NEST is doing is based on extensive research into the same target market. The implication for group pensions business is that providers who want to target the same customers as NEST may well choose to develop a basic direct group personal pension plan, while of course still supporting intermediary customers with a more bespoke offering.

... and doing more to encourage trust, understanding and responsibility

Earlier in this article we raised lack of trust in the financial services industry as a serious issue – the industry needs to tackle this, otherwise it has far less chance of increasing savings levels. Aviva's global Customer Attitudes to Saving Survey has surveyed more than 100,000 consumers across 25 countries since 2004. Time and again we have identified low levels of customer confidence in financial planning as a major barrier to saving. This in turn has meant that customers tend to focus on the short term and many continue to believe that it is someone else's responsibility to provide for them in their retirement.

Mirroring concerns raised earlier, only 38% state that they save "to enjoy a better retirement"; instead over half (55%) save "for a rainy day" and a third (31%) perceive pensions as an "unaffordable expense".

As already stated, we believe the introduction of auto-enrolment will help people focus on the longer term and realise that retirement provision is in large part their own responsibility. But a lack of trust in the financial services industry does not help. And bad-news stories often linger for years, the personal pensions mis-selling scandal of the 1980s being an obvious example. Achieving instant trust is impossible. The financial services industry may regain it only after a long period of stability, a return to more sustained levels of investment returns, and the absence over time of (often long-past) pensions and insurance-related bad-news stories in the media.

This reinforces the more general point that individuals must be encouraged to take increased personal responsibility for saving for their retirement, and questions how far voluntarism can be successful without specific, effective government involvement.

There are two main areas that Aviva believes we can all build on:

- **Trust in employers**

Aviva research shows employees have greater trust in recommendations endorsed by their employer, so we consider that savings, not just pensions, should be incentivised through the workplace. As discussed earlier, the option of auto-enrolment into a workplace ISA could be considered.

- **Confidence in the state pension**

It is essential that people understand how their state pension will be calculated, what it is likely to be, and when they will receive it. They can then confidently use this as the foundation for planning what additional steps to take to achieve their longer-term aims. If the uncertainty over the state pension continues, it will be not just confusing but also potentially damaging. When the state pension age can move with four years' notice, why should people believe that other things will not change? Stability is badly needed. For the young particularly, it is illogical to ask them to plan around a system that is almost guaranteed to change regularly.

The media have a significant role to play in restoring trust. They must of course continue to fight for the consumer and criticise the financial services industry where it falls short, but surely there is room for a more balanced and encouraging picture, including improvements in consumer protection? It is not an exact parallel, but a programme like the BBC's *Countryfile* does not cover only the unfortunate things that may happen to people in the countryside, like twisting an ankle on a rough path or being attacked by a swan. It also goes without saying that for the media to cover personal finance more constructively, it is up to government, regulators, advisers and providers to provide them with positive and newsworthy stories. There is no reason why the media should be expected to publish anything that is worthy but dull. And there is no way that they will publish empty propaganda.

Finally, the government too needs to encourage incremental increases in levels of saving by individuals and highlight the macro impacts of under-saving. It needs to be clear to everybody that they will benefit if they save and that even small levels of saving can lead to meaningful improvements in income at retirement and earlier. As argued earlier

in this chapter, this is particularly important for the young, so we recommend especially that the government increases its support for financial education in schools.

The challenges to bridging the UK's pensions gap are formidable. But at Aviva we are positive: there *are* solutions and reasons for optimism. The proposed reform of the state pension and the introduction of auto-enrolment comprise a very promising start, but only a beginning. There must always be a safety net for people who don't have enough money to be able to save, but the majority can make a considerable difference to their future through saving affordable amounts regularly. Together, we – politicians, providers, the media and the regulators – have great opportunities to encourage and accelerate this change.

Chapter 2

Pensions fit for the future

Joanne Segars, Chief Executive of the National Association of Pension Funds

Pensions fit for the future

Adequate, secure, simple and good value for money: these should be the hallmarks of any decent pensions system. But the UK pensions system is a long way from reaching these ideals.

Our pensions system, which used to be the envy of the world, has been transformed into one in which 12 million people are either not saving at all, or not saving enough for their retirement. Today, just 21% of defined-benefit schemes in the private sector remain open to new employees, and last year saw the biggest recorded increase in the number of defined-benefit schemes closing their doors to existing savers – rising 10 percentage points between 2009 and 2010¹ from 7% to 17%. Meanwhile, our state pension system is one of the least generous in the developed world.

Demographic changes will put the system under further pressure as life expectancy continues to improve. Latest ONS projections (2008-based) have added a further 1.3 years to average male life expectancy at 65 and 1.5 years to that of women, compared with the 2004 projections used by the Pensions Commission. That represents a 6% increase in the time period over which a pension paid from age 65 would be paid out. Over the next 25 years, the number of people over state pension age is projected to increase by 32%, yet the working-age population is projected to increase by just 14%.² We must celebrate longer lives – it is a major achievement of the welfare state. But we must also recognise that it has implications for the cost of pension provision. For example, one estimate suggests that if defined-benefit scheme members live on average for one year longer, this increases that scheme's liabilities by between 3% and 4%.³

Of course, it is not all bad news. It is true that many of today's pensioners are better off than ever before and that pensioner poverty is at its lowest level since records began.⁴ Indeed, since 1998/99 pensioner incomes have risen three times faster than average earnings.⁵ And it is also true that the pensions reforms due to start next year – the most significant in two decades – will make a significant difference: for the first time the vast majority of workers will be auto-enrolled into a pension that comes with their

1 National Association of Pension Funds Annual Survey 2010

2 National Association of Pension Funds *Fit for the Future: NAPF's Vision for Pensions* (2010)

3 Coughlan, G, Epstein, D, Ong, A, Sinah, A, Balevich, I, Hevia-Portocarrero, J, Gingrich, E, Khalaf Allah, M and Joseph, P *LifeMetrics: A Toolkit for Measuring and Managing Longevity and Mortality Risks* (JP Morgan, 2007)

4 Since 1979 when the HBAI began. DWP *Households Below Average Income, 2009-10* (2011)

5 DWP *Pensioners' Income Series 2009-10* (2011)

job and which benefits from an employer contribution. The power of inertia in getting people to save for retirement cannot be overstated.

But even with these reforms, significant numbers will fall through the gaps. According to the Department for Work & Pensions' own analysis, between 5 million and 9 million people could be outside the scope of auto-enrolment at any one time.⁶ For many, it will be because they are too young or earn too little to join. While we would hope that many would join at a later stage, that cannot be taken for granted in today's environment, when household budgets are under strain and young people are leaving university with significant debts. The world in which the Pensions Commission envisaged auto-enrolment would be introduced is very different from the one we are experiencing today. And for those who do remain opted in, a lifetime's saving in a pension scheme with minimum contributions (8%) will only deliver a replacement rate of 15% to someone on median earnings, 45% when combined with the state pension – not enough to reach the Pensions Commission's target replacement rate of 66%.

It is clear to the National Association of Pension Funds that without further – significant – changes, future generations will be condemned to a retirement scraping by rather than enjoying life after work.

So how do we turn this situation around? How do we rebuild our pensions system so that it works for today's pensioners and tomorrow's? How can we ensure that it is genuinely fit for the future?

Before the last general election the National Association of Pension Funds set out its blueprint for pensions reform, which builds on the 2012 reform programme.⁷ It aims to transform the UK's pensions system into one that:

- provides an adequate retirement income for all through a more generous state pension and stronger workplace pensions;
- is stable, and commands wide consensus; and
- is flexible enough to adapt to the economic and demographic environment.

The starting point must be a decent state pension that takes people clear of means-testing and which encourages, rather than discourages, additional pension saving. We proposed a simple, single state pension that we called the "foundation pension". The idea is straightforward:

6 DWP *Pensions Bill 2011 Impact Assessment* (January 2011)

7 National Association of Pension Funds *Fit for the Future: NAPF's Vision for Pensions* (2010)

- The foundation pension would combine the current basic state pension and state second pension into a single-tier, flat-rate, state pension.
- It would be paid to everyone over state pension age after 30 years of paying national insurance contributions.
- Once in payment, it would be increased each year to keep pace with inflation.

We are pleased that the government is taking up this idea and developing proposals for a single-tier pension. Under the government's proposals it would be worth £140 a week in today's prices paid to people retiring after around 2016, the earliest date such a policy could be introduced. Of course, we would like it paid to new and existing pensioners, and we would also like the level to be higher (we had originally proposed £8,000 a year), but we must recognise whereabouts we are in the economic cycle, and that the government's proposals are an important step forward towards our goal.

A foundation pension of £140 a week would bring considerable benefits:

- Some 7 million people would be better off, in particular women and the low-paid, groups that have traditionally been disadvantaged by the current system.
- Millions would be lifted out of means-testing. Under the current system, around a third (35%) of all pensioners – a staggering 4.4 million people – will be eligible for pension credit when they retire because their pensions are simply not high enough. But under a single-tier pension, this would fall to just 5%, or 800,000 people, according to research commissioned by the National Association of Pension Funds.⁸
- The same research shows that a single-tier pension would cost no more than the current system. Instead, a single-tier pension would spend state resources on pensions more intelligently, redistributing spending to lower-income groups.
- A revamped state pension would ensure that for everybody it "pays to save" – the additional pension savings people make would not be means-tested away: what they save they keep. So a foundation pension would be a boost to the 2012 reforms, helping to ensure that people who are auto-enrolled stay auto-enrolled because they would know it was worth their while saving in a pension. And not

⁸ Pensions Policy Institute *An Assessment of the Government's Options for State Pension Reform* (2011)

only would it encourage people to take up pension saving in the first place, it is also likely to encourage them to save more. National Association of Pension Funds research shows that 60% of people who have yet to retire would save more if they knew they could expect a state pension of £140 a week. Half of 18- to 34-year-olds would save £45 a month more on average. Among older age groups, the sum rises to £60 a month.⁹

If the first step to creating a pensions system that is fit for the future is a decent state pension, the second must be getting workplace pensions – defined-benefit schemes and defined-contribution schemes – working efficiently both for employees and for employers. The majority of people who are saving into a pension are invested in defined-contribution schemes, so it is particularly important that we focus on getting this kind of scheme right. Currently defined-contribution pensions are too small, too opaque and too expensive. So to make this style of pension fit for the future, it is essential to harness the power of scale.

The UK is unusual in having a long tail of very small pension schemes. Some 95% of defined-contribution schemes have fewer than 1,000 members, and just 5% have more than 10,000 members.¹⁰ Average scheme size in the UK stands at 2,600, compared with 10,500 in the Netherlands and 27,000 in Australia.¹¹

Small schemes tend to be more expensive than larger schemes. Schemes with more than 50,000 members report annual costs of around £15-£20 per member, while schemes with fewer than 1,000 members report costs of around £150 per member.¹² This matters for defined-contribution schemes because it is the scheme member who bears the cost, and the impact of high costs and charges on their final pension can be significant: someone saving in a large employer's occupational scheme with a 0.3% annual management charge could have a pension worth 30% more than someone facing a 1.5% charge.¹³

It is not just in cost terms that small-scheme members are at a disadvantage. Small schemes often have less effective governance arrangements (and sometimes none at all if they are contract-based schemes), reduced access to expert advice, higher

9 Populus poll for the NAPF. Between 3 and 5 June 2011, Populus interviewed online 1,526 adults in Britain who had not yet retired.

10 Pensions Regulator *DC Trust* (2009)

11 National Association of Pension Funds *UK Pension Regulation Compared* (2008)

12 Capita Hartshead Pension Administration Survey, May 2009

13 Pensions Commission *A New Settlement for the Twenty First Century: the Second Report of the Pensions Commission* (2005)

investment fees and higher investment risk. They are also less able to innovate or share risks. It was for this reason that the Pensions Commission proposed establishing a new, large-scale occupational defined-contribution scheme that could ensure high governance standards and low costs. This scheme is now being established as the National Employment Savings Trust (NEST), and deserves all our support. It will be a force for good, setting new standards in terms of cost, investment style and governance.

Figure 1: The impact of charges on pension outcomes

Annual management charge	Pension pot at retirement	Annual income	Amount lost to charges
0.5%	£178,842	£8,405.56	£13,702
1%	£160,531	£7,544.97	£25,469
1.5%	£144,507	£6,791.85	£35,581

Assumptions: Average earnings of £21,024; investment growth at 3.5% per year; earnings growth at 2%; 40 years of saving; contribution rate of 8%; annuity rate at 4.7%. NAPF modelling.

But other large schemes could, and should, be established to sit alongside NEST. The National Association of Pension Funds has therefore proposed that a new breed of schemes – which we call "super trusts" – should be established.

Super trusts would be large, not-for-profit, multi-employer pension schemes which could be offered on a regional, sectoral or national basis. They would be managed by an expert board of trustees whose remit would be to put the interests of the scheme members, not commercial providers, first. So super trusts would operate in a similar way to NEST, but would have less direct government involvement. To ensure that super trusts reached scale they would, we envisage, be limited in number – say, no more than 20, each issued with a licence to operate from the Pensions Regulator.

The National Association of Pension Funds' analysis shows that super trusts could operate at very low charges – as little as 0.4% annual management charge – and they have the potential to remain low-cost because of their governance structure. Super trusts could be used to consolidate the UK's current fragmented defined-contribution market into something that worked better in the interests of savers, to ensure that more of their money was working for them.

It is encouraging that the Pensions Regulator has expressed interest in supporting these kinds of arrangements.

While strong encouragement should be given to the development of larger schemes, including the consolidation of existing ones, a one-size-fits-all approach is not appropriate for today's labour market. Some employers, especially larger ones, will wish to continue to provide their own pension arrangements directly (and for a minority, this will continue to be on a defined-benefit basis); others will wish to adopt a multi-employer solution using super trusts; and others may wish to opt for a more hands-off approach using NEST. Some employers will be happy to carry more risk than others. In other words, a healthy workplace pensions system needs to offer a mixed economy of provision so that employers are free to provide the form of pension provision that is right for them and their employees, whether defined-benefit, defined-contribution or options in between.

However, rather than make long-term decisions about which form of pension provision is right for the company and its employees, employers are increasingly being driven to make short-term decisions based on the growing cost of providing schemes and the risk to which the company is exposed as a result. (The average FTSE 100 company's pension liability is 49% of its market capitalisation.¹⁴)

The current government has a real opportunity to make a difference here, through its important commitment to "reinvigorate occupational pensions". The words are encouraging. We now need to see the action. For the National Association of Pension Funds, that means some creative and bold thinking to encourage risk sharing.

Rather than see pensions as being either defined-benefit or defined-contribution, we should view types of provision along a risk spectrum which gives employers greater choice and flexibility, with risks (longevity, inflation, investment risk, for example) are shared between employers, scheme members and the government.

Risk sharing is currently possible, but it is not very common – the 2009 National Association of Pension Funds Annual Survey reports that just 13% of schemes are career-average schemes. This is because the regulatory framework is not well suited to risk-sharing schemes. As the chief executive of a large risk-sharing scheme told the Workplace Retirement Income Commission, his scheme "is not well liked by the regulator or by HMRC".¹⁵ Scheme change has, in effect, become a zero-sum game:

14 LCP *Accounting for Pensions 2011* (2011)

15 *Building a Strong, Stable and Transparent Pensions System*, final report of the Workplace Retirement Income Commission (2011)

one of either keeping the defined-benefit scheme or moving straight to defined-contribution.

The National Association of Pension Funds believes the best way to secure the future of remaining defined-benefit schemes would be to ease back on the benefits those schemes are required to provide. Under this slim-lined defined-benefit approach, benefits such as inflation proofing and spouses' benefits would no longer be a legal requirement, as used to be the case. Schemes could provide such benefits, but they would not be legally required to do so. The introduction of a good-quality foundation pension paid to all and inflation proofed would reduce the need for these benefits to be paid from workplace pensions.

So scheme members would be taking on inflation and longevity risk, while the employer would retain the investment risk. Scheme members would continue to benefit from a pension related to their salary at the point of retirement, and schemes would continue to provide more assurances for members than are currently available under the defined-contribution structure.

While it is unlikely that the availability of risk sharing will result in the rebirth of defined-benefit schemes, it could help stem the exodus from the remaining such schemes. This matters because 2.4 million people are still accruing rights to such schemes today.¹⁶

Risks could also be shared more effectively in defined-contribution schemes where scheme members bear all the risks, including investment, inflation, interest rate and longevity risk. This could be achieved in a number of ways, including through guarantees – either of annuity rate or investment.

- A guaranteed annuity rate would remove members' uncertainty about the amount they would need to save in order to be able to secure the level of income they wish to have in retirement.
- A guarantee on investment would put a floor under the fluctuation of defined-contribution investments. This might, for example, mean guaranteeing that the members' pot would – at the very minimum – be equal to the sum of contributions paid. Similarly, there could be a guarantee of the return to be achieved on investment.

16 ONS Annual Survey of Hours and Earnings Pensions Analysis

There would, inevitably, be a cost associated with such guarantees, just as any other kind of insurance requires a premium to cover the risk. But it is quite possible that many people would be content to make higher contributions or accept a lower pension if they had greater certainty over factors such as stock market fluctuations that can act as a disincentive to save.

Of course, there is a lot more the government, industry and the regulators could and should be doing (and doing together) to improve the UK's pensions system. But these proposals from the National Association of Pension Funds – a decent state pension underpin, large-scale, value-for-money super trusts; and effective risk sharing – are good starting points. They could make a big difference to the retirement incomes of pensioners today and tomorrow, and will ensure that the objectives of adequacy, security, simplicity and affordability are achieved.

Chapter 3

The role of government

Oliver Heald MP, Member of the Work and Pensions Select Committee

The role of government

It has been clear for many years that a large number of people in our society are simply not saving enough or, in many cases, not saving at all, for their retirement. Almost half the working population, 12 million people, are in this category.

Those approaching retirement face falling incomes, rising inflation and higher unemployment rates, and are concerned at falling returns on the savings they do have. Many of the "under-pensioned" will have to look to the state for benefits to provide an adequate retirement income.

Some years ago, the Pensions Commission led by Lord Turner concluded that this group would have to work later, retire poorer, save more or pay more tax. Since Lord Turner's package was put forward in 2004, there has been consensus at Westminster about the need for a better state pension that combines the basic state pension scheme with the second state pension scheme, converts it into a flat rate and thereby provides a more substantial foundation to pension provision for a wider range of people – including the poor, women, disabled people, and those with short or intermittent work records.

We should not forget that the basic state pension is public, unfunded and compulsory, and the second state pension has these features, too. They are the main source of income for the pension-age group, providing more than a quarter of their income. The starting point for deciding how to help the under-pensioned is to ensure that the state pension scheme is fully understood and that people have an idea of how much money they will receive in retirement from the state.

This explains the new Coalition government's concentration on how to provide a bigger and more clearly understood "foundation pension". This would ensure that when people came to decide what level of savings they would need for retirement, they could calculate this more readily than at present. The current state second pension scheme is not well understood by individuals and it is hard to work out exactly how much is likely to be received in retirement. To simplify this is the key to widening understanding of the fact that so many people in our society are under-pensioned. The government's recent consultation on a simpler and more generous state pension is the starting point.

Of course, many other factors affect the need to save more for retirement. One of the most significant trends of the last few decades has been the increase in life expectancy. Since the 1970s, the likely age to which a man retiring at 65 is expected to live has

increased by 10 years, and this is expected to continue to rise. By 2030, it is estimated that the number of people aged over 65 will be 50% higher than now.

The government is rightly taking action to raise the state pension age, and this will help meet the costs of longevity. It is also likely that people will choose to work longer. Currently, a third of over-55s retire against their preference, either because their employer suggests it, or because they reach the normal age of retirement at their place of work.

The default retirement age has recently gone, and without the impetus to retire it is likely that more people will want to decide for themselves when to enter retirement. Those with poor pension provision may decide that working longer is the way to improve their economic situation. This may not prove easy, with the rise in unemployment since before the recession having been higher for the over-50s than for other groups. Aviva has found high levels of people looking to "down-shift" in the run-up to retirement, but also that a significant number had jobs with fixed hours, which made this impossible. Employers should find ways of helping valued employees to stay on longer at work, but for fewer hours and with less stress than in earlier years.

Introduction of the National Employment Savings Trust

One limb of Lord Turner's proposals was the introduction of the National Employment Savings Trust (NEST), which will widen coverage of second-tier pensions and also turn to advantage the natural inertia that people feel about pensions, through auto-enrolment. This should provide an opportunity to improve the pension provision of millions of people. The widening of coverage is very much to be welcomed, but the concern remains that the mandatory level of contributions required from employers and employees (from 2012 onwards) will not be enough to provide people with an adequate income in retirement. Just as the state pension scheme is an important foundation stone, NEST is a building block, rather than the complete solution. Many, myself included, would like to see the NEST contribution cap removed and a solution found to ensure that existing pension pots can be moved into NEST.

Legislation should make it clear that NEST's contribution cap will be removed in 2017 and that government and regulators will review the transfer of pension pots at that time. I also think it would be worth looking at the same time at the mandatory level of contributions (8% of qualifying earnings), to see if an increase is warranted.

While a quarter of pensioners' income comes from the state pension scheme, about 17% comes from other pensions or annuities, and this is therefore a very important

source of income. The primary source of retirement income provided through the workplace remains pensions. In 2009, some 2.4 million employees were actively saving into a defined-benefit scheme and a further 1 million into occupational defined-contribution schemes. In 2006/07, there were also 6.9 million people contributing to personal pensions. This highlights the importance of workplace saving, as 9 million people actively save in workplace pensions (including group personal pensions). However, workplace pensions are under pressure, with just 23% of defined-benefit schemes in the private sector open to new employees. Further rapid decline of defined-benefit schemes is likely and this creates a problem for the future, as many of today's pensioners have the standard of living they do as a result of good final-salary schemes.

There is an argument for hybrid or risk-sharing schemes, which enable employers and employees to take a share of the risk in a works pension scheme. Most employers feel they have little option but to opt for defined-contribution schemes, which place 100% of the risk on members. It is possible to build hybrid arrangements, and greater flexibility can also be found in designs that offer a way to rebuild pensions where the cost to the employer can be controlled into the future.

Others have suggested a way of strengthening occupational pensions, through encouraging the creation of large, low-cost "super trusts", which would offer benefits to savers and to employers who will be able to provide access to high-quality pension arrangements.

In addition to measures to improve defined-benefit schemes, there is a lively discussion at Westminster about the Dutch pensions system, with its collective defined-contribution pension schemes. Many have noted that, compared with NEST, the Dutch system provides pensions that are between 30% and 50% higher for the same cost. To introduce Dutch-style architecture into the UK, it would be necessary to make legislative changes to encourage the formation of appropriate large collective defined-contribution pensions. At present, no further action is being taken on this by the Department for Work & Pensions, but I do think that this is an idea worth further consideration. New collective defined-contribution pensions would be of a large scale and thereby minimise costs. It would be necessary to have political consensus and adequate public information. Pensions policy should be able to embrace new ideas, which would help the "under-pensioned".

I am also still attracted by the idea of a "lifetime savings account" – an idea that David Willetts and I floated in around 2003 – whereby savings could be removed

from a simple matched savings vehicle and, provided the money was replaced prior to retirement, it would be possible to have early access to the funds for worthwhile purposes, such as putting a deposit on a house or undertaking a useful training scheme to improve one's life chances. It is important that the "worthwhile purposes" should be defined in advance and that this should not weaken policy too far. However, there is no doubt that the "lock-in" involved in conventional pension schemes can be off-putting to people on lower incomes, or with intermittent earnings.

Many low earners are in the public sector, and Lord Hutton has recently come forward with his proposals for reform. At Westminster there is widespread support for his idea of higher contributions, higher retirement age and career-average pension schemes for the future. It is important to bear in mind that many public-sector pension schemes vary considerably, and some have already made changes to reflect the huge increases in longevity estimates. Some schemes are funded and some are not, so the result of Lord Hutton's advice is likely to be considerable negotiation with the trade unions and considerable thought by ministers about the way forward. I believe that Lord Hutton has done a good job in identifying the risks for the future, but we must always remember that most state-sector pensions are small in size and that adequacy is important for public-sector employees as well.

The size of pensions in the public sector has always been an important part of the pay and conditions package, and any changes need to be well justified and carefully negotiated to ensure they are fair for the future. It is also important that trade unions and employers are prepared to negotiate in good faith and not resort prematurely to strike action or walkouts.

The key to improving our pension provision and particularly to providing solutions for the under-pensioned is to concentrate on the issue of adequacy of income in retirement. There is no doubt that the state pension scheme, particularly if it is amended in line with the government's recent consultation, will improve matters by providing a more widespread and solid foundation for pension income. NEST also addresses the question of coverage by widening the number of employees who are in membership of a second pension scheme.

But the concern is that the combination of the state pension scheme and NEST is not adequate to meet the people's expectations about their level of retirement income. It is against this background that the kind of measures I discuss in this paper may provide a way forward: working longer; innovative defined-benefit schemes with enhanced flexibility; Dutch-style defined-contribution schemes; and more flexibility to satisfy

the concerns of low-income workers who are frightened by excessive "lock-in".

The recently published final report of the Workplace Retirement Income Commission, funded by NAPF, included several workable and sensible recommendations. The most important question highlighted in the Commission's report is how to improve adequacy, because at present the poor, women, young people, the disabled, and those with short and intermittent work records are likely to be under-pensioned or not pensioned at all. If provision is not made through savings, then the cost will fall on the taxpayer. Inter-generational solidarity requires this generation to find the answers to this important question.

Chapter 4

Winners and losers under the present state pension system

Niki Cleal, Director of the Pensions Policy Institute

Winners and losers under the present state pension system

The state pension is a fundamental component of the UK's welfare state which was first introduced in the form of the old age pension in 1908. This article considers the history and evolution of the state pension in the UK, outlines the winners and losers from the current state pension system, and considers the implications of potential further reforms for the fairness of outcomes from the state pension in the future.

History and background of the UK state pension

The state pension was first introduced in the UK, after much debate, in 1908 as the old age pension. It was originally payable to those aged over 70 on a non-contributory, means-tested basis, and the government's policy objective was absolute poverty prevention.

It was not until the introduction of the Beveridge reforms in cash-strapped post-war Britain that the state pension became contributory. Beveridge's proposal was that the amount of basic state pension that citizens would receive would be linked to what they had contributed to the system – through the payment of national insurance contributions. It is here that the fundamental link between participation in the labour market and eligibility for state pension entitlements began, in the form of the contributory principle.

The government introduced the basic state pension in 1948 with a policy objective to prevent poverty, rather than to enable citizens to maintain a particular standard of living in retirement. The age at which men could draw their state pension was originally set at 65 for men and 60 for women. Men needed 44 years of national insurance contributions to qualify for a full basic state pension and women needed 39 years.

Throughout the post-war period the level of the basic state pension failed to keep up with the rise in average earnings. The level of the basic state pension was increased on an ad hoc basis from its introduction in 1948 until 1974, when it started to be increased in line with national average earnings or the Retail Price Index, whichever was higher. As a result of increases in pensioner poverty, means-tested benefits were introduced as a safety net – national assistance in 1948, followed by income support, then minimum income guarantee in 1999 and pension credit in 2003.

It was not until the early 1960s that governments started to see a greater role for the state in enabling people to earn additional state pension entitlements linked to the

level of their earnings as a way of meeting a broader policy objective about income replacement in retirement. The concept of an earnings-related state pension was first implemented in 1961 with the introduction of graduated retirement benefit, and was given much greater impetus in 1978 when the government introduced SERPs – the state earnings-related pension. This was intended to broaden access to earnings-related pensions and was originally intended to provide a state earnings-related pension of 25% of band earnings. SERPS was eventually replaced by the state second pension in 2002 – there remained an earnings link, but the state second pension was more redistributive to lower earners than SERPs had been.

There have also been changes to the age at which a state pension can be drawn. The Pensions Act 1995 legislated for the women's state pension age to rise in a series of steps from age 60 in 2010 to reach age 65 by 2020. Later acts of parliament have set out further increases in the state pension age, which is to rise to age 68 for both men and women by 2046, and there is an on-going debate about the speed of future rises in the face of increasing longevity.

Winners and losers under the current state pension system

The UK's state pension system has been based on the contributory principle since 1948. It is this fundamental link between participation in the labour market, paying national insurance contributions and eligibility for state pension entitlements that has led to a diversity of outcomes from state pensions for different individuals.

Those individuals who have had steady careers and higher earnings have tended to do well from the current state pension system – often men and those individuals with higher earnings who have managed to clock up substantial rights to the state pension.

The characteristics that can lead to low incomes from the current state pension include the following:

- *Gender/caring responsibilities*
Many women have taken time out of the labour market to care for family members – prior to the introduction of home responsibilities protection in 1978, carers would not have clocked up their own state pension entitlements, leading to lower state pension incomes in retirement.
- *Low earnings levels*
Due to the earnings link in SERPs and the state second pension, higher earners have tended to receive higher incomes from the state pension than lower earners.

- *Non-standard employment*

This includes being self-employed or unemployed. The self-employed pay lower national insurance contributions than employees and are not entitled to claim state second pension, and therefore all other things being equal receive lower state pension incomes than employees. Those on jobseekers' allowance currently do qualify for the basic state pension but not for the state second pension, which can lead to lower incomes.

Disadvantage can be cumulative, and some groups in society are more likely to have combinations of the above characteristics. For instance, there are much higher levels of self-employment among some ethnic-minority groups in the UK – particularly among some sections of the UK population from Asian backgrounds. Similarly, many women are also lifetime low earners who take time out of the labour market for caring responsibilities. Having combinations of the above characteristics can reduce the level of state pension income that an individual is likely to receive.

Home responsibilities protection and the concept of the state pension system providing some recognition of the value of caring responsibilities was not introduced into the system until 1978 – some 30 years after the state pension system was introduced in its current guise. As recently as 2005, the government estimated that only about 30% of women were expected to qualify for a full basic state pension, compared with around 85% of men.¹ In addition, until 2002 periods spent outside the labour market caring for children were not recognised in the state second pension. As a result recent Government estimates suggest that women tend to get around £40 a week less state pension income than men.² This lower income from state pensions leads to a greater reliance on means-tested benefits to alleviate poverty in old age for many women.

More recently governments have reformed the state pension system in ways that will improve outcomes for some groups of future pensioners, including women. The Pensions Act 2007 put in place legislation that will make 30 years of national insurance contributions sufficient for both men and women to qualify for a full basic state pension from 2010. The crediting options to enable carers to clock up entitlements to state second pension were also improved. The government estimates that as a result of these reforms the proportion of women qualifying for a full basic state pension will catch up with men by 2020,³ but that the outcomes from the state pension for men

1 DWP *Security in Retirement: Towards a New Pensions System*, Department for Work and Pensions (2006), figure 7 (based on GAD calculations)

2 DWP *Gross State Pension Entitlement* (2011)

3 Ibid

and women are not likely to be equivalent until around 2050.⁴ Although the 2007 reforms improved state pension outcomes for women and carers, the reforms did very little to change the situation of the self-employed.

Recent state pension policy – Coalition government

Since the Conservative-Liberal Democrat Coalition government came into power in May 2010, it has introduced a number of policy changes to the state pension system.

The Coalition announced that from April 2011 the basic state pension would be indexed to the highest of three factors – earnings levels, prices (as measured by the Consumer Price Index) or 2.5% – the so-called “triple lock”. The introduction of a guaranteed increase of at least 2.5% each year means that the triple lock is likely to be a more generous policy over the long term than linking the basic state pension to average earnings and is substantially more generous than linking it to prices. However, partly to offset the increased cost to the state of providing a more generous basic state pension, the government also indicated that it would accelerate the increases to the state pension age.

The government also announced that the Consumer Price Index would be used to index state second pension and public-sector pensions in payment – an index that is likely to be less generous over the long term than its predecessor measure the Retail Price Index. Today's pensioners who qualify for the basic state pension are likely to benefit from the triple lock, but may lose out from the lower indexation of occupational pension and SERPs/state second pension income to the CPI rather than the RPI under the Coalition's policy. How these changes affect a particular individual's pension income will vary depending on their personal circumstances.

Future policy developments – further state pension reform?

In April 2011 the Coalition government published a green paper consulting on potential further reforms to the state pension system.⁵ In the green paper the government set out four guiding principles for state pension reform:

- personal responsibility – enabling individuals to take responsibility for meeting their retirement aspirations in the context of increased longevity;
- fairness – ensuring an adequate level of support for the most vulnerable, ensuring everyone with a full contribution record is entitled to a state pension

⁴ DWP *The Gender Impact of Pension Reform* (2007)

⁵ DWP *A State Pension for the 21st Century* (2011)

above the standard level of means-tested support, and ensuring all groups are treated fairly;

- simplicity – simplifying the state pension so that it is easier for people to plan and save for their retirement; and
- affordability and sustainability – given longer-term pressures on the public finances, any state pension reform must be affordable.

The green paper sets out two broad options for further reform of the state pension:

- an acceleration of the existing reforms so that the state pension evolves into a two-tier flat-rate structure more quickly, by 2020 instead of by 2030; or
- the creation of a single-tier, flat-rate state pension set above the current level of the guarantee credit element of pension credit (for example, £140 per week in 2010 earnings terms) for pensioners retiring after the implementation date.

Both these reforms suggest that the government's main policy objective for the state pension is primarily about poverty prevention, rather than income replacement – with an expectation that citizens should save for themselves if they wish to have a comfortable standard of living in retirement in the face of increasing longevity. Both options retain the fundamental contributory principle, with eligibility for state pension still linked to the payment of national insurance contributions – although it could be argued that the second option weakens this link.

The National Association of Pension Funds commissioned the Pensions Policy Institute to conduct an assessment of the government's two state pension reform options set out in the green paper.

Option one is essentially a continuation of current policy but introduced on a faster timetable. The state pension would still have two separate elements to it – the basic state pension and the state second pension, with different qualification criteria and indexation rules. From around 2020 any further state second pension earned would simply be a flat-rate top-up, and entitlement would no longer be linked to an individual's earnings. The PPI's research found that, compared with current policy, no one would gain from this option and those individuals clocking up state second pension entitlement between 2013 and 2030 would be worse off under this reform. The PPI estimates that in 2034 around 5 million pensioners would have lower household pension income under this reform option than under the current system, losing an average of 50p per week in 2011 earnings terms. Women, carers, low earners and the self-employed are unlikely to benefit substantially from this option.

Option two is a more radical reform, which would bring to an end the existence of two separate state pensions and introduce instead a single-tier pension with a single set of qualification criteria and indexation rules. The government has suggested that a single-tier, flat-rate pension might be introduced at a level just above the current means-testing threshold of around £140 a week in 2010 earnings terms, for pensioners retiring after the implementation date only.

This reform could be beneficial for future generations of women, carers, low earners and the self-employed, who may have historically failed to qualify for the state second pension. The PPI estimates that if the government were to introduce the radical reform for all those reaching state pension age from 2016 onwards, then in 2034 some 7 million pensioners could see their household pension income increase compared with the current system, gaining an average of £23 a week in 2011 earnings terms.

Equally, higher earners who would have clocked up higher entitlements to the state second pension under the current system would lose out under the more radical option. The PPI estimates that around 5 million pensioners could have lower household pension incomes under this option in 2034 compared with the current system, losing an average of £18 a week in 2011 earnings terms.

If implemented, the government's radical state pension reform is likely to lead to fairer outcomes from the state pension in the future for groups who have historically tended to fare less well from the current state pension system, including many low earners, women, carers and the self-employed. However, the reform would not address existing inequalities in state pension outcomes for current pensioners, because it would not apply to those who had already reached state pension age before the implementation date.

Conclusions

Since 1948 and the introduction of Beveridge's reforms, the UK has had a state pension system whereby eligibility for the state pension has been based on the contributory principle with the level of state pension income an individual receives being linked to the amount of national insurance contributions that they have made through their working life. After the introduction of graduated retirement benefit and SERPs, the level of individuals' earnings has also affected their state pension entitlements.

It is this link between state pension entitlement and participation in the labour market as well as earnings that has often led to poorer outcomes from the state pension for some groups, such as women, carers, the self-employed and low earners.

It is too soon to say where the government may end up in the next phase of its deliberation on state pension reform. But it is certainly possible that state pension policy may go full circle, with a state pension in the future that looks more similar to that introduced by Beveridge in 1948 – a flat-rate benefit aimed at poverty prevention, eligibility being linked to payment of national insurance contributions.

If the government adopts its more radical reform proposal – of a single-tier, flat-rate state pension – then future generations of women, carers, the self-employed and low earners may receive outcomes from the state pension that are more similar than now to the outcomes for the rest of the UK's population, although it may take many decades before outcomes from the pensions system are actually equivalent.

Chapter 5

Fair pay and fair pensions – closing the women's pensions gap

Diana Holland, Assistant General Secretary for Equalities at Unite

Fair pay and fair pensions – closing the women's pensions gap

Yvonne's story: Part I

I will be 55 this year, and now this Con-Dem government has decided they want me to work until I am 66. I have worked since the age of 15, having only 10 or 12 weeks at home following the birth of each of my three children.

I left school to begin my working life at the age of 15. At this time the state retirement/pension age for women was 60. When I had my first daughter at the age of 22 I was unable to return to full-time work due to childcare issues so I took on part-time work to fit in around my husband's work. During the next few years I had two more children. Money was very tight and I needed to work to keep our heads above water, so I continued to work part-time. At one time I was doing three different jobs: an early-morning cleaning job before my husband left for work; a couple of hours in the middle of the day while one of my daughters was in full-time school, another was at nursery part-time and a friend looked after my youngest; and I had another cleaning job at tea-time when my husband returned home from work.

I now work in manufacturing doing a manual job; I have arthritis and a few other medical problems. At times now I struggle to cope with my work: as I get older I expect I will struggle more. If I am unable to carry out my duties at work I will be at risk of my employer dismissing me on the grounds of capability. If that happens before I can draw my pension, how will I cope financially, who else will employ me, how will I survive without an income?

I am now frightened about my future, because all I can see is an old age of financial hardship after a lifetime of working. How many thousands of women like myself are this government condemning to a dismal future? These plans do not give us enough time to plan and save for a half-decent retirement.

(Yvonne is a Unite member from the West Midlands.)

Yvonne's story graphically demonstrates not only the very worrying impact that the government's threatened pension age changes will have on women and their families, but also the way in which women's working lives and family responsibilities lead to women's poverty in retirement. Further, Yvonne's story clearly sets out why women

with caring responsibilities may need to work part-time in three jobs rather than full-time in one job, and why the demand for earnings from part-time jobs to be added together for national insurance purposes is critical – if pay in each job is below the limit set, your earnings do not count towards your state pension.

The message is simple: discrimination and unequal pay during women's working lives is compounded by discrimination and unfairness in pensions – and while the Labour government had begun to address some of the problems faced by women in retirement, the Conservative–Liberal Democrat government is set to reverse this trend as part of its desperate attempt to cut a way out of the global economic crisis and the UK recession – apparently considering that extending women's pensions injustice is a "price worth paying".

It is worth looking back at campaigning around the turn of the last century and in the first years of the new millennium, when major commitments were made to tackle child and pensioner poverty, and when the reality of women's poverty and its underlying causes began to be exposed and campaigned on, including the horrifying statistics that while nearly all men (91%) qualified for a full state pension, very few women (13%) did, and women's average retirement income stood at just 57% of men's. The example of Jim and Kathy sets out very clearly the stark situation for some women and their families.

Jim's and Kathy's story

Jim and Kathy are both aged 50, and have been partners for nearly 20 years. They have no children. Jim is a Corgi-trained gas fitter. Kathy works part-time (15 hours per week) in Debenhams, and also part-time (15 hours per week) in the local newsagents. Kathy's mother has MS, so for many years Kathy has spent an hour in the morning helping her get up, followed by a quick check at lunch-time and an hour or so at supper-time (about 20 hours a week in all). She also keeps an eye on Jim's elderly uncle, making sure he has a hot meal every day and doing his shopping and laundry. This takes another 10 hours a week. So Kathy fits her work, which she enjoys, around her caring.

Jim's work = 40 hours per week

Kathy's work = 60 hours per week (two 15-hour jobs and 30 hours caring for two people)

Jim has entitlement to the full basic state pension and an occupational pension.

Kathy will get no basic state pension because both her jobs are below the lower earnings limit, no carer's allowance because her caring of 30 hours a week divided between two people does not enable to qualify for it, and of course no occupational pension. So she will enter retirement without a penny in basic state pension income of her own, without a 60% basic state pension from Jim as they are not married, and with no entitlement to pension credit as it is household-based and Jim's income floats them off it.

So Jim works 40 hours a week and will be comfortable; Kathy works 60 hours a week and will be penniless. What did she do wrong?

From Helen Jackson MP

The introduction of the national minimum wage in 1999, which at a stroke reduced the gender pay gap in work (the ratio of women's to men's hourly earnings) by a full percentage point – with larger changes for part-time women workers and manual workers¹ – exposed the fact that 70% of the lowest-paid were working women – not surprising, then, that they were also the poorest in retirement.

While not directly a pensions measure, the minimum wage, together with union action over equal pay as at the Ford Motor Company in 1968 and 1984, and equal pay law as introduced by Labour in 1970 and from European legal action in 1984 – as well as childcare and paid maternity, paternity and family leave rights in the 1970s and 1990s – were all clearly demonstrated to be essential steps on the path to achieving dignity and security in retirement for women.

At the same time, strong campaigning alliances were built between trade union women, politicians, women's and pensioners' campaigning organisations and the Equal Opportunities Commission (now part of the Equality & Human Rights Commission); and detailed studies by the Women's Budget Group exposed the reality of inequality.² Early day motion 523 in 2003/04 from Vera Baird, for example, stated the shared priorities on women and pensions:

¹ Low Pay Commission *Impact of the National Minimum Wage* (March 2001) (<http://www.lowpay.gov.uk/lowpay/report3/003fore.html>)

² Women's Budget Group *Response to the Department for Work & Pensions *reen Paper, Simplicity, Security and Choice: Working and Saving for Retirement** (March 2003) (www.wbg.org.uk/pdf/WBG-Response-to-DWP-Pensions-Green-Paper.pdf)

That this House welcomes the launch of Age Concern and the Fawcett Society's report One in Four; expresses concern that one in four single pensioner women live in poverty and that only 13 per cent of all women pensioners have managed to build up entitlement to a full basic state pension; recognises that this is a problem which will continue in the future with one in five women currently aged between 25 and 34 relying on their partner for a pension; and supports the report's call on the Government to take action to reduce poverty for today and tomorrow's older women pensioners.³

Measures such as home responsibilities protection to address the situation of carers in particular, together with a major increase of women in paid work since the 1950s, assisted in the achievement of some improvements in women's income in retirement. However, the Department for Work & Pensions report in 2005⁴ concluded that low-earning women, part-time workers (who are mainly women), and carers caring for more than 20 but less than 35 hours were still particularly disadvantaged, as well as highlighting pensions difficulties faced by women at crisis points such as on divorce or bereavement.

The Pensions Act 2007 introduced important changes that addressed some of these concerns: restoring the pensions link with earnings, reducing the number of years of national insurance required to qualify for a full basic state pension to 30, removing the deeply unfair minimum 10-year qualification period, which so many women fell foul of (this meant that if you only had nine full years of national insurance, for example, you did not qualify for a state pension at all), and the introduction of carers' credits covering 20 hours' care from 6 April 2010 were all major achievements made as a result of these important campaigns.

In particular, the greater recognition of caring responsibilities – including, more recently of grandparents – has been of great importance. While very welcome for the future, these changes have come too late for those women retiring on the wrong side of the cut-off date. The older women in the most difficult financial situations – they paid the reduced stamp, and worked at a time when it was lawful to bar women from pension schemes if they worked part-time and when unequal pay and pregnancy discrimination were lawful – are still waiting for justice.

³ See also: Women's Working Party National Pensioners Convention "Rise up on Women & Pensions" and "Wise-up on Pensions: NPC Guide for Working Age Women" (info@npcuk.org) and National Assembly of Women "Pensions Briefing 6" (naw@sisters.org.uk)

⁴ Department for Work & Pensions *Women and Pensions – The Evidence* (November 2005) (www.dwp.gov.org)

Yvonne's story: Part II

When I was in my mid 30s, in the 1990s, we were told the age for women's retirement would be increased to 65, but it would be increased in stages from 2010 to 2020. I was not happy about it, but this change was a long way off for me. At the age of 35 I returned to full-time work with my present employer. I was invited to join the company final salary pension scheme; at last I was able to see a good future for myself and looked forward to a good income when I retired.

In 2010 my company told us they were closing down our final salary pension. I had been in the scheme for 19 years and, had the scheme remained open, I would have had a very good lump sum and monthly pension by the age of 65. In fact I had planned to reduce my hours when I reached the age of 60 to help my daughter with her childcare so she could get back into work, as she is unable to return to work now due to the cost of childcare for her two children. The good pension and lump sum I had been looking forward to has now been taken away from me.

Unlike many women, Yvonne has had access to an occupational pension scheme, but as well as highlighting again the important interrelationship between women's working lives and family responsibilities, Yvonne's story shows clearly that an occupational or private pension can never replace the need for a secure fair state pension as the bedrock of dignity in retirement for all.

More recent proposals on universal credit have also been examined in relation to key concerns for women's equality, by the Women's Budget Group.⁵ And Labour's shadow pensions minister, Rachel Reeves, is quoted in a *Pensions World* interview as saying in response to the proposed £140 flat-rate pension: "We've had a very green green paper with little in it. My big fear is that rather than raise pensions for women, the government will effectively level down pensions for men."

In autumn 2011, however, the alliance that led to some of the important achievements on women and pensions over the past decade has been extended by the more active involvement of younger women, challenging the manifest injustice of proposed pension age changes for women, in a campaign that keeps growing. Rachel Reeves has organised a powerful united campaign, exposing the shocking timeframe and shameful proposals, and ensuring that the real-life suffering of women like Yvonne (featured

⁵ Women's Budget Group *Written Evidence on the White Paper on Universal Credit – Work and Pensions Committee* (7 March 2011) (www.publications.parliament.uk)

here) and Barbara,⁶ who features in the Unions Together campaign, together with Age UK's Report *Class of 53/54*,⁷ is properly recognised:

- Half a million women will have their state pension delayed by more than 12 months.
- For 300,000 women the delay is between 18 and 24 months.
- For 33,000 women the delay is two years, costing them over £10,000.

Jack Jones, union leader and pensioners' champion, has said that pensions are about "solidarity between the generations". The achievements of previous generations on women's pensions have been passed on in solidarity to the next generation. We must not allow the current proposals to be the legacy passed to the next generation to retire. Women's pension equality is too important – we have all waited long enough.

6 Unions Together "Barbara's Petition" (www.unionstogether.org.uk/page/signup/handsoff)

7 www.ageuk.org.uk/spa (March 2011)

Chapter 6

Issues for small firms and the self-employed

Mike Cherry, Policy Chairman at the Federation of Small Businesses

Issues for small firms and the self-employed

The economy remains unsettled for everyone, including the small business community. Our members in the Federation of Small Businesses are telling us that they are struggling with securing contracts, getting paid on time and obtaining finance from the banks.

The FSB Voice of Small Business Index for the first quarter of this year showed that small businesses' employment intentions weakened even though business confidence has been gradually improving.

UK unemployment is currently 2.43 million, and there are still 895,000 young people unemployed and 1.02 million women out of work.¹ With further public-sector cuts still to be felt, it is paramount that small businesses are given the right tools to help boost the recovery and growth.

The government's growth agenda rightly focuses on small businesses leading the next wave of economic growth. It concentrates on providing new employment opportunities for those who have unfortunately lost their jobs, or may lose them over the coming months. Given the right tools and conditions, small businesses can and want to play their part. This means working towards an environment where people are encouraged to go it alone and start up their own business, and in which small firms are able to offer valued, well-paid and long-standing jobs.

As we continue to live longer and healthier lives, the pensions issue has become more serious. The Federation of Small Businesses believes the issue must be addressed to help people save for their future. And being able to take retirement at whatever age one chooses is just as important.

Costs to businesses have steadily risen over the past few years and are unlikely to fall any time soon. We continue to see rises in property prices, the costs of renting a home, and fuel prices, alongside increases in the price of energy and food as well as other living costs. All of this means that people will be paying more for day-to-day living alongside the increasing need to save for a pension. This imbalance of expenditure must be addressed.

Auto-enrolment looms

Within the government's Growth Agenda, it is going to implement radical changes

1 ONS *Labour Market Statistics* (June 2011) (<http://www.statistics.gov.uk/pdfdir/lmsuk0611.pdf>)

to the way pensions are run. In 2012 the process to ensure that all eligible staff² are auto-enrolled into a pension scheme will begin. It will start with large employers in 2012, and affect small businesses from 2014. This means that the Pensions Regulator will give each small business a start date, based on the last two characters of its PAYE reference numbers. All new staff will have to be enrolled by the end of the third month after the start of their employment. By October 2017, minimum contributions must be at least 4% from employees and 3% from employers, while the government will add a further 1% with a tax rebate.

When the concept of automatic enrolment was first announced, it was supposed to fully encompass the recommendations of the 2005 Turner report, but the spirit of this seems to have been lost. The government's intention to cater for those on low pay without any private pension provision fell by the wayside once the element of choice was introduced. We have always said – and this is also a suggestion of the Turner report – that instead of making people choose a scheme, there should be a good default scheme into which everyone who is not currently saving could be enrolled. Those wanting to save more would be able to seek further advice and to choose for themselves. However, the government-backed National Employment Savings Trust (NEST) may not be the best choice for every small business. In addition, the burden of compliance with any qualifying scheme is now disproportionate to the benefits gained for any business with fewer than 10 employees.

The Federation of Small Businesses is extremely concerned that employers will not be able to choose a pension scheme suitable for their company and for their employees. Business owners are not pensions experts and do not have the confidence to make such decisions. Small-business owners have neither the human resources departments nor the expert pensions resources that a big business has.

The Federation of Small Businesses believes that there should be an exemption for micro-businesses – those with fewer than 10 employees – from the requirement to automatically enrol, in order that both employers and employees should be able to make their own choices in their best interests.

Our research shows that 60% of small-business owners believe pensions should be an individual's responsibility.³ The government's intention to ensure that qualifying employees are automatically enrolled into a pension scheme presents a substantial

² An eligible worker is an employee aged between 22 and state pension age and earning above the income tax personal allowance (£7,475 in 2011/12).

³ Federation of Small Businesses Pensions Survey, March 2009

financial and administrative burden for small-business owners.

Unfortunately, there has so far been little consideration given to the impact these pension proposals will have on small employers. Currently, only 18% of small businesses offer a pension scheme to employees, and 49% feel that pensions are too expensive. Further, only 50% of businesses with a pension scheme contribute towards their employees' pensions.⁴

The costs for small firms

The average small firm – those with four employees, earning an average salary of £25,000 – will pay at least an extra £2,550 per year in administration and pension costs. While this may not sound like a significant amount, when you consider it against the average turnover of a small business, at only £500,000,⁵ this amount could be their annual marketing budget or money to go towards expansion.

Turning to the administrative costs for small businesses, Department for Work & Pensions modelling has suggested that the move will cost micro-firms with up to four employees £46 per person in administration. We believe that this incorporates a gross underestimation of the actual time the process will take and, as a result, the cost. Given that the process will demand not only direct financial expenditure but also considerable time spent in administering pension payments, this will be a burden on the small-business owner who works on every aspect in their business. None of us who run small businesses work a nine-to-five job, and are often to be found catching up on regulatory requirements at the kitchen table in the evenings or at the weekends, when everyone else is enjoying family time, or time off.

The Federation of Small Businesses is concerned that because of the complex nature of pensions, the implementation of automatic enrolment could lead to employers being penalised for minor errors as opposed to deliberate non-compliance. We have suggested all along that a "light touch" will be necessary in helping small businesses to understand the system and to help them to comply. We feel that if there must be a fixed penalty notice, then the level should be reduced from the £400 being proposed to £125, a similar level to a comparable HMRC penalty. However, while the registration process has been made easier, we remain to be convinced that the regulator will take a light touch rather than simply issue fines.

4 Ibid

5 The mean turnover for FSB members' main business in the last financial year was approximately £525,000. At the extremes, a quarter (23%) turned over less than £50,000 while one in 10 (10%) turned over more than £1 million (Federation of Small Businesses/Institute ICM Voice of Small Business Annual Survey, February 2010).

Our research has shown that 73% of small businesses are not confident in their ability to choose a pension scheme.⁶ It is extremely likely that the person undertaking any pension administrative role will inevitably be the business owner or occasionally a member of staff. Both these people are in business or are employed by a business because of their skills in their chosen field. They are not and should not ever be deemed to be the equivalent of the kind of pensions or human resources expert found in big businesses.

The Pensions Policy Institute argues that in order to provide "desired retirement income solely through state and private pensions, many people may need to have a minimum of 15% of their salary contributed to their private pension, and in some cases people may need to contribute more in order to meet desired retirement income".⁷ This is because people are living longer and many expect to maintain the same standard of living in retirement as when they were employed.

As we have already said, NEST does not meet the Turner recommendations as employers will have to actively choose to join the scheme. What is also worrying is that the taxpayer, as well as pension scheme contributors, could end up with a bill for the £379 million NEST subsidy if take-up to the scheme is lower than expected and its target market is not reached. This worst-case scenario figure excludes the cost of the government's loan, which could end up being as much as £1.275 billion if take-up is low.⁸

NEST has proposed to repay its loan to government by charging members 1.8% on contributions. However, we have voiced concern about what might happen if NEST cannot repay its debt in time. While the charges are currently low and will be met by the employee only, we remain concerned about the impact of any potential increase.

Risks for low-earning employees

We are also worried about the impact of these proposals on staff earning a low income, especially those on the minimum wage. The worst-case scenario would be if those on low incomes lost entitlement to benefits from the state. Thus any change to pensions legislation has to be accompanied by a radical change in the way benefits are administered. For example, the National Association of Pension Funds has indicated

⁶ Ibid

⁷ Pensions Policy Institute *Retirement Income and Assets: Outlook for the Future* (March 2010) (https://www.pensionspolicyinstitute.org.uk/uploadeddocuments/Briefing%20Notes/PPI_Briefing_Note_54.pdf)

⁸ "Taxpayers Face £380m Bill if Nest Falls Short of Target" in *Money Marketing*, 7 April 2011 (<http://www.moneymarketing.co.uk/pensions/taxpayers-face-%C2%A3380m-bill-if-nest-falls-short-of-target/1029220.article>)

that the poorest workers, by being automatically enrolled, may lose entitlement to means-tested top-ups to the basic state pension, which is currently £97 a week.⁹ This benefits no one. We therefore agree with the association that unless means-testing is addressed, the government could face accusations of mis-selling.

It is assumed that most small businesses will choose NEST as their company pension scheme. However, there will be employers who decide to enrol their employees into other pension schemes. Such a decision could expose many employees to the risk of their money being deposited in funds that are not really suitable, losing a proportion of savings in higher fee charges. This has been suggested by David Pitt Watson, of Hermes Fund Managers. He adds: "Perhaps even worse, it seems there are no restrictions on how the money will be invested, or adequate standards for the records that providers will need to keep. A recipe, some might say, for fraud."¹⁰ The government has said that it has the powers to prevent excessive charging. We hope that if excessive charges do emerge, the government will intervene.

Joined-up and effective communication is paramount. We remain concerned that the Department for Work & Pensions, NEST and the Pensions Regulator are all issuing different communications in their own right. We have long encouraged one simple, joined-up source of information, encompassing the remits of all three bodies in a single resource for all employers and their employees.

This is a particular worry, given that big businesses are being automatically enrolled a few years before smaller ones. For the pension reforms to work as smoothly as possible, there must be greater focus by government and representative bodies to effectively communicate what is happening, how it is to work, and that big businesses will be the first ones to start the process.

A recent survey of finance and human resources directors at some of Britain's biggest companies – which will have to commence auto-enrolment in just over a year – indicated that 40% of finance directors were still not even aware of the October 2012 deadline.¹¹

If the communications challenge is not addressed there will be chaos, or if the larger

9 "Government Risks Pension 'Mis-selling Scandal'", Reuters, 16 February 2011 (<http://uk.reuters.com/article/2011/02/16/uk-nest-napf-idUKLNE71F00320110216>)

10 "New Pension Rules 'Risk a Mis-selling Scandal'" in *Daily Telegraph*, 31 May 2011 (<http://www.telegraph.co.uk/finance/personalfinance/pensions/8546698/New-pension-rules-risk-a-mis-selling-scandal.html>)

11 "Pension Changes Heading for 'Car Crash'" in *Financial Times*, 20 June 2011 (<http://www.ft.com/cms/s/0/179fd07e-9b4a-11e0-a254-00144feabdc0.html#axzz1QanZb2X6>)

employers leave it too late there could be a sudden rush that pension providers and NEST will not be able to handle. As a result, providers may become more discerning when it comes to choosing clients, thus putting significant pressures on NEST in its early stages and storing up problems for small businesses and their lower-paid employees in the future.

Furthermore, without good communications in place, employers may face difficult conversations when their staff question why a proportion of their earnings is now going into a pension scheme rather than into their pocket. Employers will not be in a position to suggest that saving for a pension is not really a good choice for a particular employee at a particular time. This is why we have always said that employees must be able to choose to opt in rather than choose to opt out, in order to guard against the risk of accusations of employer inducement.

Problems with online procedures

It is also essential to make the point that not every business is, or needs to be, online – or in fact uses a computer. A building firm is a prime example. However, NEST is solely an online-based service for employers. This means that businesses have to set up online and administer payroll to NEST online. Their employees, however, will be able to communicate with NEST by telephone or letter. The problem is exacerbated by poor broadband provision across the UK.

Figures from a Federation of Small Businesses survey of 1,300 small firms showed that 24% of respondents are dissatisfied with their broadband service. Federation of Small Businesses members in the South West have noted that current broadband provision means many small businesses in rural areas find the process of online filing “times out” before they can complete it. This has been reported for DEFRA forms, where security protocol prevents the business using someone else's computer to make the return. Government must ensure that broadband coverage is fast and reliable enough across the UK before putting a focus on online portals.

Some small businesses are having to pay for accountants¹² to file accounts online because of earlier experiences again with the HMRC website. The Federation of Small Businesses expresses concern that small businesses in areas of poor broadband provision will struggle to access information from the Pensions Regulator or be able to use NEST, and that while this is especially so in rural areas, it is also prevalent in urban areas as well.

¹² Not all small businesses use accountants.

An employer commits a criminal offence if it wilfully fails to enrol or re-enrol someone automatically or denies them their rights to opt in. This can lead to a criminal fine and or prison.¹³

To go some way to ensure this does not happen, common commencement dates should be used when employers enrol and re-enrol their employees. Additionally, using these at the beginning of the process also reduces the impact of a small business being staged ahead one or two years before a competitor. Under the changes, some small businesses will be staged ahead of others, acting as a barrier to competing on a level playing field for those staged significantly earlier in the process. It is extremely disappointing that, throughout this process, government has failed to "think small first".

We are also extremely disappointed that there has been no further impact assessment looking at the administrative burden and cost to small firms. Our research has shown that 59% of small businesses believe that the pensions reform will have a negative impact on their business. Despite being promised that regulation would only be introduced as a last resort and that micro-businesses would be exempt from all new domestic regulation, small businesses have not yet been exempted from the requirement for automatic enrolment of employees into a pension scheme. Having an exemption for micro-businesses would have enabled both employers and employees to make their own choices in their own best interests.

Small businesses make up 99.3% of all businesses in the UK, and make a huge contribution to the UK economy. They contribute 51% of the country's GDP and employ 58% of the private-sector workforce. The Federation of Small Businesses is concerned that these reforms as they currently stand will have a significant impact on small businesses. The accumulation of the unknown administrative and fixed financial costs, combined with extra financial burdens such as increases to the minimum wage and increases in employer national insurance contributions, will act as a barrier to business growth. Consequently we call on government to think again and exclude micro-businesses from automatic enrolment.

¹³ Burges-Salmon *Automatic Enrolment in a Pension Scheme: New Employer Duties* (June 2011) (http://www.burges-salmon.com/Practices/pensions_and_incentives/Publications/Automatic_enrolment_in_a_pension_scheme_New_employer_duties.pdf)

Chapter 7

Pensions and ethnicity – a problem set to increase

Phil Mawhinney, Research and Policy Analyst at Runnymede, and
Omar Khan, Head of Policy Research at Runnymede

Pensions and ethnicity – a problem set to increase

Black and minority ethnic (BME) people are less likely than average to have a private pension and more likely to experience pensioner poverty. In this time of significant reform to state and workplace pensions, it is crucial that policy makers understand the particular nature and causes of this problem. This concern takes on added significance when the number of older BME people is set to rise significantly from what have, until recently, been very small numbers. By 2051 there may be in the UK 2.7 million BME people aged 65 and over, compared with 230,000 in 2001 – nearly a 12-fold increase.¹ By making effective interventions today, policy makers can prevent an escalation of pensioner poverty among older BME people in future.

As with other areas of social life, poverty among older BME people varies by ethnic group. Those from Bangladeshi and Pakistani backgrounds are the most likely to experience pensioner poverty and among the least likely to have a private pension. The main explanatory factor for this disadvantage is people's position in the labour market. In this chapter we show that BME people's experience of unemployment, self-employment and disproportionate employment in particular industries means, firstly, that they are less able to *access* pensions; and, secondly, that they are less able to *contribute* to them. We also mention other important factors, such as people's migration status and financial awareness.

Pensions, savings and assets

Being under-pensioned means having a retirement marred by poverty, discomfort, ill health and often anxiety about day-to-day expenses. The fact that BME people, across the different ethnic groups, continue to be at a higher risk of pensioner poverty than the rest of the population marks them out as a group that must be given urgent attention. The most recent figures show that nearly half (48%) of pensioners from Bangladeshi and Pakistani backgrounds are in poverty, as are one in three of Indian ethnic background (33%) and of black Caribbean ethnicity (30%); this compares with one in five (20%) white pensioners.²

The immediate cause of this poverty is that BME people tend to have fewer pensions, savings and total assets than the wider population. A 2008 report by the Pensions Policy Institute provides evidence of the multiple ways in which BME people are under-pensioned. Firstly, and most importantly, they are less likely to have a private

¹ Lievesley, N *The Future Ageing of the Ethnic Minority Population of England and Wales* (Runnymede, 2010), p79
² DWP *Households Below Average Income: An Analysis of the Income Distribution 1994/5 – 2009/10* (2011), p148

pension. Among those in work, 39% of BME people have a private pension, compared with 53% of white people.³ The gap in pensions is biggest among 25- to 34-year-olds. As the report says:

*This is significant, as this age group accounts for a large proportion of the ethnic minority population, given the younger age structure of the ethnic minority community.*⁴

This cohort will make up a large proportion of the future older BME population, and so it is of particular concern that this group is under-pensioned.

Secondly, BME people are more likely to be dependent on means-tested benefits and less likely to build up entitlement to the state second pension. This latter point may become less relevant if the state second pension is scrapped. Nevertheless, only 65% of BME people are building entitlement to the state second pension, compared with 75% of the whole population⁵ and this may continue to result in lower state pensions. In terms of means-tested benefits:

*Nearly half (46%) of Asian and Black pensioners receive means-tested benefits, compared to less than one-third (31%) of White pensioners.*⁶

In some cases, people are unwilling to apply for such benefits, further reducing their pension income.

We also know that BME people are less likely to have savings and other assets, such as property. At least 60% of those of black and Asian ethnicity have no savings at all, compared with an average of 33%.⁷ We argue that this lack of savings is mainly a result of people's position in the labour market, which we discuss below. In terms of total assets, white British households hold an average of £221,000 of wealth, while households of black Caribbean ethnicity hold £76,000 and those of Bangladeshi ethnic background hold as little as £15,000.⁸ These figures partly reflect differences in the age

3 Steventon, A and Sanchez, C *The Under-pensioned: Disabled People and People From Ethnic Minorities* (Pensions Policy Institute, 2008), p42

4 *Ibid*, p41

5 *Ibid*, p59

6 *Ibid*, p46

7 Khan, O *Why Do Assets Matter? Assets, Equality and Ethnicity – Building Towards Financial Inclusion* (Runnymede, 2009)

8 National Equality Panel *An Anatomy of Economic Inequality in the UK: Report of the National Equality Panel* (2010), 208

structures and migration history of different communities, but there is clearly significant asset inequality.⁹ These data indicate that the lower level of pensions among BME people is *not* explained by or compensated for by a large value of other assets.

Unemployment and discrimination

The main reason why BME people cannot fully access and contribute to pensions is their experience of disadvantage in the labour market. There are various elements of this disadvantage, and we will now discuss the ways in which these affect pension outcomes.

Perhaps the most fundamental aspect of labour market disadvantage is unemployment. We assume that people need to supplement the state pension in order to maintain a decent standard of living in retirement and that those not in work are unlikely to be able to access or afford a private pension. Figures for the end of 2010 show that BME people currently experience lower rates of employment than average – 61%, compared with 72.6% for Great Britain as a whole.¹⁰ They are also more likely to be unemployed – the unemployment rate for Great Britain is 7.7%, whereas for BME UK nationals it is 12.7%, a full 5 percentage points higher. The situation is even worse for BME non-UK nationals, among who unemployment is at 13.7%.

Of course, unemployment varies significantly between ethnic groups. Whereas unemployment in 2006–08 was around 4% among men of Chinese origin, it was 11% among men of Bangladeshi ethnic background and as high as 16% among men from the “other black” ethnic category.¹¹ Among women, the picture is different, with more people economically inactive, looking after the home and family – indeed, over 40% of women from Pakistani and Bangladeshi backgrounds are economically inactive. But even among those looking for work, all BME groups experience higher unemployment than white British women (for whom unemployment sits at 3%), with around 7% of women of black African ethnicity and 11% of “other black” women unemployed.

We cannot fully discuss the reasons for unemployment among these groups. In our recent report into pensions and self-employment among BME groups, we noted that low levels of human capital (education and skills) and structural economic changes are significant factors.¹² However, it is important to highlight that *direct discrimination* on the basis of race/ethnicity continues to disadvantage BME people in their attempts to gain

9 For a full discussion, see: Khan, op cit

10 Black Training & Enterprise Group *Race Equality in Employment Briefing* (2011)

11 National Equality Panel *An Anatomy of Economic Inequality in the UK: Report of the National Equality Panel* (2010), p113

12 Mawhinney, P *Ready for Retirement? Pensions and Bangladeshi Self-employment* (Runnymede, 2010)

employment. A study commissioned by the Department for Work & Pensions involved submitting fake job applications from "applicants" with similar qualifications but names associated with different ethnic groups. The researchers concluded:

*Differences between the ethnic groups in the proportion of positive responses from employers can therefore be attributed to discrimination.*¹³

One important way of reducing ethnic inequalities in labour market outcomes and, by extension, pensions is to continue to stamp out such direct discrimination. Among the policies that might address discrimination are the adoption of name-blind job applications or CVs (a policy advocated, prior to the last general election, by the Liberal Democrats),¹⁴ or greater use of positive action.

Self-employment

Self-employment is more common among some ethnic groups. One explanation is that many people have limited success in finding a job, which is partly caused by discrimination. Figures from 2007 show that self-employment is particularly common among people of Bangladeshi and Pakistani ethnic backgrounds, with 16% and 26% of the working population of these groups, respectively, being self-employed.¹⁵ Given that these two groups experience the highest rates of pensioner poverty, it is important to recognise and explain the important link between self-employment and pensions.¹⁶

Firstly, self-employment overall is associated with lower and more volatile income, as well as being subject to high levels of risk. Many self-employed people who have a pension will find it more difficult to make regular and significant contributions than someone on a steady wage. This may be especially true for owners of small businesses, which can act like a "black hole" in terms of their owners' spare cash. Indeed, many owners of small businesses eschew pensions in favour of investing in their business, which can be a risky strategy given that many businesses fail. Rates of business failure vary by industry, with more businesses in the hospitality and catering industry failing than in other industries. This is significant because some BME groups are concentrated in this industry – among self-employed men, those of Bangladeshi ethnic background are three times as likely as white men to be in this industry (63%, compared with 19%).

¹³ Wood, M, Hales, J, Purdon, S, Sejersen, T and Hayllar, O *A Test for Racial Discrimination in Recruitment Practice in British Cities* (DWP, 2009) (http://research.dwp.gov.uk/asd/asd5/report_abstracts/rr_abstracts/rra_607.asp)

¹⁴ Liberal Democrats *Liberal Democrat Policies for Racial Equality* (2010)

¹⁵ Steventon and Sanchez, op cit, p35

¹⁶ Mawhinney, op cit

The second point is that people who are self-employed are less able to access workplace pensions than employees, especially employees of larger companies and in certain well-pensioned industries, such as construction.¹⁷ Many employees are, rightly, given the opportunity to take up a workplace pension – commonly “handed on a plate”, or otherwise formally offered in a way that overcomes the inertia that often blocks pensions uptake.

Furthermore, the self-employed cannot benefit from the significant additional employers’ contributions to most pensions schemes. As auto-enrolment and NEST are rolled out next year, there is a real danger that low-income self-employed people will see very little benefit. The nature of self-employment means that self-employed people will not be auto-enrolled into a scheme but may opt *in* to NEST. Those who do will not enjoy the minimum 3% employer contribution and so may struggle to build up an adequate pensions pot.

Occupational segregation and in-work poverty

Having discussed unemployment and self-employment, we now turn to the kinds of employment that BME people tend to get. People from BME groups are disproportionately located in industries that are less “well-pensioned” than others. For example, we have already explained that men of Bangladeshi origin are concentrated in the catering industry (as employees as well as self-employed) in which fewer companies offer pension support.¹⁸ This is true of other groups, as ONS data from 2004 shows:

Two in five Chinese women and one in three Bangladeshi women worked in [the distribution, hotel and restaurant industries] in 2004, compared with one in five of all women in employment.

These people are less likely to be offered a pension or supported to take one up. This partly explains the fact, discussed above, that BME people in work are less likely than their white counterparts to have a pension.

While the industry people work in influences how likely they are to access a pension, their earnings and progression through the ranks affect their ability to make contributions. In a previous report we drew attention to the prevalence of in-work poverty among BME people.

17 DWP *Employers Pension Provision Survey: Research Report No 163* (2002)

18 Steventon and Sanchez, *op cit*, p35

Although the high proportion of [BME] groups living in income poverty is largely due to lack of work, [BME] groups also experience rates of in-work poverty higher than those of White households, and these are notably high among Bangladeshi and Pakistani households.¹⁹

Those experiencing in-work poverty are unlikely to have disposable income to put towards a pension. Indeed, men and women from Bangladeshi and Pakistani backgrounds have particularly low average wages – men of Pakistani ethnic background earn £7.74 per hour, while white British men earn £11.35.²⁰ This partly reflects the fact that one in seven men of Pakistani origin in employment in the UK are taxi drivers, compared with one in every 1,000 white British men.²¹ Again, auto-enrolment may have limited impact on those unable to afford decent contributions.

In terms of progression in work, some BME people are under-represented at senior levels, influencing their capacity to save into pensions. Data from 2004 shows that between 19% and 22% of people in work from the black Caribbean, black African and Bangladeshi ethnic groups were in managerial or professional occupations, compared with 27% of white British people and 38% of those from Chinese backgrounds.²²

The last point in this section is that some ethnic groups may be especially affected by changes to public-sector pensions. The increase in employee contributions that is expected following the Hutton review will disproportionately affect, among others, women of black Caribbean ethnicity, 49% of whom are full-time public-sector employees; this compares with 35% for all women.²³ This is a problem in so far as the mandatory extra contributions may force some people to leave their pension scheme because of an inability to afford the payments.

Other factors

Other factors influence pension outcomes for BME people. A person's migration status – the stage of life at which they come to the UK, their intention to settle or return – affects their ability to work, save and contribute sufficiently to pensions. Researchers suggest that while people may come to the UK with the intention of one day returning to their country of origin, many end up staying indefinitely, wanting to stay close

19 Runnymede *Personal Accounts: Implications for Black, Asian and Minority Ethnic Communities* (2007), p5

20 National Equality Panel *An Anatomy of Economic Inequality in the UK: Report of the National Equality Panel* (2010), p148

21 ONS *Employment Patterns* (2004) (<http://www.statistics.gov.uk/cci/nugget.asp?id=463>)

22 Ibid

23 Platt, L "Child Poverty, Employment and Ethnicity in the UK: The Role and Limitations of Policy" in *European Societies* vol 9, no 2 (2007)

to family in the UK. This "myth of return"²⁴ is likely to result in people failing to plan financially for retirement in the UK.

Similarly, people who migrate into and out of the UK multiple times will have fragmented national insurance contribution records. This reality is reflected in the Pensions Commission recommendation that the pensions system should include more people with interrupted work histories.²⁵ A related point is that some groups experience higher rates of ill health, affecting their ability to work and save and also meaning that healthcare needs add to the cost of retirement. For example, data from the 2001 UK census show that Pakistani and Bangladeshi people are much more likely than white British people to suffer a long-term illness or disability that restricts their daily activities.²⁶

Recent migrants are also likely to be sending a significant proportion of their income overseas via remittances. A recent report to the UK Remittance Task Force indicates the scale of this activity:

*The UK market is estimated at around £3 billion of outbound payments per year. The money goes to the Asian sub-continent, the Caribbean, Africa, China and Eastern Europe.*²⁷

Families making such payments will have less disposable income left to contribute towards pensions. Of course, many people making such payments do not intend to spend their retirement in the UK, although, as indicated above, some may end up doing so.

Families tend to be larger among some BME groups, especially those of Pakistani and Bangladeshi ethnic backgrounds. This again means that the earners in a household have less disposable income to put towards pensions, especially given that average incomes tend to be lower among these groups. Also, there is often the expectation in these communities that older people will be looked after in the home by their (married) children, rather than live alone or in some kind of residential home. Consequently, some do not consider pensions to be necessary. However, this arrangement appears to be changing as fewer people live less in accordance with traditional norms, especially as more BME people are British-born.

24 Anwar, M *The Myth of Return: Pakistanis in Britain* (Heinemann Educational Books, 1979)

25 Pensions Policy Institute *Initial Analysis of the Pensions Commission's Second Report* (2006), p2

26 Mawhinney, op cit, p15

27 Isaacs, L *Research on Migrant Remittances & Linkage to Broader Access to Financial Services* (Developing Markets Associates, 2008), p9

Another factor is suggestive evidence that BME people may have poorer financial awareness.²⁸ Of course, many white British people also struggle to understand pensions, but those who do not speak or read English well, or who are new to the UK and less familiar with its institutions and practices, may find it particularly difficult to navigate the state and private pensions systems. Indeed, there is some evidence that BME people often seek advice about financial matters from friends, family and others in the community,²⁹ partly because of distrust of financial institutions and pension schemes.³⁰ Some Muslims choose to avoid mainstream pensions products because such funds may violate Islamic principles.

Pensions uprating overseas

A somewhat different but equally important form of being under-pensioned is through the UK state pension *not* being annually uprated for people who have left Britain to spend their retirement overseas. At present most BME people over 65 were born abroad, and so some seek to "return" to their country of birth. These people may have contributed to their UK state pension for over 40 years, but once they leave the UK their state pension may be frozen in value for the duration of their retirement, meaning they miss out on thousands of pounds they would have received if their pension was uprated with the cost of living every year.

Whether or not pensions are uprated varies by country, but among the prominent countries where pensions are frozen are India, Pakistan, Bangladesh, Grenada, Trinidad and Tobago, and all African countries. People retiring to these countries will have a lot less money than they may have expected. For example, a person who retired in 1990 and moved to India or Nigeria is still receiving £47 per week, compared with the £98 per week for pensioners living in the UK (in 2010); over those 20 years, they have missed out on almost £24,000.³¹

Conclusion

Black and minority ethnic people in the UK are under-pensioned. Their disadvantaged position in the labour market – whether through discrimination, migration or other factors – means that they are less able to access pensions and contribute meaningfully to them. As the population of older BME people grows at a proportionally faster rate, it is vital that this situation is addressed. Doing so will require stamping out

28 Khan, O *Financial Inclusion and Ethnicity: An Agenda for Research and Policy Action* (Runnymede, 2008), p43

29 Mawhinney, P *Seeking Sound Advice: Financial Inclusion and Ethnicity* (Runnymede, 2010), p35

30 Khan, op cit (2008), p40

31 Khan, O and Mawhinney, P *The Costs of "Returning Home": Retirement Migration and Financial Inclusion* (Runnymede, 2010), p8

discrimination, improving life chances and providing information and support to more marginal communities, in addition to whatever other incentives or policies are developed to encourage everyone to save more into pensions.

Note: All Runnymede's reports can be accessed for free at www.runnymedetrust.org

Chapter 8

Engaging young people

Otto Thoreson, Director-General of the Association of British Insurers

Engaging young people

I have been very encouraged in recent years by the growing interest in and understanding of the scale of the pensions crisis. Sometimes, too much can be made of the need for a national debate before policy makers are able to move forward with necessary reforms, but in this case I think it is true. Effective pensions reform is not just a matter of contracts, regulations and investment strategies. It is about the reassessment and renegotiation of the social contract between people and the government. And as such, it cannot happen until there is a coming together of both public and political engagement.

There is no doubt that we are now at such a moment. The financial crisis has thrown into such stark relief the difficulties we face in making good on old promises, that we are being forced into a complete reassessment of the assumptions underlying our pensions system.

This opportunity must not be wasted. It is all too easy to look only at how those in retirement or soon to retire are affected by the crisis. Of course, we cannot ignore pensioners left high and dry by insolvent defined-benefit pension schemes, or those sinking into poverty as a result of unplanned long-term care costs. But we cannot let the "grey vote" dominate the agenda if we are serious about building a long-term, sustainable pensions system. It is much harder to focus on the longer-term challenges of the younger generation, and the Smith Institute's work in opening up this debate can be a crucial part of making sure that our lasting legacy does not leave young people in the same place when they reach retirement as we are today.

A new era of responsibility...

There is no question but that we are asking a lot of our young people when it comes to making financial decisions; far more than was ever asked of previous generations.

Entitlement to a sufficient retirement income is no longer to be expected as a matter of course. As the difficulties of funding the generous promises made to previous generations become clear, young people are being given only partial assurances, hedged around with caveats, conditions and an entirely new set of expectations as to what they need to do.

The most obvious indication of this shift is the closure of so many defined-benefit schemes to new members. By the end of 2009, 91% of defined-benefit schemes were

closed to new members,¹ and more have followed in their footsteps since. Outside the public sector, it is now very unlikely indeed that a young person will have the opportunity to save into anything other than a defined-contribution pension scheme. Young people will be expected in future to bear many more of the risks of private pension saving – investment, inflationary and demographic – which were previously taken on by employers.

The state pension system is also placing more burdens on young people. The state pension age is rising, even faster than expected, as the government seeks to pass the cost of the recent dramatic increase in life expectancy from the taxpayer back to the individual. Even in the public sector, young people will in future have to bear more demographic risk.

Young people seem to be facing a bleak picture. But many of these trends are not the obstacles to a sufficient retirement income that they seem to be. The most obvious advantage young people will possess is their incredible life expectancy. ONS statistics² show that growing numbers of young people today can expect to live beyond 100 – an almost inconceivably long time to people brought up on the old calculation of a natural span of life being three score and ten. Along with this increased life expectancy come continuing good levels of health and vigour at ages older generations associate with exhaustion and decline. The growing evidence around the benefits of continuing to stay active and engaged in society, including in work, at later ages suggests that rising pension ages will not be as unbearable a burden on young people as they are sometimes portrayed.

Young people are also uniquely positioned to take advantage of the shift from defined-benefit to defined-contribution pension schemes. Their working life is going to look very different from that of older generations, with recent research suggesting that the average person today will have 11 different jobs over their lifetime – a number that will surely continue to rise. Being able to transfer and amalgamate pension savings helps the saver keep track of where their money is and how much they have managed to put away. In particular, the transparency around how much money is sitting in a defined-contribution pension pot helps young people appreciate how much is added to their pot by government tax relief and employers. This will be crucial to ensuring the new defined-contribution system works well to give young people sufficient income in retirement.

¹ Association of Consulting Actuaries survey, January 2010

² ONS *Centenarians* (2010)

The defined-benefit system is drowning as the cumulative cost of all the longevity, investment and inflation risk overwhelms employers, but we can make sure that its greatest strength – the high average level of employer contributions – is thrown a lifebuoy and carried over to the new defined-contribution system. With the advantage of transparency to encourage these contributions, plus the flexibility to allow young people the control they like over their lives and their financial assets, defined-contribution schemes could deliver pensions for young people much more suited to their way of living.

... and austerity

Recent events have, of course, put further unforeseen pressures on young people that restrict their ability to start paying into a pension, or indeed into any other savings vehicle.

The introduction of student fees in 1998 signified the end of free higher education and introduced many young people to previously unknown levels of debt. Government figures show that people aged 16–24 now have an average of £5,100 of non-mortgage debt, of which 30% is student debt. The recent increase in student fees will only increase this financial burden for many.³

The financial crisis has also made getting onto the first rung of the housing ladder harder for young people. Nationwide's figures show that the average cost of a house for a first-time buyer has more than doubled in 10 years to £137,000. Mortgages now require an average deposit of over 20%, and the proportion of earnings that first-time home owners are paying to service their mortgage has risen from 26% in 2001 to 35% in 2010.

Faced with such hurdles, it is no surprise that the number of first-time buyers under 30 turning to parents or other relatives for financial support has doubled in five years, from 38% in 2005 to 84% in 2010. The average age of those buying a home for the first time without financial backing from relatives has risen from 33 to 37 in the past two years.

Again, however, the full picture is not as bleak as the statistics above might paint it. The average age at which all people buy their first home has remained around 31, suggesting that parents or other family members are, where they can, transferring some of the rewards they have reaped from the rise in house prices back towards the

³ ONS Wealth and Assets Survey, 2006–08

generation most adversely affected.

There is also a widespread, deeply held but fundamentally misplaced conviction that owning your own home is a critical, even the most important, part of your retirement saving. But the financial crisis was caused by the collapse of a housing bubble; property is at least as volatile as the stock market, and relying on your home for your retirement income is not, and never was, a sustainable strategy.

How will young people cope?

My optimism about the long-term sustainability of defined-contribution pension schemes does of course depend on young people being able and willing to make sufficient contributions. There is unfortunately plenty of evidence to suggest that the opposite is true.

Perhaps the biggest obstacle to bridging the pensions divide for young people is their low saving rate and the difficulty they have in seeing saving for their retirement as at all relevant to their daily life. Currently young people are only half as likely (30%) to be saving into a pension than those over 25 years old (62%).⁴ A Department for Work & Pensions report in 2007 explored in some depth young people's attitude to savings and pensions.⁵ Unsurprisingly, it found that those aged 16-29 had a "living for now" attitude that translated into an unwillingness to defer enjoyment today for any benefit that might be had many decades in the future. Young people were found not to be proactive about their financial planning, nor did they see saving as important.

As with other age cohorts, the biggest obstacle to pension and other saving was people's view that they could not afford to do it.⁶ Although this view was consistently held, no matter what the young person's income, it is understandable given the financial characteristics of so many young people. Some 24% of them, by far the highest for any age cohort, have fallen into arrears on a bill. And 50% of young people run out of money by the end of the week or the month, as opposed to only 30% of the population as a whole. Combined with their high level of debt, it is no surprise that many feel they cannot afford to save.

And yet, once again, the situation is not as hopeless as it might seem. The same government report showed that despite their view that saving was not a priority for

4 ONS General Lifestyle Survey, 2009, table 6.1

5 DWP *Live Now, Save Later? Young People, Saving and Pensions*, research report no 438 (2007)

6 The ABI Quarterly Consumer Survey for Q3 2010 showed that all respondents viewed the biggest reason not to save more in a pension was "can't afford to". The ONS Wealth and Assets Survey for 2006-08 showed that 65% felt the same.

them at that time, it was something young people intended to do as they grew older, earned more and started a family. The older participants in the survey bore this out, being more likely than their younger counterparts to have started financial planning for the future.

There is also plenty of evidence that even if young people don't see the need to start pension saving in particular, viewing planning for retirement and old age as very low on their list of priorities, they do have the capacity to save in other ways. A 2005 HMRC report showed that despite the considerable demands on their limited income stream, over 40% of young people aged 18-24 had a savings account in addition to their current account, and 21% had an ISA.⁷

The 2006 Department for Work & Pensions report also showed that young people appreciated many of the benefits of pension saving, being aware, for example, of how any employer contributions to a pension were essentially "free money". They were also enthusiastic about auto-enrolment, seeing it as a useful way of overcoming their apathy while retaining personal control over their money. Similarly, salary deductions were agreed to be the most painless way of accepting a decrease in income.

What more can be done?

I have argued so far that while the present is undoubtedly painful for so many people approaching retirement, the future need not be the same way for young people. However, there is much more to be done before we can feel confident that they will be able to take advantage of the opportunities in front of them.

The most obvious, and the most immediately concerning, is the need for a young person to have a job before being auto-enrolled into pension saving. The recent financial crisis and subsequent recession has increased youth unemployment more than unemployment among any other age group. Youth unemployment rose above 20% at the beginning of this year, with 951,000 adults under 25 being out of work. If this unemployment crisis continues, we are in danger of excluding the very people who should benefit most from this once-in-a-generation chance of changing the nation's saving habits and making pension saving the norm. Young people will need to be able to find stable, well-paying full-time jobs before they can take the opportunity to save into a good-quality pension scheme.

Another concern is whether young people in particular are capable of making the right

⁷ HMRC *Individual Attitudes to ISAs*, working paper 38 (2007)

financial decisions in this new world of increased responsibility. Applying nudge theories of behaviour can only go so far. Although auto-enrolment will do a great deal to introduce people to the benefits of pension saving, young people will still need to make important decisions about increasing their contributions, changing their investment fund and making complementary short-term savings plans. Unfortunately, the recent ONS survey showed that only 19% of young people understood how pensions worked, compared with 40% of the rest of the population. Their financial capability is the least of any age cohort.⁸

The Money Advice Service's research in November 2010 clearly demonstrates that increasing a person's financial capability makes them more likely to start saving, more likely to continue saving, and more likely to save more.⁹ The difference that financial capability can make to a person's saving habits is compared to giving an unemployed person a full-time job. We need to do much more to educate young people in school, and beyond, to help them understand the decisions they need to make about when, how and how much to save. This is, of course, not just about pensions, but about budgeting, debt management and the confidence to seek out and buy the right financial products for you.

It is clear that there are challenges to be overcome, both those that have resulted from the recent financial crisis and recession, and longer-term trends and characteristics. The challenges faced by young people are, in many cases, unique to their age cohort. No other group of people faces such an uncertain retirement income and untested pensions system, with the potential for either complete success or utter failure.

We cannot let older generations' disappointment and disillusionment with their pensions distort the opportunities open to young people. Pensions remain the best way to save for your retirement. Tax relief and employer contributions combine to multiply any amount you put in, and the restrictions on early withdrawal counter any temptation to dip into your pot for short-term goals. If we can help young people appreciate the value of pension saving, and ensure that employers and the government contribute sufficiently, we have an opportunity to kick-start a genuine savings culture.

Young people are ready and willing to listen to trusted advice and information about savings and pensions – 68% of those aged 18-24 asked someone for financial advice in 2010, as opposed to 62% of people over 25.¹⁰ It is clear, though, that helping them

8 Financial Services Authority *Establishing a Financial Capability in the UK* (2006)

9 Consumer Financial Education Body *Financial Capability and Saving: Evidence from the British Household Panel Survey* (2010)

10 ABI Quarterly Consumer Survey, Q1 2011

through traditional channels such as independent financial advisers or even impartial help-lines will not be sufficient. Some 55% of young people indicate that they trust their friends and family for advice above all other sources. To be effective, we need to help bring about a cultural change.

This may not be as hard as we expect it to be. ABI statistics show that young people in general are, if not more optimistic than older generations about their retirement prospects, certainly not as pessimistic.¹¹ If we continue to spread messages of doom and gloom about pensions, we will perpetuate the vicious cycle of low savings rates leading to poor outcomes leading to lower savings rates down the generations. If, instead, we focus on positive messages of support and encouragement, we have the opportunity to help young people learn how to operate confidently in the new world in which they are living.

¹¹ ABI Quarterly Consumer Survey, Q1 2011 – 33% of young people thought the benefits of pension saving had gone down from a year ago, as opposed to 56% of the rest, and 21% thought it had gone up.

Chapter 9

Reaching retirement

Sally West, Strategy Adviser on Income and Poverty at Age UK, and
Jane Vass, Programme Manager for Private Sector Policy at Age UK

Reaching retirement

The financial resources that people have in retirement depend on a wide range of factors throughout their life, including their personal circumstances, the opportunities they have had to work and save, and the choices they have made. Some people are fortunate enough to reach retirement with good pensions and savings and have the money to really enjoy later life. For others it is more a matter of survival – while poverty rates have fallen from a peak of 39% in 1989, there are still 1.8 million pensioners (16%) who live in poverty.

Looking forward, Age UK believes that the broad direction of pensions reform is positive. Indeed, recent research by the Pensions Policy Institute commissioned by Age UK projects that pensioner poverty rates will gradually decrease under current policies, so that by 2025 the proportion in poverty will have fallen to 11%. If the single-tier state pension is introduced as proposed, this would fall further to 10% – and to 7% if the single-tier pension is also introduced for current pensioners from 2016.¹ However, as well as a good state pension, people need opportunities to work and save. The impact of the government's Work Programme and welfare reforms will be important, as will the wider economic policy environment. For example, unemployment, property prices and levels of debt could all affect the ability of younger people to save for their retirement.

In looking to the future we must not forget the needs of those already in retirement, who have little opportunity to improve their current position. And for those approaching retirement now, there are a range of challenges. A third of people aged 55 to 64 have no private pension wealth;² those who do may have savings in a mixture of defined-benefit and defined-contribution schemes. Although the baby boomers are often described as a lucky generation, their savings are unevenly distributed. The top 10% of people aged 55-64 each have more than £1.3 million in total wealth (including property, private pensions and possessions) whereas the poorest 10% have less than £28,000.³ For many, pension savings are low. Including defined-benefit pensions, the median saving in a private pension at age 56 is only £52,800 for men and £9,100 for women.⁴ This generation is also one with rising debt: while credit use still falls with age, those in the 55-64 age group have experienced the fastest growth in the amount of outstanding credit.⁵

1 Pensions Policy Institute *The Implications of Government Policy for Future Levels of Pensioner Poverty* (2011)

2 ONS *Wealth in Great Britain* (2009)

3 National Equality Panel *An Anatomy of Economic Inequality in the UK* (2010)

4 *Hansard*, 4 February 2011, written answer

5 Help the Aged *Debt and Older People* (2008)

Individuals will face some difficult decisions, and ironically these decisions are often most difficult for people on the lowest incomes, particularly those with defined-contribution pensions. Can you cash in a small pension? If you cannot, how can you get a decent annuity? If you are one of the half of men or third of women who leave the workforce before state pension age – either voluntarily or for reasons such as ill health, unemployment or caring responsibilities – how can you bridge the gap between working and a state pension age that appears to be receding into the distance?

Groups at risk

Some groups are at greater risk of poverty and low income. Higher private pension provision is associated with higher earnings and more years in paid work, so those at a disadvantage in the labour market or who are unable to work due to caring responsibilities or ill health have more limited opportunities to save. As a consequence, women tend to have lower provision than men, and disabled people and those from ethnic-minority groups are more likely to be "under-pensioned".⁶

The likelihood of paying into a pension also depends on industry and occupation. For example, over three-quarters (77%) of those in professional occupations have private pensions, compared with just under a fifth (19%) of those in sales and customer service occupations. While this partly reflects higher earnings by professionals, there are substantial differences at all earnings levels.⁷

So while it is important to look at ways of encouraging people to make better provision, there are wider issues about ensuring opportunities for those groups at a disadvantage in terms of saving.

The role of the state in provision for retirement

The state has a clear responsibility to provide a safety net for those who have little or no resources in retirement, and there will always be a role for a system of means-tested benefits. Indeed, falls in poverty during the 1990s can be at least partly ascribed to the more generous means-tested support through benefits such as pension credit. However, there is widespread concern about the levels of means-testing within the current system. The procedures are complicated, and many older people do not claim their entitlements. There is also concern that high reliance on means-testing reduces incentives to save.

The 2007 Pensions Act reforms started the process of improving state pension provision.

⁶ See, for example: Pensions Policy Institute *The Under-pensioned – Disabled People and People from Ethnic Minorities* (2008)

⁷ <http://www.statistics.gov.uk/statbase/Product.asp?vlnk=14058>

Age UK (and, before that, its predecessor organisations, Age Concern and Help the Aged) has long campaigned for better provision for women and carers, so we have been very supportive of the changes that came into force in 2010. These have improved coverage, but the reforms will take many years to complete and in the meantime we continue to have a state pension which for many is very low, extremely complicated and too reliant on means-tested top-ups such as pension credit.

We were delighted that one of the Coalition government's early decisions was to uprate the basic state pension by the triple lock so that it will rise by the highest of three factors: prices (as measured by the Consumer Prices Index), earnings or 2.5%. This will ensure the basic state pension maintains or increases its value in relation to earnings and general living standards.

We have also welcomed the government's green paper on state pension reform, which includes proposals for replacing the basic and additional state pensions with a single-tier pension paid at a level of around £140 a week (at March 2011 prices). This would be paid to all who reach state pension age with 30 years' paid or credited contributions after the changes have been introduced – which could be around 2016. We support this approach, although there are considerable challenges ahead. Reform will need to be fair, and seen to be fair, including by those who are already pensioners, who under the current proposals would not benefit. And good communications will be essential. While a flat-rate pension, once fully introduced, would be much simpler to understand, there would still be a considerable transition period during which many people would have part of the £140 paid through a private pension.

The state also has a role in facilitating and enabling private saving, and major reforms to private provision are on the way. Changes, which will start to be phased in from 2012, will mean that most employees will be automatically enrolled into either their employers' workplace pension or the new National Employment Savings Trust (NEST). Age UK is very supportive of this approach, which should get more people building up private provision. However, it will be important to monitor the levels of saving in particular industries and occupations, as auto-enrolment will only apply to people with incomes above a threshold (currently £7,475) and employers will be able to apply a waiting period, which could disadvantage people in short-term work. In addition, less attention has been paid to how people turn their pension savings into an income in retirement.

Drawing a private pension

The move from defined-benefit to defined-contribution schemes has shifted a good deal of risk on to individual pension savers. For people approaching retirement, the need to

turn a pension fund into an income presents new risks, as buying an annuity is a once-and-for-all decision. It is vital that small pension savers can get the best value from their pensions: choosing a good-value annuity can boost pension income by 20%, or even more if you qualify for an "enhanced" or "impaired" annuity because of reduced life expectancy. Small annuities tend to get worse rates than large ones, and the type of annuity chosen is also important. Most people buy single-life annuities, even if they are married – not necessarily the wrong decision, but people accustomed to defined-benefit pensions may not be aware of the impact on a surviving partner.

Many of the people retiring in the next 10-20 years will have a mixture of small pensions, of various types and quality. It is disappointing that while the requirement to annuitise at age 75 has been liberalised – a reform that will currently benefit less than 5% of savers – we are still waiting for reform of the "small pots" issues that are likely to affect many more. According to research by the Pensions Policy Institute, 45% of annuities bought between 2001 and 2009 were for less than £10,000.⁸

The issue is urgent because, unless every employer uses NEST, auto-enrolment will increase the incidence of small pensions as employees move from employer to employer. In Australia, an estimated 5.8 million "super" accounts, or one in five, are lost – an average of one lost account for every two working Australians.⁹ In the UK, the lack of any transfer market for defined-contribution pensions reduces competition. Action is also urgently needed to allow people to consolidate small pensions, to reduce the risk of "lost" pensions, reduce costs and increase competition.

It should be possible to take small savings in cash without excessive taxation. Although it is possible to "trivially commute" total pension savings under £18,000 in total, the tax treatment of these payments is regressive – for example, because the tax-free amount is 25% for all. So those with a £1.5 million fund can draw a tax-free amount of £375,000, while those with £18,000 are taxed on everything over £4,500, possibly pushing them into a higher tax bracket for the year in question.

Age UK has been pressing the government to take action to improve the value that small savers get from their pension, by fairer tax treatment of pensions drawn as cash, and by making it easier to shop around for an annuity – the so-called "open market option". It should be made easier to consolidate small pensions, and the current ban on transfers to NEST should be removed so that it can act as a consolidation vehicle.

⁸ Pensions Policy Institute *Retirement Income and Assets: The Implications of Ending the Effective Requirement to Annuitise by Age 75* (2011)

⁹ <http://www.thegovmonitor.com/economy/australia-makes-it-easy-to-find-lost-superannuation-accounts-45941.html>

Working longer

Increasingly, retirement is not a predetermined event that happens when we reach a specific age. Some people leave work early – either by choice because they can afford to retire, or because they are forced to – for example, due to health problems, unemployment or the need to provide care. Overall, however, the age that people leave the workforce has been increasing, and more people are now working after state pension age, either because they find work enjoyable and fulfilling or because they cannot afford to stop earning.

As average life expectancy increases, it is important that people continue to work and save for longer where they are able. We very much welcome the abolition of the default retirement age, which should help reduce barriers to later working after the age of 65. However, there are other barriers to working longer, particularly in some sectors, such as those with high proportions of manual workers. These barriers include the following:

- *Age discrimination*
Age UK has recently published research showing that younger people (aged around 30) are regarded as more acceptable as a boss than a 70-year-old.¹⁰
- *Health inequalities*
Professor Sir Michael Marmot estimated that, by the age of 68, three-quarters of the workforce either have a disability or are restricted in what they can do due to health impairments.¹¹ Occupational health and well-being policies must be resourced to provide sufficient levels of support for people and employers.
- *Problems facing older job-seekers*
Long-term unemployment is a particular problem among older workers, with 44% of all those unemployed who are aged over 50 having been out of work for over 12 months.¹² Older workers who lose their jobs need appropriate help.

We are pleased that the government is consulting on extending the right to request flexible working to all workers, and believe that flexible working will play an increasingly important role in extending working lives and creating the opportunity for increased savings. However, in conjunction with these developments, employers will also need to review their managerial and organisational practices and provide opportunities to re-

¹⁰ Age UK *A Snapshot of Ageism in the UK and across Europe* (2011)

¹¹ Marmot, M *Fair Society, Healthy Lives* (2010)

¹² ONS Labour Market Statistics, June 2011

skill, which are often denied to older employees. This must be underpinned by raising awareness among employers of demographic changes and how to get the most from their older workers.

Maintaining confidence

If people are to be persuaded to put money aside for their retirement, they need to feel confident that forgoing current income will be worthwhile. One area of concern is that while building up a pension is a long-term process, governments come and go, and new administrations could make policy changes that might reduce the value of savings. Age UK has been campaigning against changes in the 2011 Pensions Bill to speed up equalisation of state pension age, not because we disagree with treating men and women equally, but because changes are being introduced which do not give people sufficient time to plan. Consequently, some women face waiting up to two years longer for their state pension with only a few years' notice – and, understandably, feel the goalposts have been moved.

Following the work of the independent Pensions Commission (2003-06) chaired by Lord Turner, there was a general consensus around pensions reform. There has of course been on-going debate on the detail and aspects of policy, but broad agreement on the direction of travel has continued under the Coalition government.

The Pensions Commission was very conscious of the need to maintain a long-term consensus, and recommended that a permanent Pensions Advisory Commission be created with the role of assessing developments and presenting a report to parliament every few years setting out key trends and "the unavoidable trade-offs which result".¹³ Age UK sees value in this approach. Ultimately, decisions about pension provision need to be taken by parliament, but we believe there is a greater chance of maintaining long-term goals if decisions are based on agreed evidence and analysis carried out by an independent body.

Confidence and encouragement to save may also be increased by improving incentives. Even after the £4 billion saving from the latest restrictions to pensions tax relief, the UK will still be spending around £15 billion on tax relief, the majority of which goes to higher-rate taxpayers – in 2008/09 they represented 19% of pension savers, but received 65% of the tax relief.¹⁴ Age UK believes that the system of tax relief should be reformed to provide better and fairer incentives to those on low and modest incomes.

¹³ *A New Pension Settlement for the 21st Century – the Second Report of the Pensions Commission* (2005), pp406-407

¹⁴ HM Treasury *Implementing the Restriction of Higher-rate Tax Relief* (2009)

Overall, we are in the process of major reforms to state and private pension provision, and Age UK is supportive of the direction of travel. But there is still more that needs to be done, particularly to ensure that lower-income and disadvantaged groups can build up retirement resources and then convert these into an income that ensures retirement is a time of opportunity rather than one when horizons are narrowed due to financial restrictions.

The Smith Institute

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If you would like to know more about the Smith Institute please write to:

The Smith Institute
Somerset House
South Wing
Strand
London
WC2R 1LA

Telephone +44 (0)20 7845 5845

Fax +44 (0)20 7845 5846

Email info@smith-institute.org.uk

Website www.smith-institute.org.uk