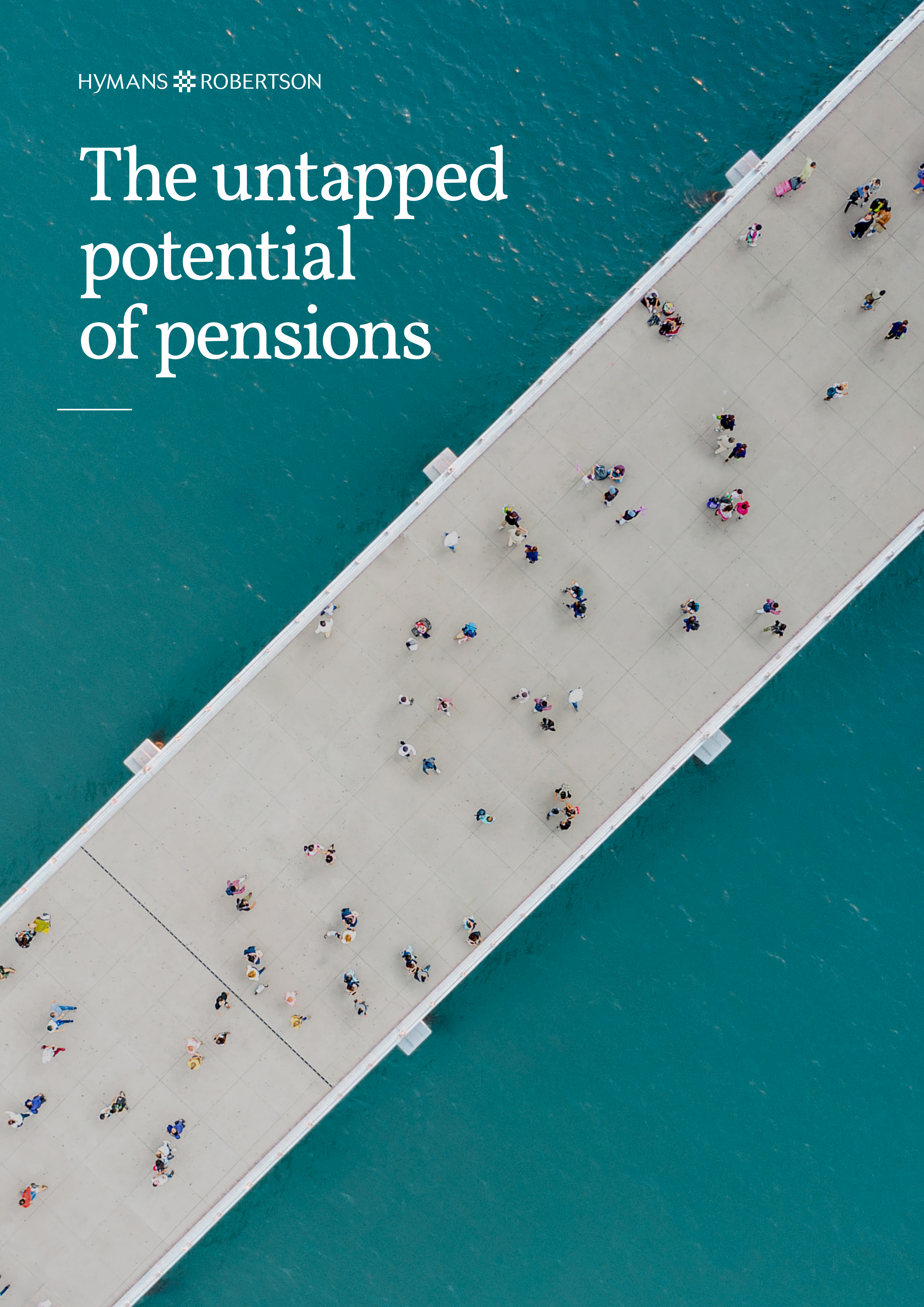
HYMANS ROBERTSON

The untapped potential of pensions



Policy team

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The untapped potential of pensions

The government is committed to change in pensions. We're encouraged by how quickly the pensions and retirement review, and new pensions bill, have moved ahead. The promised second phase presents an opportunity to make lasting changes to pensions, so they can give people financial independence in later life for as long as they live.

But it's also an opportunity to meet other important aims, which might seem unrelated at first glance. These include improving equity, unlocking billions of pounds and investing in economic growth at a huge scale.

People expect the government to set adequate default rates for pension saving. Auto-enrolment has been successful in getting people saving into pensions, but the current default rates aren't enough to give people adequate retirements.

The industry knows this, but most savers don't. They will when Pensions Dashboards launch, laying bare the retirement income inadequacy before this parliamentary term ends. The government needs a plan to get people on the path to adequate retirements.

This sounds like a plan that's expensive for the Treasury, employers and savers – and times are tight. But what if there were a way to get there while **making** money?

Our package of proposals would make money for the Treasury, save money for employers and enhance people's financial wellbeing. It would also stimulate investment in the UK, bringing us the £100bn a year that we need for 3% economic growth.

A big change requires lots of work, and this would be a big job for the pensions industry to implement. But the opportunity is also huge – to help current and future generations of workers, and the economy.

What we could achieve

In addition to more adequate pensions for all workers…

The Treasury would get

£28.5bn a year

£22bn
from
tax changes

£3bn
from
DB surpluses

£0.5bn
from collective
pension saving
auto-enrolment
changes

£3bn
from reforms to
the state pension

To invest in

£26.5bn
national wealth
fund

£1bn
pension for
self-employed
workers

£1bn
auto-enrolment
increases

Employers would get

£14.2bn a year

£1.2bn
from offering collective pension schemes

£13bn
from DB pension surpluses

Employees would get

50%+ more

Pension income

Deposit-free
mortgages for
first property
purchases

Financial resilience
through a dedicated
savings vehicle

Industry ideas to match the government's ambitions

Last year, we published a pensions plan for the new government. As the Labour government has shown its ongoing ambitions for pensions, we've developed our ideas to help it meet those ambitions. We see pensions as a force for good, with tremendous untapped potential for people today, the economy and future generations.

We've developed some of our ideas into detailed, costed proposals, in the context of a holistic view of retirement saving. Many of our ideas have broad industry agreement, and we expect them to ease the pressure on working people, deliver growth and massively alleviate fiscal pressures in the near term. In the long term they provide people with better pensions, for life.

Our package of proposals comes in two parts.

The first part covers proposals to save money; the second, proposals for where to invest it.

Cost is a barrier to increasing pension contributions, both for the contributors themselves (workers and their employers) and the Treasury (in the form of increased tax relief). We therefore propose four areas for saving money, which, once in effect, would unlock £28.5bn a year.

- Tax changes on pensions
- Collective pension saving
- Using pensions surplus for UK investment
- Sustainable state pensions

We then propose directing these saving to the Treasury to three areas.

- Investment where it's needed
- Enhancing auto-enrolment
- Including self-employed workers in pensions

Tax changes on pensions

Changing the way pensions are taxed can give the government **£22bn extra to invest in UK growth every year**, now rather than decades in the future.

We propose changing the tax arrangements on pensions in a way that's cost-neutral for employers, workers, pensioners and the government, but gets the money to the Treasury sooner and makes future pensions savings a much smaller drain of Treasury finances.

Currently, the government provides tax relief on pension contributions as an incentive to save. It gives this relief upfront and gets most of it back as people retire, as most workplace pension income is taxed when it's paid to the pensioner.

We propose no upfront tax relief on pension contributions. Instead, the government would pay a simple and transparent 'top-up' bonus into a saver's pension. Any pension income in retirement would then be fully tax-free.

Changing when pension income is taxed wouldn't disincentivise people from saving for retirement. Evidence shows that participation in pensions is driven by auto-enrolment rather than by the tax system.

Implementation would take years alongside operational innovation, but investment in anticipation of the extra cash flow could begin during this parliamentary term.

Collective pension saving

We'd love collective defined contribution (CDC) pensions to be accessible to more savers and employers. A CDC scheme pools risk between a group of members to give higher expected pensions than for an individual saver, for the same contribution.

CDC pension schemes are new to the UK, but a growing CDC market is a route to retirement adequacy and better outcomes for working people. CDC balances the interests of current and future pensioners, the government and employers. It also provides patient capital to invest in critical infrastructure for the long term.

To incentivise investment into CDC scheme development, we propose introducing a 'lifetime CDC' scheme, potentially leveraging some of the Pension Protection Fund's (PPF's) £13bn surplus, and its infrastructure and expertise.

To incentivise employers to pick CDC for their workers, we suggest a distinction between pure DC auto-enrolment contributions and CDC auto-enrolment contributions. With 20% take up, **a minimum CDC contribution rate of 1 percentage point less than for DC could save employers £1.2bn a year** and **save the Treasury £500m a year**.

CDC may deliver a **retirement income between 20% and 50% more than individual DC** with drawdown in retirement, for the same contribution. A successful CDC market has the potential to save money for employers, employees and the Treasury, while delivering higher overall expected pensions.

Using pensions surplus for UK investment

Connecting a vast store of surplus capital and wealth with the economy would stimulate growth and improve retirements for many people.

UK defined benefit (DB) pension schemes hold an estimated **£160bn** in surplus capital. Compared with our current trajectory, a shift towards growth-oriented assets over the next decade could unlock **more than £150bn** in growth assets and generate a **further £100bn in surpluses**, bringing total additional growth investment to over **£400bn**.

Legislation and pension scheme rules often mean that this surplus capital can't be distributed. But if the government lifted the restrictions and introduced incentives, we could mobilise hundreds of billions of pounds for the UK economy.

If half of the £260bn surplus is distributed to employers and taxed at 25%, it could raise **£3bn a year for the Treasury for the next decade**, enhance UK investment and improve DC pensions, with material amounts going back to employers.

A further step could be to increase DB schemes' risk appetite by using part of the PPF's £13bn surplus to provide a greater safety net.

A sustainable state pension

The government needs to make the state pension sustainable for generations into the future. The state pension is so important to many people – to have good retirements, they need confidence in it.

The government's 'triple lock' commitment to increase the state pension by the highest of earnings growth, inflation or 2.5% is more generous than in many countries, but it's unsustainable.

The state pension doesn't need to grow as fast as it does now once it's caught up with a minimum retirement income level – such as the Pensions and Lifetime Savings Association's (PLSA's) minimum retirement living standard (£14,400 a year for a single person).

By moving away from the triple lock in time, the government could **save £3bn a year from the late 2030s**, while still providing a pension above the minimum retirement living standard.

Investment where it's needed

The money saved should be used to boost the economy by investing in UK productive finance and growth assets. Pensions could play a much bigger role in the government's investment ambitions than currently envisaged.

Our proposals for tax changes would make £22bn a year available to the Treasury over 10 years. With a national wealth fund targeting £3 of private investment for every £1 of public money, we could make **more than £1trn available for investment in the UK**, for the benefit of current and future generations. The private capital could be raised from private-sector DB pension schemes, DC schemes, LGPS funds and other institutional or private investors.

For productive finance to work, we need clear plans and attractive opportunities. The government should identify where investment is most needed and make it attractive. Practical and tangible targets and goals will be vital to engaging and attracting investors.

Enhancing auto-enrolment

Many people are enrolled automatically on workplace pensions, but the amounts are not enough to give them adequate retirements. And many people aren't eligible for auto-enrolment.

We propose phasing in an **increase to the auto-enrolment minimum contribution** from 8% to 12%. We also propose **extending auto-enrolment to all workers**, not just those earning over £10,000 in a job.

Once the auto-enrolment minimum reaches 12%, the cost to the Treasury would be £1bn a year if our tax proposals are implemented (allowing for NI costs), or £2bn a year under the current tax system.

Alongside these changes, we propose **introducing a savings vehicle** to give flexibility and financial resilience. This 'side car' concept has been trialled by Nest Insight. Employee contributions would be directed to the 'side car' until it reaches at least £1,000; from then on, they'd go into the pension.

We propose **allowing pension saving to be used as collateral for mortgages for first-time buyers** only. This arrangement would let people get on the housing ladder without a deposit, and benefit from lower interest rates as lenders take on less risk of negative equity. Crucially, the money in the pension is still invested.

Increasing auto-enrolment contributions and extending auto-enrolment to all workers can help achieve retirement adequacy and narrow the pensions gender gap. Removing the £10,000 earnings threshold would make an additional 1.2m women and 328,000 men eligible.

Including self-employed workers in pensions

We would set a default pension provider for self-employed workers, and extend auto-enrolment and the 'side car' savings vehicle to them.

Only 18% of self-employed workers save for retirement, compared with nearly 90% of the employed population eligible for auto-enrolment. Any plan to fix retirement adequacy needs to include self-employed workers. Our proposals would be a first step to getting more of the self-employed workforce to save into pensions – we can improve pensions for **3.4m** workers in this way.

We propose treating self-employed workers the same as company employees, regardless of how much they earn. The first phase would be to introduce an increase in NI contributions for the self-employed, bringing them in line with those for the employed, and pay the extra money HMRC makes into the workers' pensions.

After the rate is equal to that of employed workers, we suggest phasing more rises, funded by the government, to equal the 1% contribution made by the government for the employed.

The second phase would make pension saving the default. The government could consider starting auto-enrolment for self-employed workers through the self-assessment tax return. The 'side car' would solve the problem of illiquid savings.

A better future for all

We hope our proposals stimulate discussion and help the government, policymakers and the industry to think big. Our plan is bold, costed and imperfect. We expect it will evolve, and we look forward to engaging the industry in delivering a better pensions future for all.

Tax changes on pensions

Calum Cooper
Head of Pensions Policy Innovation

Emma Foster
DB Actuarial Consulting

Our proposal:
Change the way pensions are taxed so the government gets money to invest in the UK and higher pensions saving now, rather than decades in the future.

	Sustainable growth	Treasury	Employers	Low to middle earner	High earner
How it affects stakeholders	^	Gets £22bn	—	—	—

One of the biggest barriers to change in pensions policy is cash flow to the Treasury. We propose changing the tax arrangements on pensions in a way that's cost-neutral for employers, workers, pensioners and the government, but gets the money to the Treasury sooner. This can fuel UK investment, economic growth and higher pensions savings.

Changing when pension income is taxed wouldn't disincentivise people from saving for retirement. Evidence shows that participation in pensions is driven by auto-enrolment rather than by the tax system. We have pension enrolment by default – workers can opt out rather than having to opt in – and participation is high for low, medium and high earners.

How it would work

Currently, the government provides tax relief on pension contributions as an incentive to save. It gives this relief upfront and gets most of it back as people retire, as most workplace pension income is taxed when it's paid to the pensioner.

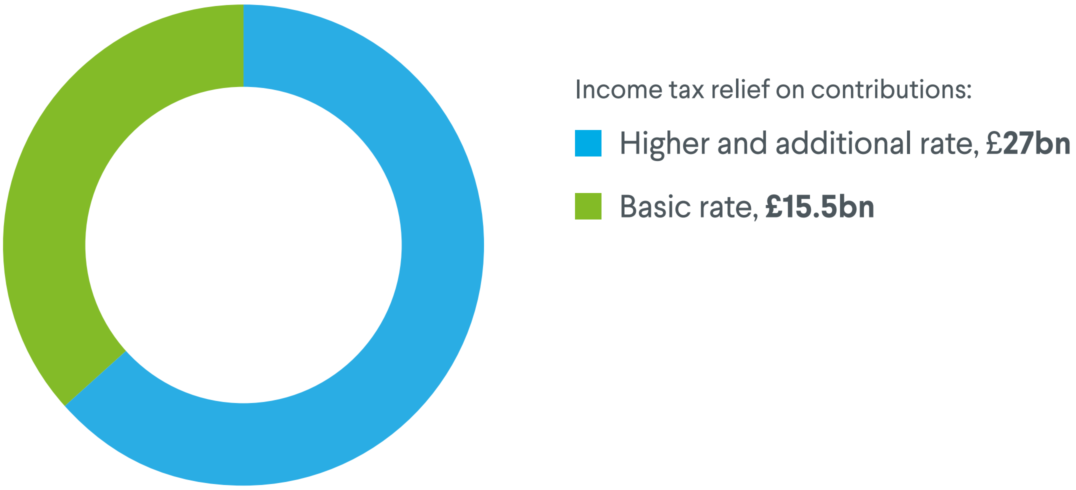
We propose no upfront tax relief on pension contributions. Instead, the government would pay a simple and transparent 'top-up' bonus into a saver's pension. Any pension income in retirement would then be fully tax-free.

This approach ensures that a saver's take-home pay while working and their total income in retirement remain unchanged, regardless of their earnings. It also maintains the government's overall lifetime tax revenue.

The difference lies in the timing of when the tax is collected. Instead of providing tax relief that it would get back later, the government keeps hold of the money for now, improving its cash flow.

The government currently spends **£42.5bn** on income tax relief for pension contributions (**£27bn** to higher- and additional-rate taxpayers, and **£15.5bn** to basic-rate taxpayers).

Tax relief on pension contributions



By changing **when** tax relief is given, we estimate the government could bring forward **£22bn** in tax revenue each year (**£12bn** from basic-rate taxpayers and **£10bn** from higher- and additional-rate taxpayers).

There are several ways to implement this change to the tax system. Our examples show one way it could be done.

How it could work for a basic-rate taxpayer

Sam earns £20,000 a year and has 15 years until retirement.
Sam contributes 5% of gross salary into his pension.

Under the current system
Sam receives tax relief immediately when contributing to his pension. At retirement, he can take 25% of his savings tax-free, and pays tax on the remaining amount.

Sam contributes **£1,000** of gross salary to his pension. He is a basic-rate taxpayer, so 20% (**£200**) of this contribution is income tax relief – what the government would otherwise get in tax.

Over the 15 years until retirement, Sam's pension savings grow at around 5% a year (the rate is illustrative and doesn't change the result). His £1,000 contribution reaches **£2,000** by retirement. Sam takes 25% of his pension (**£500**) as tax-free cash, and pays 20% tax (£300) on the remaining **£1,500** when it is withdrawn.

After tax, Sam's total retirement amount is: **£500** (tax-free cash) + **£1,200** (remaining pension after tax) = **£1,700**.

Under our proposal
Sam's pension contributions are taxed as income when he pays into his pension.

Sam, in effect, contributes **£1,000** of gross salary to his pension. This is taxed at 20%, leaving **£800** to go into his pension. The government pays in a top-up of **£50**, giving Sam **£850** in his pension.

Over the 15 years until retirement, Sam's pension savings grow at around 5% a year, so his £850 contribution reaches **£1,700** by retirement. All of this is tax-free, as he already paid tax when he paid in.

After tax, Sam's total retirement amount is **£1,700**.

In both scenarios, Sam pays £1,000 of his gross salary and gets to £1,700 (after tax) in retirement. There's no difference to his take-home pay or his take-home pension between the scenarios.

Savers would still, in effect, receive 25% of the upfront tax relief they get under the current system. The balance (75%) of what's currently given as tax relief would be collected immediately, bringing forward £12bn in revenue (75% of £15.5bn, the current tax relief for basic-rate taxpayers).

How it could work for a higher-rate taxpayer

Helen earns £70,000 a year and has 15 years until retirement.
Helen contributes 10% of gross salary into her pension.

Under the current system
Helen contributes **£7,000** of gross salary to her pension. She is a higher-rate taxpayer, so 40% **(£2,800)** of this contribution is income tax relief.

Over the 15 years until retirement, Helen's pension savings also grow at around 5% a year, so her **7,000** contribution reaches **£14,000** by retirement. Helen takes 25% of her pension (**£3,500**) as tax-free cash and pays 20% tax on the remaining **£10,500** – so she pays **£2,100** in tax over the course of retirement. This leaves her with **£8,400** in her pension pot.

After tax, Helen's total retirement amount is: **3,500** (tax-free cash) + **£8,400** (remaining pension after tax) = **£11,900**.

Under our proposal
Helen contributes **£7,000** of gross salary to her pension. This is taxed at 40%, leaving **£4,200** to go into her pension. The government pays in a further £1,750, giving Helen **£5,950** in her pension.

Over the 15 years until retirement, Helen's pension savings grow at around 5% a year, so her **£5,950** contribution reaches **£11,900** by retirement. All of this is tax-free, as she already paid tax when she paid in.

After tax, Helen's total retirement amount is **£11,900.**

In both scenarios, Helen pays £7,000 of her gross salary and gets to £11,900 (after tax) at retirement. There's no difference to her take-home pay or her take-home pension between the scenarios.

Taking it further

Our proposal changes the timing of the tax collected but not the amount. The government currently spends an estimated **£27bn** on income tax relief for higher- and additional-rate taxpayers. Paying only a 'basic-rate top-up', regardless of earnings, would result in the government saving a further **£13bn** a year. However, it would reduce the retirement savings of a high earner like Helen, so this move is likely to be politically contentious.

Let's take a look at Helen again. Here's what happens if Helen receives the same top-up as a basic-rate taxpayer (£50 per £1,000 contribution).

Helen earns £70,000 a year and has 15 years until retirement.
Helen contributes 10% of gross salary into her pension.

Helen contributes **£7,000** of gross salary into her pension. This is taxed at 40%, leaving **£4,200** to go into her pension. The government pays in a further **£350**, giving Helen **£4,550** in her pension

Over the 15 years until retirement, Helen's pension savings grow at around 5% a year, so her £4,550 contribution reaches **£9,100** by retirement. All of this is tax-free, as she already paid tax when she paid in.

After tax, Helen's total retirement amount is **£9,100**.

Under this scenario, Helen is around 25% worse off at retirement than under the recommended proposal.

Higher- and additional-rate taxpayers would, in effect, receive the same 5% government bonus as basic-rate taxpayers (per £1,000 contribution). Savers would still, in effect, receive 12.5% of upfront tax relief (5% ÷ 40%). The remaining 87.5% of tax relief would be collected immediately, bringing forward £23bn in revenue (87.5% of £27bn, the current tax relief for higher- and additional-rate taxpayers).

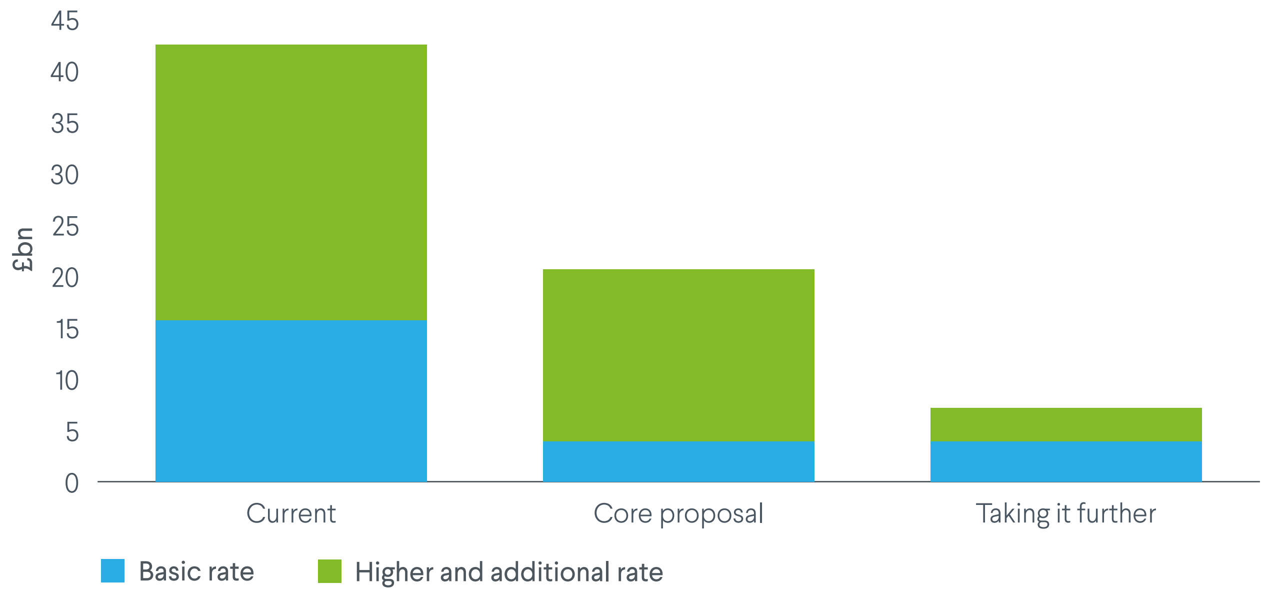
This total includes £10bn for the impact of moving to the basic-rate equivalent top-up. This leaves £13bn of additional tax relief that's saved for higher earners, if the government took it further and paid a consistent top-up to all savers.

What it would achieve

Our core proposal could make £22bn available to the government now, rather than decades in the future. It would reduce the cost to the Treasury of more pension saving – which we need if people are to have adequate income in retirement. It would keep expected pension income at retirement unchanged per pound of gross earnings saved, without any extra cost to employers.

Because future pensions would be tax-free, planning for retirement would be simpler and surer. And a government 'top-up' is more visible and straightforward than tax relief, giving people even more confidence in their retirement – and in the government.

Estimated annual government spend on incentivising pension savings



This would be a meaningful change, so getting the implementation right is crucial. Fully implementing tax reform could take more than five years. But the government could borrow against the revenue flow once secure, to start investing sooner.

We believe it's worth serious consideration. We could lower the government cost to retirement adequacy and get on our way to a £1trn national wealth fund. Importantly, it means the money is invested in the UK for the next generation.

Collective pension savings

Kathryn Fleming
Head of DC Consulting

Our proposal:
Make collective defined contribution (CDC) pension schemes accessible to more savers and employers, by having a lifetime provider and incentivising a broad range of CDC types and providers.

	Sustainable growth	Treasury	Employers	Low to middle earner	High earner
How it affects stakeholders	^	Gets £500m a year	Get £1.2bn a year	^	^

CDC pension schemes are new to the UK – so far, the only one with regulatory authorisation is the Royal Mail Collective Pension Plan.

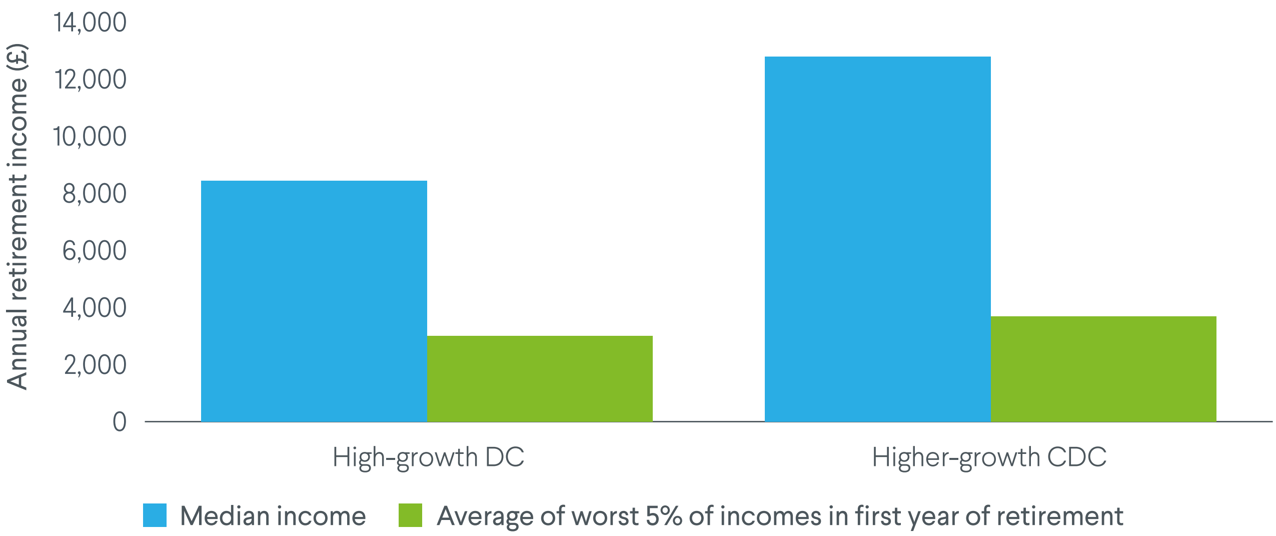
A CDC scheme pools risk between a group of members, to give higher expected pensions than for an individual DC saver for the same contribution. Both the employer and the employee pay contributions into a collective fund. The retirement income is not guaranteed and is treated as a target.

We see a growing CDC market as a route to better retirements for many working people. A CDC scheme provides savings and income in one place. It's an option for the many who are uncomfortable making complicated retirement decisions.

CDC offers a meaningful third way in UK pensions. It balances the interests of current and future pensioners, the government and employers. As an intergenerational investor, a CDC scheme invests capital in critical infrastructure for the long term. This investment is what we need for our ambitious climate-transition goals, including the decarbonisation of our energy network by 2030.

Our research found that two-fifths of employers with DC schemes are 'very likely' to introduce a CDC scheme or a risk-sharing alternative. CDC schemes are attractive because they offer protection against members exhausting their pension pot in retirement, and because they can give higher pensions from the same contribution amount.

Traditional defined contribution vs collective defined contribution pension income



Nonetheless, concerns remain. The companies we polled are especially worried about legislative changes that would increase employer risk, and pensioners' dissatisfaction with their retirement income.

For CDC to have maximum effect, it needs to be affordable for employers and accessible to the people likely to benefit the most: those paying minimum auto-enrolment contributions. Research from Nest Insight suggests that just over half of employers that only offer minimum auto-enrolment contributions do so because they can't afford to contribute more. Typically, these employers are in industries that face high cost pressures – such as manufacturing, transport, retail and care.

How it would work

Regulation should develop to stimulate a range of designs. A particularly important area is multi-employer schemes, as single-employer schemes will only be suitable for a handful of the largest employers. Moreover, competition barriers make it difficult or impossible for some sectors to set up a collective scheme without government help.

To encourage saving into CDC schemes, we need incentives that give certainty, accessibility and affordability.

The Pension Protection Fund (PPF) has a surplus of £13bn. It could use 3% of this surplus to introduce a 'lifetime CDC' scheme. This is based on following the blueprint used to establish Nest: seed funding with an aim of self-sustainability and a long-term payback period to pay off the initial seed cost. A lifetime scheme run by, for example, the PPF, would give savers financial security should another CDC scheme decide to wind up.

Auto-enrolment and getting more for less

To get the lifetime CDC scheme off the ground, it could be offered as an employer's auto-enrolment vehicle or as a single lifetime provider pension. Upon employment, an employee can choose their workplace pension provider (the default) or the lifetime fund. This approach offers certainty and accessibility to employers of all sizes, as well as self-employed workers.

Because CDC shares longevity risk and structurally anticipates higher investment returns than DC, it can give savers more pension for less contribution. We therefore suggest changing auto-enrolment regulations for CDC to take advantage of this feature. Certification of a CDC scheme should be at a rate of 1 percentage point less than the employer's contribution for a DC scheme, to kickstart the market.

There are two ways to do this: set a lower contribution rate now or raise default DC levels while letting CDC lag by 1 percentage point. In the second scenario, employers that might not easily afford the increased contributions could get protection from future rises by picking CDC now.

These changes would encourage some employers to pick a scheme that offers higher returns instead of paying more into a traditional DC scheme – perhaps because they can't afford to. Employers would be able to assess comparative designs on workers' retirement incomes instead of simply inputs.

What it would achieve

Our modelling shows that, keeping contributions equal, CDC may deliver a retirement income between 20–50% more than individual DC with drawdown in retirement.

(Based on a 20-year-old earning £15,000 and accepting a 25% chance of running out of money in retirement).

Around 22m people are saving into workplace pension schemes – about half in DC trust schemes.
For illustration, if 20% started saving into a CDC scheme instead, the Treasury would gain £500m a year as a result of the auto-enrolment contribution changes. Employers would get £1.2bn a year to invest in their businesses. Pension scheme members would get 15–40% more income in retirement.

Making CDC accessible and incentivised, and providing a PPF-led (for example) lifetime CDC arrangement, would give savers and employers financial security. A growing CDC market could also benefit sustainable UK growth. As intergenerational investors with high capacity for illiquidity, CDC schemes have more investment opportunities available to them than individual DC schemes. As schemes open to new members, they also have longer time horizons – which are crucial for the investment the UK needs in areas like the green economy.

Using pensions surplus for UK investment

Sachin Patel
Head of Corporate DB Endgame Strategy

Our proposal:
Connect a vast store of surplus capital and wealth with the economy to stimulate growth and improve retirement income.

	Sustainable growth	Treasury	Employers	Low to middle earner	High earner
How it affects stakeholders	↑	Gets £3bn a year	↑	↑	↑

UK DB pension schemes hold an estimated **£160bn** in surplus capital. Compared with our current trajectory, a shift towards growth-oriented assets over the next decade could unlock **more than £150bn** in growth assets, and generate a **further £100bn in surpluses**, bringing total potential investment to over **£400bn**.

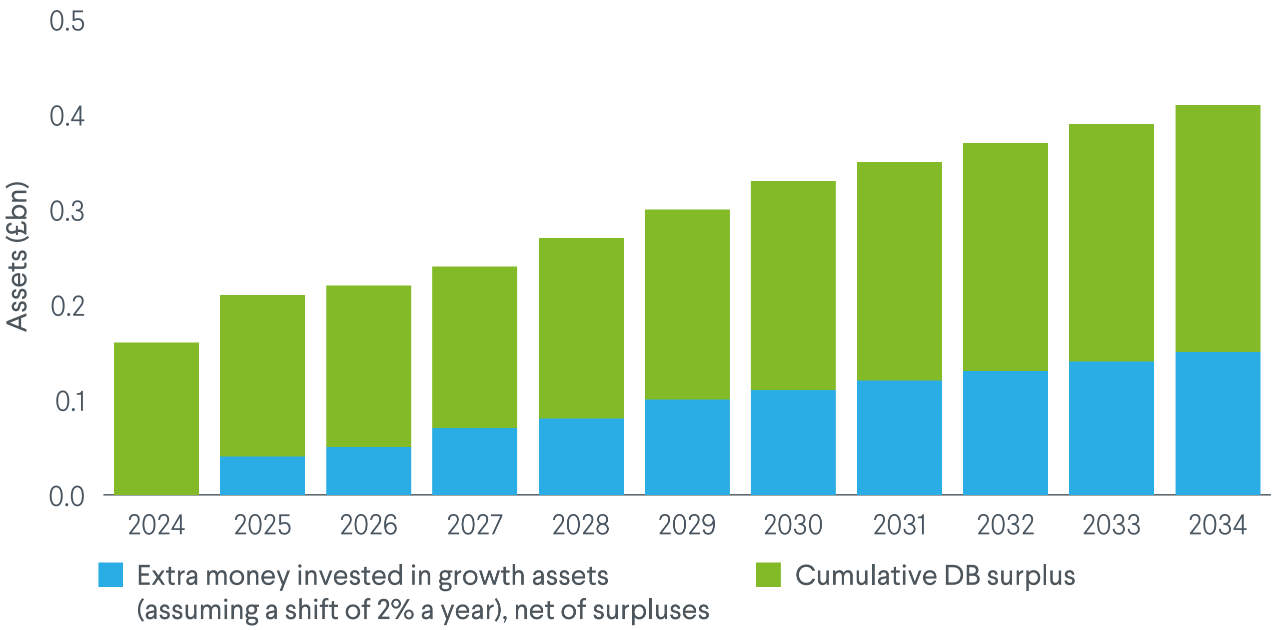
Legislation and pension scheme rules often mean this surplus capital can't be distributed. Unlocking DB pension surplus is a once-in-a-generation opportunity to mobilise hundreds of billions of pounds for the UK economy while enhancing income in retirement for many people.

We've got very low-growth, well-funded DB schemes, in part because the Pension Regulator's (TPR's) statutory objectives prioritise protecting the PPF and the security of the pensions of previous generations. Now that many schemes and the PPF are well funded, it's time to reassess these objectives.

The government should ask TPR to focus on improving outcomes for the next generation, through enhanced pensions or targeted investment. This change in regulatory focus could also help DB schemes open to new members – there are more than 180 such schemes.

It doesn't take many schemes to make a difference: the largest 300 schemes in the UK account for nearly £1trn of assets.

DB pension scheme surplus and investment in growth assets



How it would work

For DB pension schemes to free surplus for other uses, the government must lift legislative and regulatory restrictions. We think a Pension Schemes Bill should include a 'statutory override' – a rule that would give employers and pension scheme trustees flexibility to distribute surplus funds.

As well as removing the obstacles, the government could offer incentives. These might take the form of tax-favourable mechanisms for sharing surpluses with other workplace pension schemes, or tax relief for investment into UK productive assets.

Any changes must continue to safeguard existing member benefits, so they shouldn't conflict with the fiduciary duties of pension scheme trustees. Guidance must be clear that neither fiduciary duty nor the Pension Schemes Act 2021 restricts responsible risk-taking where it is expected to benefit all stakeholders. Pension scheme trustees and sponsoring employers can then make informed decisions confidently.

Surplus distribution should be available to schemes that meet the funding requirements in TPR's DB funding code. TPR should provide explicit guidance and confidence on responsible surplus distribution and growth investment strategies.

Even a modest reallocation of capital could boost economic growth while maintaining pension security. As many schemes are de-risking, a gradual shift to surpluses and 2% a year towards growth and productive finance could unlock hundreds of billions of pounds, without excessive risk.

A further step could be to increase DB schemes' risk appetite by using part of the PPF's £13bn surplus. For example, a scheme that enters PPF could have a guarantee of no reduction to its members' pensions at point of entry.

What it would achieve

Once the barriers are removed, well-governed schemes would be free to use the surplus as they wish. Some may distribute it to the sponsoring employer for use in capital projects. If half of the £160bn surplus today and £100bn generated over the next decade is distributed to sponsors, it would give employers £13bn a year.

Shareholders may expect to receive some of the surplus, which is not the optimal use, but the Treasury could benefit by collecting tax on surpluses distributed in this way. If the £13bn distributed to employers was taxed at 25%, it would generate extra tax receipts of £3bn a year for the next decade.

Accessing surpluses gives DB schemes an opportunity to increase retirement income for their members. They could redistribute money from already secure DB pensions to less adequate DC pensions, and improve DB benefits where they haven't kept up with inflation.

An indirect benefit could be to help keep DB alive. If DB schemes could use surplus funds, more would be encouraged to run on so they can build up surplus.

Encouraging employers to invest surpluses in productive assets could unlock hundreds of billions of pounds for UK growth, with material amounts being available for use by employers. As more schemes build surpluses, they'll remain investors in gilts, helping to maintain long-term confidence in the UK gilt market too.

A sustainable state pension

Emma Foster
DB Actuarial Consulting

Our proposal:
Make the state pension sustainable for generations into the future by setting a target for moving away from the tripple lock.

	Sustainable growth	Treasury	Employers	Low to middle earner	High earner
How it affects stakeholders	^	Gets £3bn a year from the late 2030s	—	—*	—*

For people to have good retirements, they need confidence in the state pension. That means the state pension needs to be sustainable into the future, with mechanisms to keep it there.

Even as the UK has increased the proportion of GDP it spends on the state pension (to 4.9%), more than two-thirds of OECD countries spend a greater proportion of GDP on the state pension than the UK does.

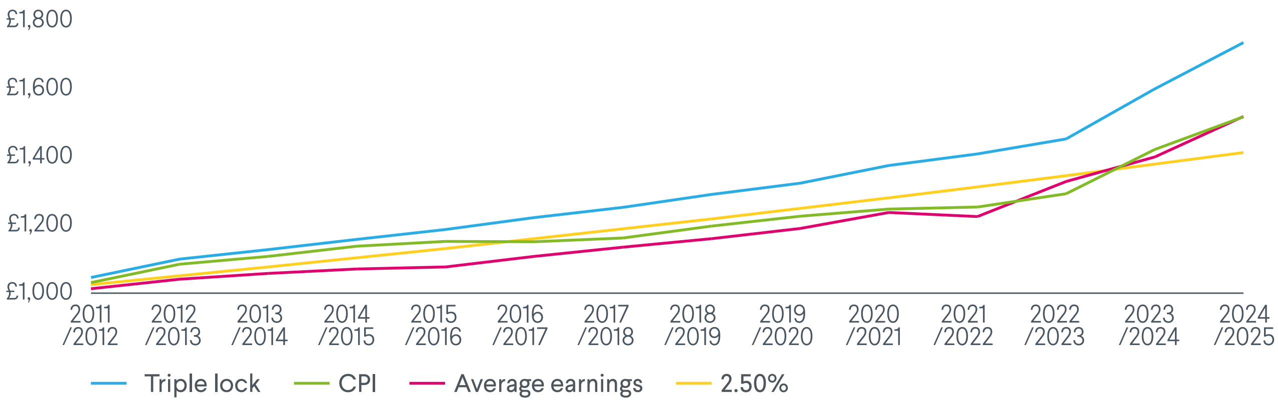
Pensions in the UK are lower relative to earnings than in many other developed economies. The UK's pension replacement rate – a person's pension income as a percentage of previous earnings from work – from the state pension and auto-enrolment occupational pensions is 54%, below the OECD average of 61%.

The Netherlands and Denmark provide similar flat-rate state pensions based on contributions over a person's working life, but both have much higher replacement rates. The UK has some catching up to do.

But the UK has the triple lock: a government commitment to increase the state pension by the highest of earnings growth, inflation or 2.5%. This commitment is more generous than in many countries. We've had the triple lock since 2011/12, and it may help the UK to catch up with some countries' state pension offering.

As a result of the triple lock, the state pension is now 14% higher than it would have been if it increased in line with average earnings in that time. The difference is set to become bigger still.

Effect of triple lock on £1,000



Sources: https://researchbriefings.files.parliament.uk/documents/CBP-7812/CBP-7812.pdf and ONS

*Moving from the triple lock would reduce expected future income for pensioners. However, we expect doing so to promote sustainable growth and boost government investment, easing the financial pressure on taxpayers during their working years.

The state pension is unsustainable in its current form. In its review of the National Insurance Fund at April 2020, the Government Actuary's Department projected that it would be exhausted in 2043/44, as benefit expenditure is expected to increase by more than income.

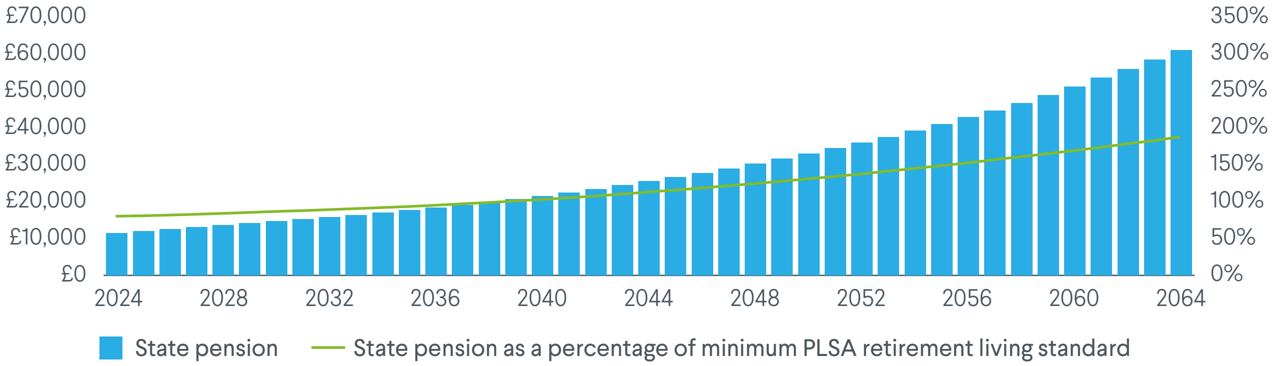
How it would work

The triple lock is expensive for the government, and ultimately unsustainable. The question is when to replace triple lock – and with what. By replacing the triple lock, the government can save money and keep an adequate state pension that's sustainable long into the future.

It can only do so once the state pension has reached an adequate level. A good basis for adequacy is the Pensions and Lifetime Savings Association's (PLSA's) minimum retirement living standard, which is £14,400 a year for a single person. The state pension is around 80% of this minimum standard. Under triple lock, it would rise to 90% in 10 years and 100% by 2039. In 2065, we estimate the state pension would be 87% higher than the projected minimum standard.

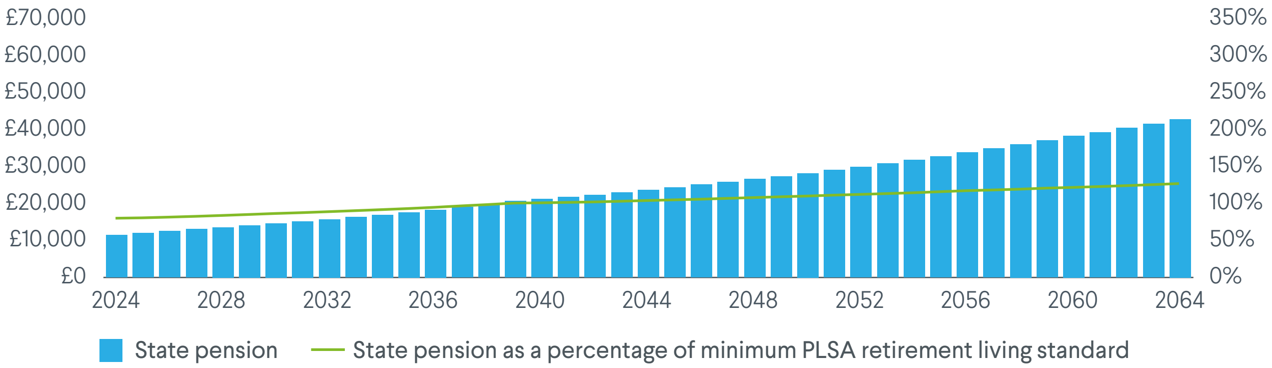
This is a costly surplus for the government to maintain, and it goes well beyond adequacy. Would it still be appropriate to spend so much on state pension increases once the state pension reaches the minimum retirement living standard, or should the focus switch to sustainability?

Annual state pension over time, rising with triple lock



Note. Based on Hymans Robertson modelling. Minimum retirement living standard is projected to increase with CPI inflation.

Annual state pension over time, rising with average earnings



Source: Hymans Robertson modelling

What it would achieve

Government spending on the state pension is £137.5bn in 2024/25. If from 2039 the state pension were to increase in line with only average earnings (one of the components of the triple lock), it would still stay above the projected minimum retirement standards. The government could give people adequate retirements for a much lower spend.

After 40 years, the state pension is around 27% above the projected minimum living standard, but the government pays around 30% less than it would under triple lock – saving an average of £3bn a year from 2039.

The NI fund would still diminish, so the government may need to take a further steps. We think our proposal set out here would be good first step.

Investment where it's needed

Chris Arcari

Head of Capital Markets

Sachin Patel

Head of Corporate DB Endgame Strategy

Our proposal:
Use the money saved to supercharge the national wealth fund, attract private capital and boost the economy by investing in UK productive finance and growth.

Meaningful investment into the UK economy, especially into productive finance, is high on the government's agenda. Pensions could play a much bigger role in these ambitions than currently envisaged.

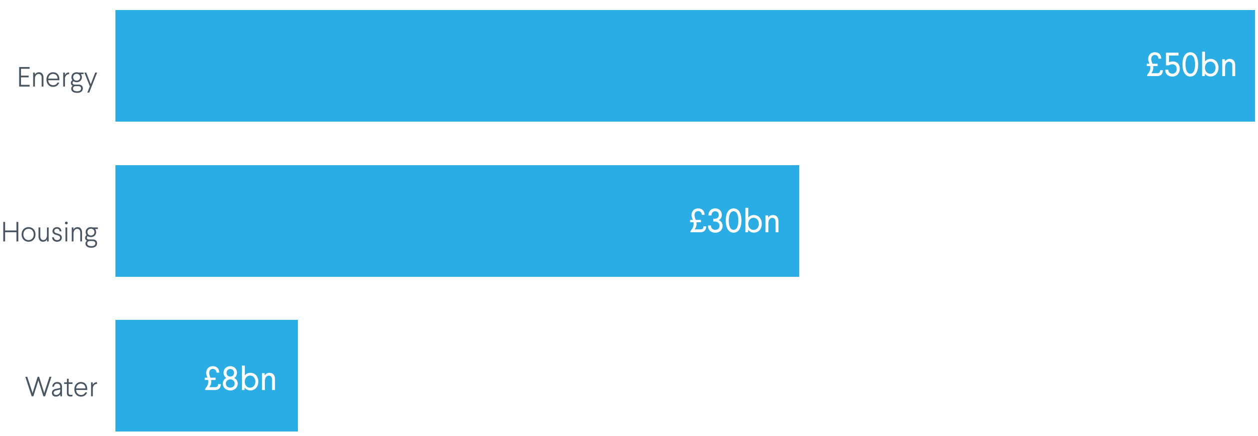
The UK economy has performed poorly since the global financial crisis, and government debt has increased to 100% of GDP. During the government's quantitative easing programme, the UK delivered gilt rates that were both stable and lower for longer. However, the UK missed a huge opportunity to boost investment during this period.

In a recent report, the [Capital Markets Industry Taskforce] says that to achieve annual GDP growth of 3%, the UK needs to invest an extra £100bn a year over the next decade. The report looks at capital markets and their capacity to supply that demand, with a clear need for investment to support energy, housing and water initiatives.

The [Climate Change Committee's Seventh Carbon Budget] suggested that to reach net zero by 2050, the UK needs to invest around £37bn a year.

As Torsten Bell notes in his 2024 book *Great Britain?*, a record of underinvestment has left the UK with large pools of uninvested capital and a range of opportunities for domestic productive investment.

Annual new investment required over next 10 years (£bn)



How it would work

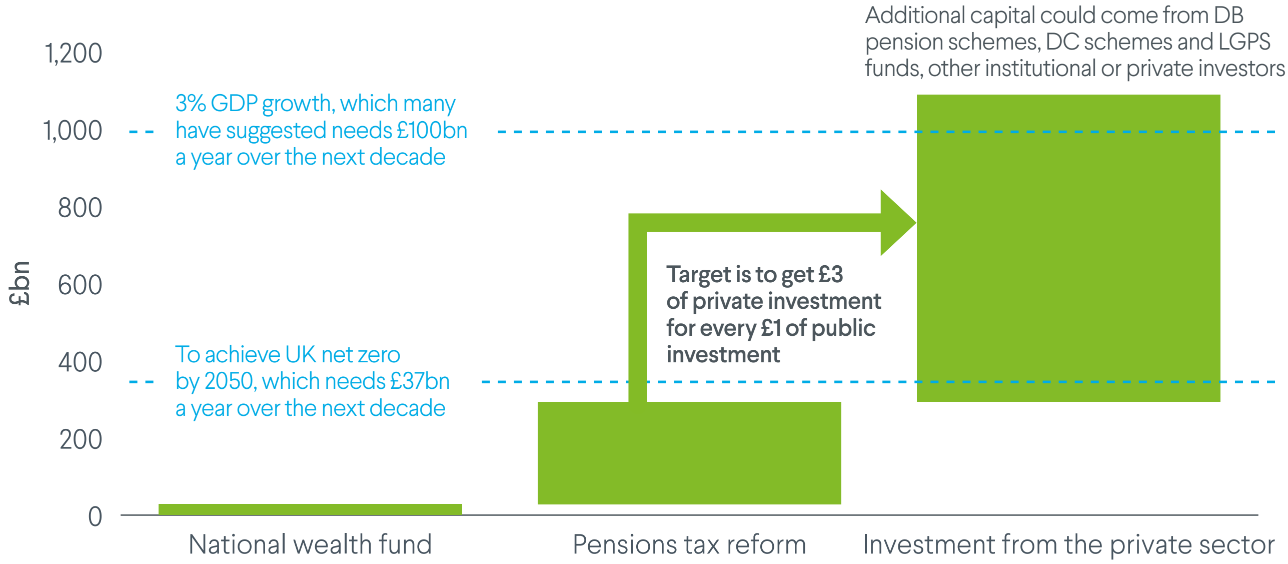
Our proposals in the first part of this paper would make £285bn available to the Treasury over 10 years. We suggest investing £265bn where it's needed alongside private capital, using the proposed national wealth fund.

We like the government's idea of the national wealth fund, but it needs to be more ambitious to solve the UK's growth and investment challenges. Here, we assume the original design of targeting £3 of private investment for every £1 of public money. The private capital could be raised from private-sector DB pension schemes, DC schemes and LGPS funds, other institutional or private investors.

For productive finance to work, we need clear plans and attractive opportunities. The government should identify where investment is most needed and make it attractive. Practical and tangible targets and goals will be vital to engaging and attracting investors.

The government may need to offer targeted incentives. It could go further and direct how the money is invested, and underwrite the risk that investors would face.

Meaningful investment over the next decade



What it would achieve

The dividend to the next generation from sustainably investing in the UK, done well, would be huge. The extra money available would contribute to the proposed National Wealth Fund or equivalent for investment in priority areas like the green transition. We could have £1trn available for investment in the UK, for the benefit of current and future generations.

Money in pension schemes is likely to be invested internationally. By freeing it from those schemes, for direct oversight and investment by the government, it could improve the government's debt-to-GDP position.

Enhancing auto-enrolment

Sue Waites
Partner, DC

Hannah English
Head of DC Corporate Consulting

Our proposal:
Extend the eligibility for auto-enrolment and increase minimum contributions. Introduce a savings vehicle for financial resilience. Allow first-time property buyers access to borrow against pension and property value.

	Sustainable growth	Treasury	Employers	Low to middle earner	High earner
How it affects stakeholders	^	Invests £1bn-2bn a year	—	^	—

Many people are enrolled automatically into workplace pensions, but the amounts are not enough to give them adequate retirements. And many people aren't eligible for auto-enrolment.

We recommend raising the minimum auto-enrolment contribution level and abolishing the earnings threshold for auto-enrolment. Our proposals assume that everyone will be eligible for the full state pension.

We also propose introducing a savings vehicle to give people financial resilience, and enabling zero-deposit borrowing against pensions for first-time property buyers.

How it would work

We propose increasing the auto-enrolment minimum contribution from 8% to 12%. Times are tight for the government, savers and employers, so change needs to be gradual and predictable. We propose raising the rate by 0.5 percentage points a year, starting two years from now. We are agnostic over this time horizon about how this increase is split between employers and employees – the priority is that it increases.

We also propose extending auto-enrolment to all workers, not just those earning over £10,000 in a job. Some people have more than one part-time job, each of which pays less than £10,000. These people, mostly women, lose out on pensions altogether, which adds to the gender pensions gap.

As with the change in contribution levels, this extension of auto-enrolment eligibility would be phased in. Again, we suggest starting two years from now and taking a further eight years to do it. Doing it this way gives time for employers and employees to adapt.

Once the auto-enrolment minimum reaches 12%, the cost to the Treasury would be £1bn a year if our tax proposals are implemented (allowing for NI costs), or £2bn a year under the current tax system.

In the longer term, the government might be able to review which earnings these rates apply to. For now, we suggesting leaving them as qualifying earnings.

A dedicated savings vehicle

Alongside these changes, we propose introducing a savings vehicle to give people financial resilience. Without this, low earners might be forced to opt out of auto-enrolment and lose their employer contribution.

This 'side car', a concept trialled by Nest Insight, gives the option of spreading the auto-enrolment increase between the employee and the employer, reducing the burden on employers if they were to bear the entire increase.

Employer contributions would always go into pensions. Employee contributions would be directed to the 'side car' until it reaches at least £1,000. From then on, they'd go into the pension. The £1,000 level is not perfect, but it balances realism and effectiveness. It's aligned with the Nest Insight trial and the Resolution Foundation's observation that one-third of working-age families lack 'rainy day' savings of at least £1,000.

If the employee ever needs to access these savings, employee pension contributions would flow back into the 'side car' until it's full. This arrangement would ensure workers have no reason to opt out of auto-enrolment. It would give them a liquid source of funds to improve their financial wellbeing.

The industry needs to innovate to create a suitable product. The 'side car' savings would be invested, and they need to be invested in liquid assets. Employees would have the option to opt out of the 'side car' and have their savings just go into pensions – high earners may have less need for a financial resilience fund but may want a higher return on investment.

Pensions as collateral for low-cost, deposit-free mortgages

Pensioners who rent need an extra £5,200 a year for life to cover the cost of renting. It's no surprise that private renters are three times as likely to experience pensioner poverty as homeowners, according to Age UK.

Yet it seems impractical for pensions to meet the needs of renters in retirement. If they had to, it would be too expensive for employers and the government given where we are today. Rather, we should reduce the number of retired renters, by helping more people into property ownership. The government's supply-side reforms need to work so that we have enough good-quality property at affordable prices to meet demand.

However, pensions can play a critical role that doesn't diminish their capability to deliver an income for life. We propose allowing pension saving to be used as collateral for mortgages for first-time buyers.

This arrangement would let people get on the housing ladder without a deposit, and benefit from lower interest rates as lenders take on less risk of negative equity. Crucially, the money in the pension is still invested. This proposal would require product innovation and government support.

What it would achieve

The policy goal for tax relief on pensions is financial independence for as long as someone lives. Our proposed changes would mainly help low and middle earners, who would otherwise risk becoming dependent on the state for retirement income.

A worker earning £20,000 a year and contributing 12% of qualifying earnings would have a greater than 80% chance of meeting the PLSA's minimum retirement living standards. Increasing to 12% is unlikely to have a material impact on higher earners, as most are already in pension arrangements that meet this standard.

Extending auto enrolment to all workers and increasing minimum contributions can help narrow the pensions gender gap. Removing the £10,000 earnings threshold would make 1.2m women and 328,000 men eligible for auto-enrolment, and therefore employer contributions – an improvement on where these workers are now.

Letting people borrow against their pension to get on the housing ladder will reduce pensioner poverty from being trapped in lifelong rental.

Including self-employed workers in pensions

Sue Waites
Partner, DC

Hannah English
Head of DC Corporate Consulting

Our proposal:
Set default provider for self-employed workers,
and extend auto-enrolment and the 'side car' savings vehicle to them.

	Sustainable growth	Treasury	Employers	Low to middle earner	High earner
How it affects stakeholders	^	Invests £1bn a year	n/a	^	^

Self-employed workers currently pay lower NI contributions than other workers. But according to some estimates, only 18% of self-employed workers save for retirement. That's 3.4m people not saving into a pension, in contrast with around 88% of the employed population eligible for auto-enrolment.

According to the Institute for Fiscal Studies, the most common amount that self-employed workers pay into a pension (among those who do) is £600 a year. For someone earning £20,000 a year, this is 3% of earnings, and gives them only a 40% chance of meeting the PLSA's minimum retirement living standard.

Any plan to fix retirement adequacy needs to include self-employed workers. To encourage this group to save into a pension, we need to give them what they need – which we can't do if we treat them the same as company employees.

For many self-employed workers, saving into a pension can be unattractive in principle. Pension savings are illiquid, so they can't be used as emergency savings – which is often a high priority for the self-employed. Added to that, the legislation and tax treatment of pensions often changes, taking away the stability that many people want.

Setting up and managing a pension isn't always easy, especially for people with low financial literacy. For example, pension contributions receive basic-rate tax relief, but higher-rate relief has to be claimed through a tax return.

The problem is known, but a workable solution is challenging. Self-employed workers face barriers such as unpredictable income and affordability, so any solution needs to combine accessible and locked-in savings, which are not widely available at the moment.

How it would work

To remove these barriers, we propose treating self-employed workers the same as company employees, regardless of how much they earn.

Phase 1

The first phase would be to gradually increase NI contributions for the self-employed to bring them into line with those for the employed. We suggest starting this phase-in in two years and raising the rate by 0.5 percentage points per year for four years. The extra money HMRC makes from this would then go directly into the self-employed worker's pension.

After the rate is equal to that for employed workers, we suggest phasing in two more years of 0.5 percentage point rises. Funded by the government, this increase would be the equivalent of what the government would pay were they employed and auto-enrolled. These changes would give a self-employed worker a pension contribution of 3% of earnings that they don't have to explicitly pay for.

We propose that self-employed workers who don't have a pension arrangement already and don't want to choose one should have a default option, like Nest.

Phase 2

The second phase would make pension saving the default. The government could consider starting auto-enrolment for self-employed workers through the self-assessment tax return. This could be phased in at 0.5 percentage points a year until it's the same as default saving rates for employees.

The 'side car' would solve the problem of illiquid savings. The savings limit may be higher for the self-employed, as they need a larger cushion. We've not costed this option – it's a longer-term idea, and the immediate priority is to help get self-employed workers saving into pensions.

What it would achieve

Our proposals would be a first step to getting more of the self-employed workforce to save into pensions – from 18% now, we could get to 100%. After eight years, we'd have a 3% saving rate for self-employed workers, and a route to aligning with employee savings. We'd still have a long way to go to give self-employed workers adequate retirements, but we have to start somewhere.

The principles behind our thinking

Hymans Robertson is not just another pensions firm. We're a certified B Corp, so we really care about all stakeholders and about sustainability. And we have a record of implementing industry-changing innovation.

We've been the scheme actuary to Clara-Pensions, the UK's first superfund, from its inception. We founded Club Vita, the industry standard for longevity analytics. Our Guided Outcomes (GO™) proposition changed the narrative in DC to focus on member outcomes and benefit adequacy. We've developed our technology, and GO now underpins our market-leading Hymans Robertson Expected Retirement Outcomes modeller.

We advise more UK DB schemes open to new members than anyone else – so we're used to advising on sustainability to help clients thrive in the long term.

Our proposals have been guided by 10 principles.

1 **Clear policy intent**
We assume the government wants to ensure financial independence from the state and dignity in later life.

2 **Aligned time horizons**
In the long term, collective pensions schemes open to new members will ensure pensions finance is productive, responsibly stewarded and plays its part in stimulating UK investment and UK growth.

3 **Affordability**
Pensions must be affordable now and into the future for the government, employers and workers.

4 **Equity**
Respecting difference and giving people what they need is key to an inclusive future.

5 **Sustainability across generations**
We need to stimulate growth and create jobs for the next generation in the spirit of a healthy social contract and exchange of gifts between generations.

6 **Adequate retirement security**
Retired people need to have financial security.

7 **Financial resilience**
People must have access to emergency funds for their financial wellbeing. And the economy needs to be resilient to financial crises by having a diversity of pension design and investments, not a monoculture.

8 **No 'cliff edges'**
Change must be gradual, so that all stakeholders know where things are going and have time to adapt. The introduction of auto-enrolment is a great example.

9 **Costed and valued proposals**
Any proposals should meet stakeholders' financial needs, and government incentives should be easy to see and appreciate.

10 **Holistic policies**
We're mindful of the role private pensions play in the context of the state pension and housing.

Tapping the potential

Our package of proposals would improve pensions adequacy and retirement security while helping government finances and economic development in the areas where it's needed.

Our proposals for:

Tax changes on pensions	Collective pensions saving	Using pensions surplus for UK investment	Sustainable state pensions

would give an extra

£28.5bn a year

to invest in pension adequacy and the wider economy

We can invest this money in productive finance and growth assets, use it to enhance auto-enrolment and include self-employed workers in pensions.

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Methodology and assumptions

Tax changes on pensions

In the high-earner example, the top-up is based on the drop in tax rate from 40% (higher rate) to 25% (basic-rate equivalent top-up). Savers would still, in effect, receive 62.5% of upfront tax relief (25% ÷ 40%). The remaining 37.5% of tax relief is collected immediately, bringing forward £10bn in revenue (37.5% of £27bn, the current tax relief for higher and additional-rate taxpayers).

Collective pension savings

The methodology and assumptions for our modelling are summarised in a report we published last year.

The chart in this section shows illustrative figures for a 20-year-old pension scheme member with a starting salary of £15,000 a year, contributing at 8% until retirement at age 67. DC investment strategy is 80% equities and 20% corporate bonds; CDC strategy is 80% equities and 20% private markets. DC income is based on a 25% probability of ruin.

Using pensions surplus for UK investment

The surplus amounts that employers could get are gross of tax.

Our projections are consistent with a 'roll forward' method of assets and liabilities, and include an allowance for future contributions, benefits paid and returns on assets. We project the size of assets in the future, the make-up of those assets and how much surplus DB schemes could generate.

We've started by projecting what we expect the UK DB universe will look like in 10 years, without a change in approach. This current projection assumes that 40% of liabilities are fully insured by 2034 (and therefore outside DB schemes), 40% target future insurance and 20% is in schemes that are running on. We've assumed what a typical investment strategy would be for schemes that fall into these three groups in 2034. Our projections from 2024 are based on 27% currently invested in growth assets, 24% in credit assets and 50% in matching assets (sourced from the 2024 PPF book).

In projecting the alternative scenario, where there is a shift towards growth assets, we've assumed that only 33% of liabilities are fully insured by 2034, with an overlay of 2% a year of remaining assets moving to growth assets over the next 10 years. This means we get to a 2% a year shift in allocation to growth over the next decade, with a corresponding reduction in matching assets and credit assets. In 2034, this results in 46% in growth assets, 20% in credit assets and 34% invested in matching assets.

We've used a 'low-dependency' funding basis of gilts + 0.5% a year. Under our alternative scenario, £160bn of surplus is extracted today, and surplus then builds again over the next decade.

If surpluses were extracted regularly, the figures would be similar (to the nearest £50bn). The current minimum threshold for extracting surplus from a scheme is the buy-out funding level; there are discussions about whether the government will realign this threshold to the low-dependency basis. A scheme would be open to extracting surplus at a level suitable for its circumstances.

Our projections make a broad allowance for benefits paid, contributions, the cost of insurance compared with the equivalent low-dependency liabilities, and future returns on investments.

We have taken figures from the 2024 PPF Purple Book, TPR's funding analysis at September 2024 and the most recent ONS data on funded occupational pension schemes.

A sustainable state pension

The charts in this section illustrate how the current state pension could grow over time under various scenarios. These projections have been calculated using thousands of simulations of the Hymans Robertson Economic Scenario Service (ESS).

In projecting the state pension under the triple lock (the first scenario), the current state pension of £11,500 has been increased each year in line with the higher of average earnings or CPI with a lower limit of 2.5%.

Under the second scenario, the current state pension has been projected under the triple lock until 2039. Thereafter, the state pension has been projected in line with increases to average earnings.

The current PLSA retirement living standard of £14,400 a year for a single person has been inflated with CPI (no caps and floors) to reflect how the PLSA might update the standard over time.

We can provide further details of the underlying assumptions for average earnings and CPI on request.

Enhancing auto-enrolment

The minimum retirement living standards are quoted in terms of expenditure. Our DC projection model uses income targets, so we convert the living standards to incomes by adjusting for the appropriate marginal income tax rates. The pre-tax income for the minimum retirement living standard is £14,858 a year.

Our DC projections are based on the Hymans Robertson Guided Outcomes model, which calculates future retirement incomes by considering member-specific characteristics such as age, salary, contribution rate, current accrued fund, assumed investment choice and retirement age. The effective date of our modelling is 31 January 2025.

In the modelling, we project forward each member's salary and current fund using stochastic projections of asset returns and economic variables such as inflation. We assume that the member continues to contribute to the assumed investment strategy at the assumed contribution rate until they reach their retirement age, at which point they convert their accumulated fund to retirement income by purchasing an inflation-linked annuity.

Stochastic projections of yields are used to estimate the cost of income in retirement.

Income streams have been priced assuming that insurers adopt the S2 series of mortality tables, with best estimate future improvements in mortality rates assumed to be:

- CMI_2018 model, calibrated to E&W population data
- An initial addition to mortality improvements (A) parameter of 0.3%
- Otherwise core settings (including a smoothing parameter (SK) of 7.0)
- Long-term rates: 1.5% a year for both males and females.

We've calculated the chances of meeting the minimum standard based on a representative member assumed to have the following characteristics:

- Aged 25
- A starting fund value of £0
- A retirement age equal to state pension age
- Invested in a typical lifestyle investment strategy
- Contributions are paid at the same level until retirement
- An inflation-linked salary increase each year.

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