Pension Trends Chapter 6: Private Pensions, 2013 Edition

Abstract

This chapter looks at private pensions in the UK. By contrast with state pensions (see Pension Trends Chapter 5) which are comprised of the basic and additional state pensions, private pensions are provided by employers in the private and public sectors and by insurance companies. The analysis presented here focuses on private pensions in the 'accumulation' stage, when people are building up their pensions. Receipt of state and private pensions is covered in Pension Trends Chapters 11 and 12.

Background

This chapter considers some of the key features of the private pensions system, such as differences between funded and unfunded pensions and between Defined Contribution (DC) and Defined Benefit (DB) pensions. It also presents evidence on how the characteristics of the system are changing over time, and indicates what this may mean for the future of the private pension system.

It observes that the comparison between the public and private sector is more complex than is apparent at first sight. The evidence suggests that the differences are associated with underlying factors, such as size of both pension scheme and employer, and with approaches to management of risk.

Previous editions of this chapter contained data from the Organisation for Economic Co-operation and Development (OECD) that compared the private pension system in the UK with other countries. However, at the time of publication, updates for this information were not available. Therefore, the data presented within the previous versions of this article have not been included in this new edition. Also, the data used in this chapter is prior to the workplace pension reforms introduced in the Pensions Act 2008, which began in October 2012. More details about this can be found within the section entitled **Workplace pension reform**.

Data sources

The various data sources used in this chapter have different coverage and characteristics. The analyses use the source that is most appropriate for the topic, but this inevitably means that there are differences in the types of pension covered and in the population base between one analysis and another.

The main sources used are:

- the Office for National Statistics (ONS) Occupational Pension Schemes Survey (OPSS), for estimating numbers of active members of occupational pension schemes and deferred member entitlements;
- the Department for Work and Pensions (DWP) Family Resources Survey (FRS) for estimating proportions of populations that belong to a pension; and
- the ONS Annual Survey of Hours and Earnings (ASHE), for providing breakdowns of employee membership according to pension type and other characteristics.

Participation in private pensions

People in the UK are encouraged to participate in private pension schemes in order to supplement the retirement income provided through the state pension system. Pension Trends Chapter 7 provides estimates of membership of private pension schemes in the UK during the ‘accumulation’ stage, while Pension Trends Chapter 12 covers private pension income received in retirement. In 2010/11, 70% of pensioner units[1] in Great Britain were in receipt of private pensions.

Voluntary private pension provision in the UK is encouraged by Government through the tax system[2] and, most recently, through the implementation of auto-enrolment. Further details on auto-enrolment can be found in the **Workplace pension reform** section of this article. Individuals’ contributions to private pensions qualify for tax relief, as do the investment income and capital gains of pension funds. Many people can also take part of their pension as a tax-free lump sum when they retire[3]. In addition, contributions employers make towards their employees’ private pensions are free from both employer and employee National Insurance.

Notes

1. Estimate from the Department for Work and Pensions ‘Pensioners’ Income Series’.

   Pensioner units are defined as either:

   - single pensioners: people over state pension age (65 for men and over 60 but under 61 for women in 2010/11); or
   - pensioner couples: married or cohabiting pensioners where one or more are over state pension age.

2. The tax structure of the UK pension system is known as ‘Exempt-Exempt-Taxed’ (EET) because contributions and earnings from investment are tax exempt, but pensions in payment are taxed.

3. People belonging to defined contribution pension schemes (see **Definitions**) can take up to 25% of their accumulated pension pot as a tax-free lump sum. Those belonging to Defined Benefit schemes (see **Definitions**) can take part of their pension as a tax-free lump sum if their scheme rules permit.

Definitions

Occupational pensions

An occupational scheme is an arrangement, other than accident or permanent health insurance, organised by an employer or on behalf of a group of employers to provide benefits for employees on their retirement and for their dependants on their death. It is a form of workplace pension. In the private sector, occupational schemes have trustees and are governed by trust law.

Total membership comprises:

- Active members. Current employees who contribute (or have contributions made on their behalf) to the pension scheme;
- Deferred members. Former employees who have preserved their pension rights within a scheme but are not yet receiving pension payments, and widows, widowers, other dependents and pension credit[1] members with some preserved pension; and
- Pensioner members. Those who are receiving pension payments from their scheme, and their dependents and pension credit members.

An occupational pension scheme may be open, closed, frozen or winding up. An open scheme admits new members. A closed scheme does not admit new members but may continue to receive contributions from, or on behalf of, existing members who continue to accrue pension rights. In a frozen or 'paid up' scheme, benefits continue to be payable to existing members but no new members are admitted, and no further benefits accrue to existing members. Members can make no more contributions but further employer contributions may be made, and may have to be made, for example to correct a deficit. A scheme that is winding up is in the process of termination, either by buying annuities for the beneficiaries or by transferring assets and liabilities to another scheme or to the Pension Protection Fund[2].

Personal pensions

Personal pensions are available to any UK resident under 75 years of age. They are contract-based, not trust-based. The money from each member's contributions is invested and a fund is built up. The amount of pension payable in retirement depends on:

- the amount of money paid into the scheme,
- how well the investment performs,
- whether an annuity is purchased, which uses a factor to convert the member's fund into a pension, at or after retirement, and
- whether any lump sums are taken.

Stakeholder pensions are a type of personal pension designed to incorporate a minimum set of standards that were introduced in April 2001. They have capped management charges and there are no penalties for stopping contributions or transferring benefits to another scheme.

Self-invested personal pensions (SIPPs) are designed for people who want to manage their own fund. They have relatively high management charges and the more changes that are made to the investment plan, the higher the level of fees charged. On the 6th of April 2006 (known as ‘A-day’), the rules surrounding SIPPs were changed to encourage investment in them.

Group personal pensions (GPPs), group stakeholder pensions and group SIPPs are collective arrangements made for the employees of a particular employer to participate on a group basis. They are usually facilitated by employers and are, therefore, a form of workplace pension. However, the legal contract is between the individual and the pension provider, an insurance company.

DB and DC pensions

Defined benefit (DB) pension schemes are those in which the rules specify the rate of benefits to be paid. One of the most common DB schemes is one in which the benefits are based on the number of years of pensionable service, the accrual rate and final salary. However, Career Average Revalued Earnings (CARE) schemes are becoming more common. While people remain within these schemes, pension benefits are based upon their earnings over this part of their career. More information about this can be found within Table 5.7 of the Office for National Statistics' (ONS) annual report on the Occupational Pension Schemes Survey (OPSS) .

A Defined Contribution (DC) pension is one in which the benefits are determined by the contributions paid into the scheme, the investment return on those contributions (less charges), and any annuity that is purchased. DC pensions are also known as money purchase pensions. All personal pensions are DC pensions.

Notes

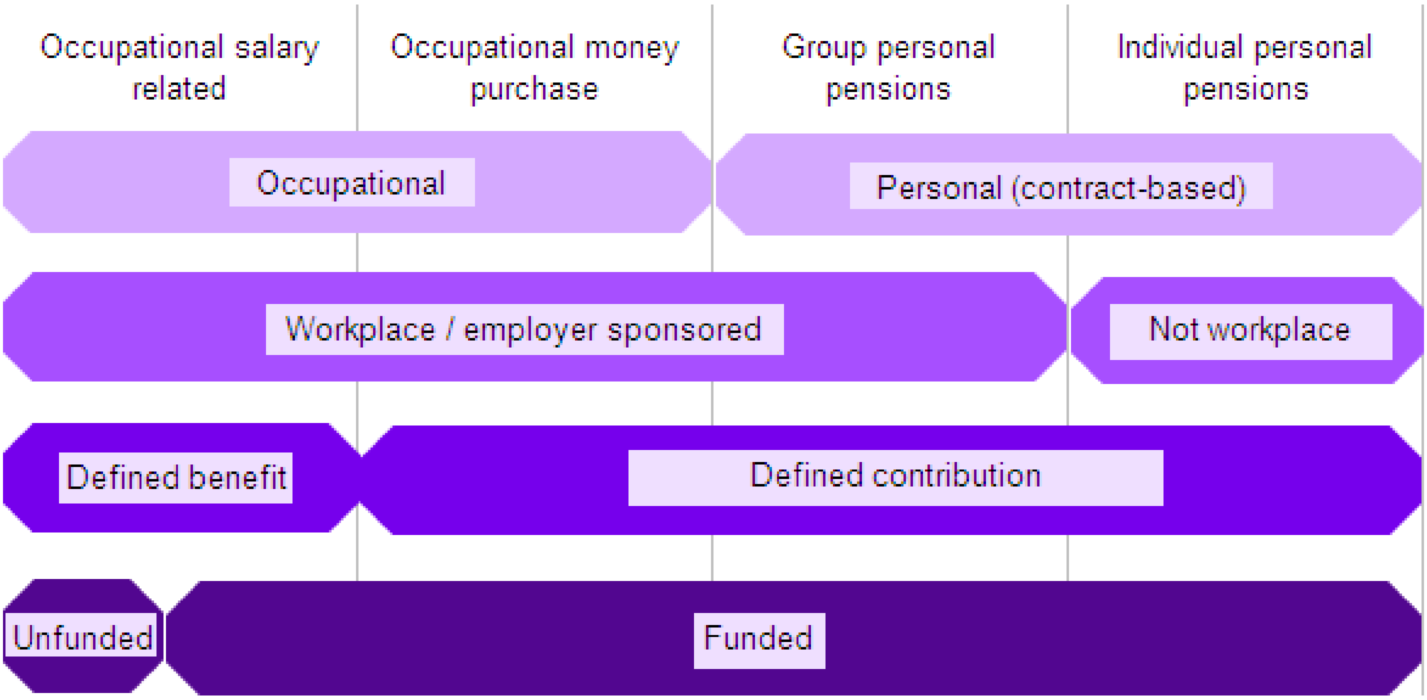
1. Pension credit in this case refers to instances where the spouse of a pension scheme member is given a credit in respect of any pension benefits arising on divorce.

2. The Pension Protection Fund was established in April 2005 to pay compensation to members of eligible defined benefit pension schemes, when there is a qualifying insolvency event in relation to the employer and where there are insufficient assets in the pension scheme to cover Pension Protection Fund levels of compensation.

Structure of the private pension system

In the UK, private pension schemes can be split into two main groups: occupational and personal (Figure 6.1).

Figure 6.1: Private pension system in the UK.



Source: Pensions Commissions 2004.

Occupational pensions are provided by employers (see **Definitions**). According to the Office for National Statistics' Occupational Pension Schemes Survey (OPSS), there were 6.2 million active members of occupational pension schemes in 1953. The highest number of active members was recorded in 1967, when there were 12.2 million. In 2011 there were 8.2 million active members, the lowest level since the 1950s.

Personal pensions, including stakeholder pensions and self-invested personal pensions (SIPPs), are those where individuals enter into a contract with a pension provider, usually an insurance company. According to data from HM Revenue and Customs (HMRC), the recent trend in the number of individuals contributing to personal pensions has been downwards. It fell from 7.6 million in 2007/08 to 6.0 million in 2009/10 and fell again in 2010/11 to 5.7 million .

Workplace pensions comprise:

- occupational pensions (provided by employers), and
- Group Personal Pensions (GPPs), group stakeholder pensions, and group SIPPs (all facilitated by employers).

From October 2012, in a phased implementation based on the employer size, employees have started to be automatically enrolled into workplace pension schemes (see **Workplace pension reform**).

Figure 6.1 shows that occupational schemes can be divided into Defined Benefit (DB) and Defined Contribution (DC) schemes (see **Definitions**). All personal pensions are DC. The private sector has a mixture of DB and DC pensions, while public sector schemes are mainly DB.

Figure 6.1 also shows that private pensions can be classified according to the funding approach taken: funded or unfunded (this is explained further in the Pension Trends Glossary (198.9 Kb Pdf)). 'Funded' consists of private sector occupational pension schemes, individual and employer-sponsored personal pensions and some occupational schemes in the public sector, the largest of which is the Local Government Pension Scheme (LGPS) for local authority employees.

'Unfunded' or 'pay as you go' pension schemes are found in the public sector. The main unfunded pension schemes are for the Civil Service, the Armed Forces, the National Health Service, teachers, police and firefighters. The benefits of unfunded public service schemes are financed from general taxation and employee contributions.

Options at retirement

There are a number of options available to people with DC pensions (occupational and personal) at retirement. Most DC members opt to purchase annuities with their funds. Many also take part of their pension fund as a tax-free lump sum (up to 25% of a DC pension fund can be taken in this way). Tax-free lump sums are also available for Defined Benefit (DB) schemes. Further information about the provision of a tax-free lump sum upon retirement is available on the HM Revenue and Customs (HMRC) website.

Annuities are a financial instrument, provided by an insurance company, that pay a guaranteed annual income to the holder for the rest of their life. Insurance companies are able to offer this by 'pooling' the mortality risks associated with individual annuity holders.

The amount of the annuity offered at retirement will depend on a combination of different factors and these include the size of the individual's fund, the annuity rate used and the type of annuity chosen. There are further details about annuities, including features such as enhanced rates, available on The Money Advice Service's website. There are many different types of annuity that can be purchased at retirement, and these include:

- Level annuities that provide the same level of payments for the whole of retirement. Their real value is eroded over time by inflation;
- Index-linked annuities that provide payments which rise over time in line with some measure of inflation. However, the initial payments will be lower than for a level annuity; and
- Escalating annuities with payments rising over time by a fixed amount every year. Again, the starting point will be lower than for a level annuity.

Until 5 April 2011, unsecured pensions were an alternative to buying an annuity before age 75. In this case, the fund remained invested and may have continued to grow. Members could take an income from the fund either by using income withdrawal, or by using a 'short-term annuity'. However, unsecured pensions could not be continued beyond age 75, when the member had to secure an income by buying an annuity or an Alternatively Secured Pension (ASP). ASPs were introduced in April 2006. They were a more restricted form of income drawdown for those aged over 75 who chose not to buy an annuity.

From 6 April 2011, however, the income restrictions applying to income drawdown arrangements from age 75, which effectively required people with DC pensions to buy an annuity by age 75, were removed. At any time from age 55 they can now either buy an annuity or opt for a 'drawdown pension'. In either case, 25% of the fund can be taken as a tax-free lump sum. The drawdown option allows people with an annual pension income of £20,000 or more to take unlimited amounts out of their pension fund at any time (‘flexible drawdown’). In drawdown, after 26th March 2013, people with less than £20,000 other pension income can take up to 120% of the equivalent amount they would receive from an annuity in any one year. This is referred to as ‘capped drawdown’[1]. The fund remains in existence until it is exhausted and on death any unused funds can be passed on to heirs (subject to taxation). The drawdown system replaces the unsecured pension and ASP.

Alternatives to the traditional annuity or drawdown options are Unit Linked Guarantees (ULGs). These are relatively new to the UK. They use a combination of investment growth and risk hedging to guarantee increasing payments during retirement.

Notes

1. The March 2013 budget included further developments on pension provision.

The changing landscape

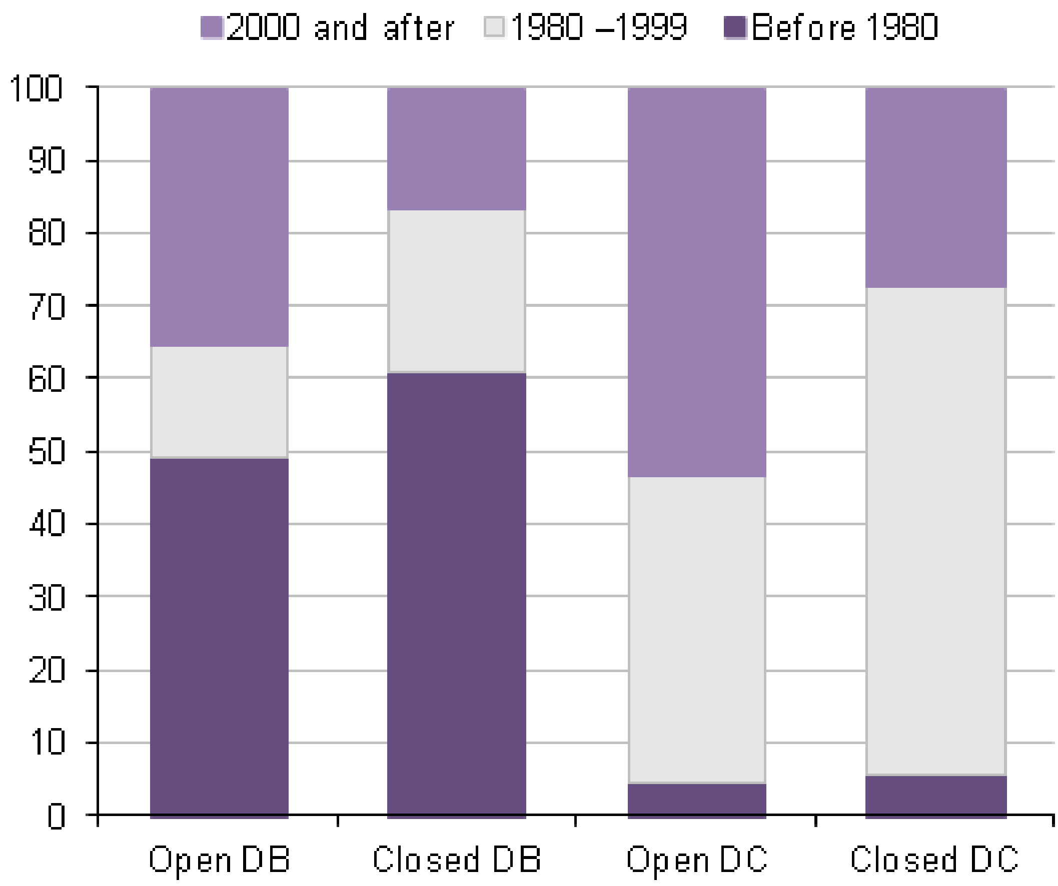
From the 1950s to the 1980s, most occupational pension schemes were Defined Benefit (DB) schemes, and employers had the option to make membership of such schemes compulsory. However, the Social Security Act 1986 made membership of occupational schemes voluntary and introduced changes designed to promote Defined Contribution (DC) occupational pension schemes and personal pensions. The rapid growth of financial markets from the 1980s also made saving in DC pension schemes more of an option than it had been before. The growth of DC occupational pension scheme membership in the private sector dates from this period.

Figure 6.2 shows active membership of private sector DB and DC occupational schemes by their scheme foundation dates. Most (95%) active members of open DC schemes in the 2011 Occupational Pension Schemes Survey (OPSS) were in schemes founded in 1980 or later, and 53% were in schemes founded in 2000 or later. By contrast, 49% of active members of open DB schemes in the 2011 OPSS were in schemes founded before 1980.

Around 35% of active members of open DB schemes were in schemes that were founded in 2000 or later. However, some of these schemes recorded in OPSS as ‘new’ may actually have been replacements for existing schemes, for example Career Average Revalued Earnings (CARE) arrangements replacing final salary schemes.

Figure 6.2: Proportion of active members of private sector occupational pension schemes: by scheme's foundation date, status and benefit structure, 2011.

United Kingdom, Percentages.



Source: Occupational Pension Scheme Survey (OPSS) - Office for National Statistics

Notes:

1. Excludes schemes with fewer than 12 members.
2. Proportions are calculated excluding non-response.

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(126.5 Kb)

Figure 6.3 shows the proportion of active members of occupational pension schemes in the UK (employees currently contributing) by sector (public or private), funding approach (funded or unfunded) and benefit structure (DB or DC).

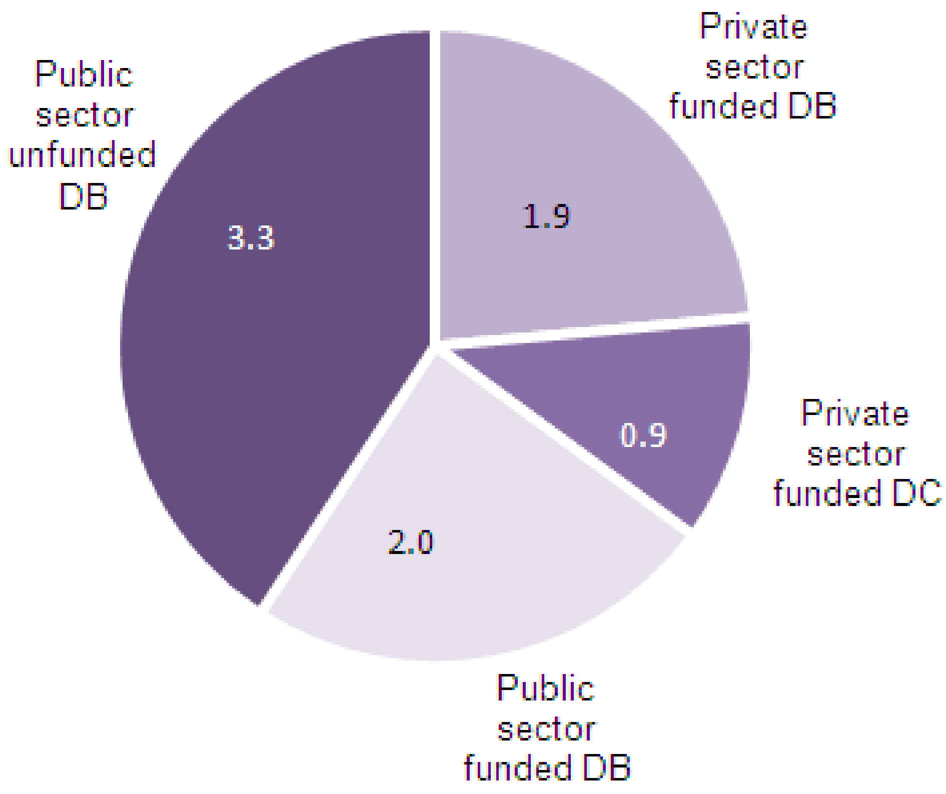
It should be noted that most of the data presented in this chapter is for active (employee) membership of pension schemes, or, in the case of personal pensions, individuals currently contributing. This is because, while looking at income from private pensions (Pension Trends Chapter 12) tells us about the outcome of the private pension system that existed in previous decades, our main focus here is the structure of the current pension system and its implications for the current generation of working age people when they retire.

In 2011, according to the OPSS, there were 8.2 million active members of occupational pension schemes. Of these, 88% (7.2 million) belonged to DB schemes and 12% (0.9 million) to DC schemes (Figure 6.3).

For DB and DC occupational pensions, in 2011, just under two-thirds of membership (65%, or 5.3 million) was in the public sector and just over one-third (35%, or 2.9 million) was in the private sector. This is in contrast to 1953 (when the survey was first run), when active membership of occupational schemes was divided equally between the private and public sectors, each with around 3.1 million members.

Figure 6.3: Active members of occupational pension schemes: by sector, funding approach and benefit structure, 2011.

United Kingdom, Millions.



Source: Occupational Pension Scheme Survey (OPSS) - Office for National Statistics

Notes:

1. Excluding where funding status is unknown (less than 0.01% of public sector active membership). All private sector schemes are funded.

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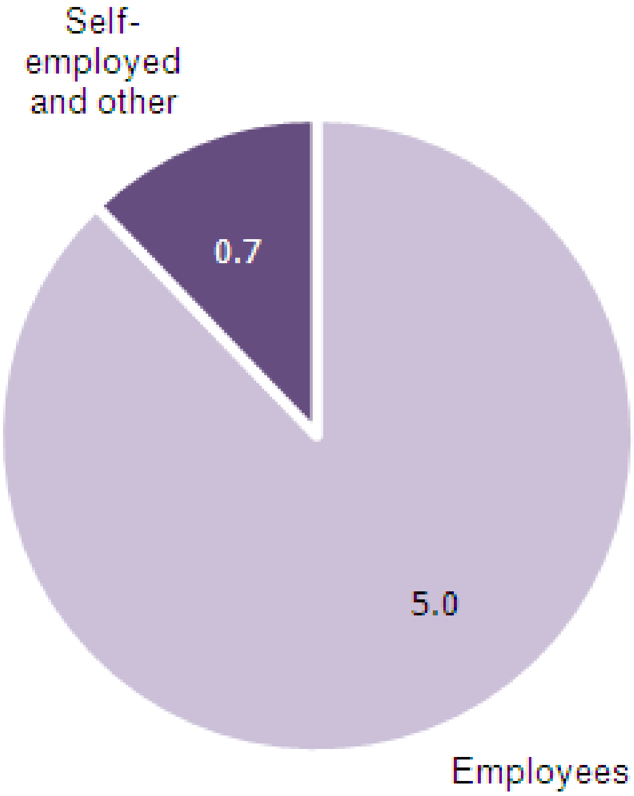
Figure 6.3 also shows that, in 2011, 59% of active members of occupational pension schemes belonged to funded schemes. Funded private sector schemes accounted for 35% of active membership, while funded public sector schemes accounted for 24% of active membership and 37% of active membership in the public sector[1]. Unfunded public sector schemes accounted for two-fifths (41%) of all active membership in 2011, and 63% of active membership in the public sector.

The proportion of private sector active members that are in occupational DC schemes has been gradually increasing in recent years, reaching 33% in 2011. However, the actual number of active members, while fluctuating slightly, has remained around 1.0 million. If we add this to the HM Revenue and Customs (HMRC) estimate of the number of individuals contributing to personal pensions (5.7 million), the total active membership of DC pensions can be estimated at 6.6 million[2] in 2011. Membership of employer sponsored (group) personal pensions has been increasing, leading to an overall increase in workplace DC membership (see Figure 6.8). However, as the number of active members in DC occupational pension schemes has remained broadly flat (OPSS) and the number of individual personal (or non-employer sponsored) pensions has been falling, the trend in overall DC membership is downwards.

Figure 6.4: Individuals contributing to all personal pensions: by occupational status, 2010/11.

United Kingdom, Millions.



Source: HM Revenue and Customs

Notes:

1. Personal pensions include stakeholder pensions and cover both group and individual personal pensions.

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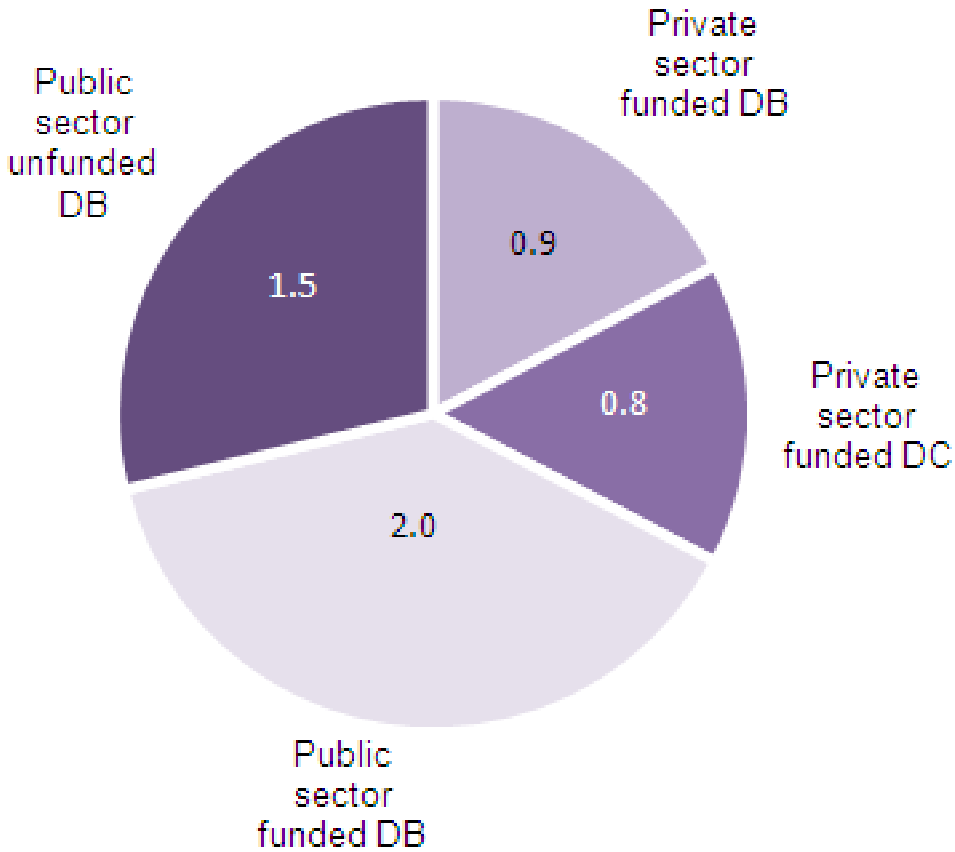
Figure 6.4 shows information from HMRC on the numbers of individuals contributing to personal pensions, including stakeholder pensions and covering both group and individual personal pensions. The majority (88%) of those contributing to personal pensions were employees. There were 0.7 million 'self-employed and other' individuals contributing to a personal pension in 2010/11, the majority (90%) of which were self-employed. (Pension Trends Chapter 7: Private pension scheme membership includes a section on the self-employed).

Figure 6.5 focuses on open schemes, which accept new members. A comparison of the results with those shown in Figure 6.3 (which includes active members of closed schemes) shows that, for the younger generation, the option of joining a DB scheme is much reduced. In 2011, there were only 0.9 million active members of open DB schemes in the private sector, compared with 1.9 million active members of private sector DB schemes as a whole (Figure 6.3). Over half (56%) of active members of private sector DB schemes were in schemes that were closed to new members. In the public sector, in 2011, over a third (35%) of active members were in schemes that were closed to new members.

Figure 6.5: Active members of open occupational pension schemes: by sector, funding approach and benefit structure, 2011.

United Kingdom, Millions.



Source: Occupational Pension Scheme Survey (OPSS) - Office for National Statistics

Notes:

1. Excluding where funding status is unknown (less than 0.01% of public sector active membership of open schemes).

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Notes

1. The Local Government Pension Scheme for local authority employees is the only major public sector scheme that is funded.

2. It should be noted that there is likely to be a small element of double counting here, as some people with occupational pensions may also contribute to personal pensions. According to estimates from the Family Resources Survey, less than 1% of individuals in the UK who had a pension had both a workplace and a personal pension in 2010/11. It should be noted that there is no public/private sector split available for personal pensions as a whole. While the majority of individuals with personal pensions are likely to be employed in the private sector, public sector employees may also have personal pensions (for example, the Civil Service offers a group stakeholder arrangement called Partnership).

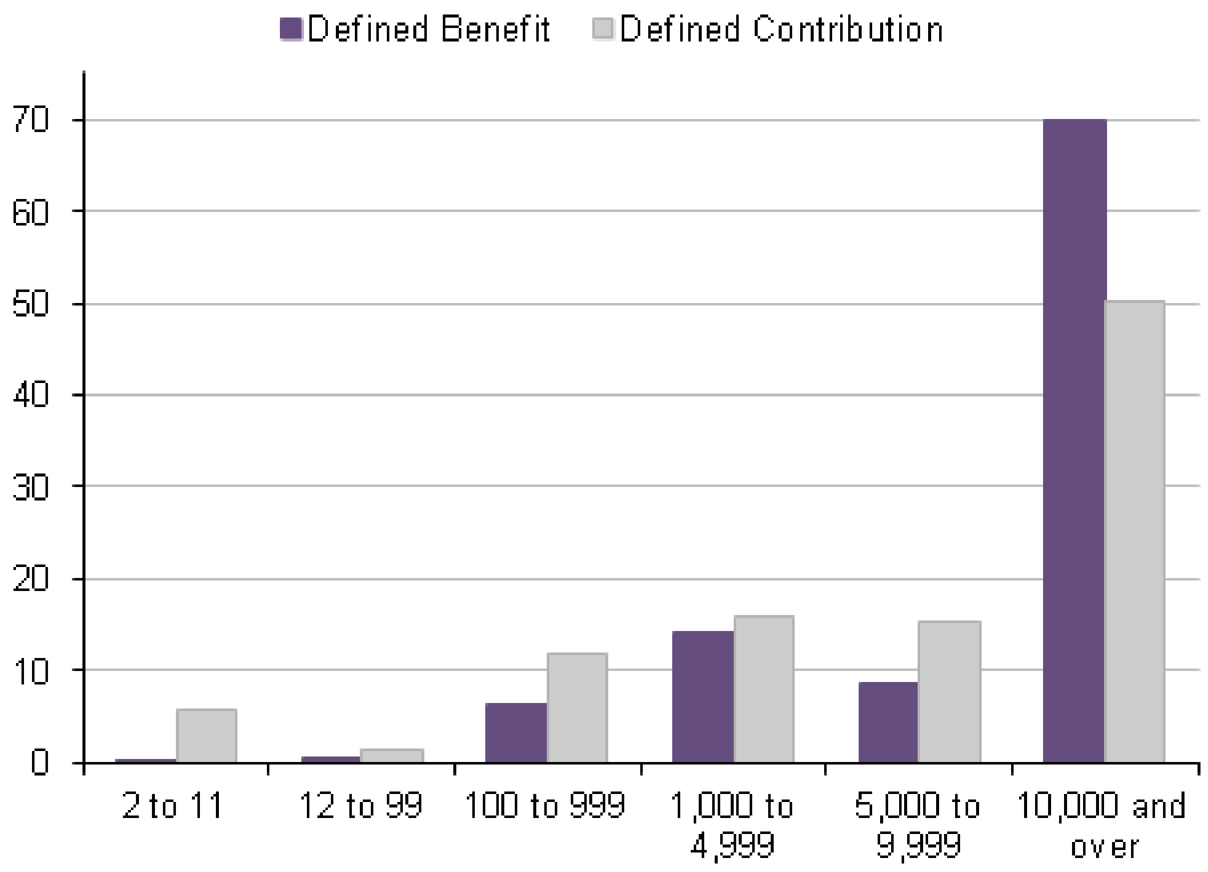
The importance of scheme size

One of the most important factors explaining the structure of the private pension system in the UK is the size of pension schemes, which is usually associated with size of employer. Defined Benefit (DB) schemes are traditionally mainly associated with large employers, while Defined Contribution (DC) schemes are frequently favoured by smaller employers. The public sector, predominately made up of large employers, has schemes which are mainly DB, while the private sector, with a mixture of employer sizes, has a mixture of DB and DC schemes. Further information about this can be found in Table 3.6 of the Office for National Statistics' (ONS) annual report on the Occupational Pension Schemes Survey (OPSS).

Within the private sector, there are a small number of large schemes and a much larger number of small schemes. However, the majority of active members belong to large schemes. This pattern is likely to be reinforced as automatic enrolment polices are implemented and employers enrol their employees into the National Employment Savings Trust (NEST), a large occupational pension scheme (see **Workplace pension reform**). However, given the possibility that NEST may generally be used more by the smaller employers (and their implementation dates are not until 2017 to 2018), the impact may not be seen immediately.

Figure 6.6: Distribution of active membership of private sector occupational pension schemes: by scheme size (total membership) and benefit structure, 2011.

United Kingdom, Percentages.



Source: Occupational Pension Scheme Survey (OPSS) - Office for National Statistics

Notes:

1. Open and closed schemes only.
2. Scheme size bands are based on total membership, i.e. actives plus pensioners plus those with preserved entitlements.

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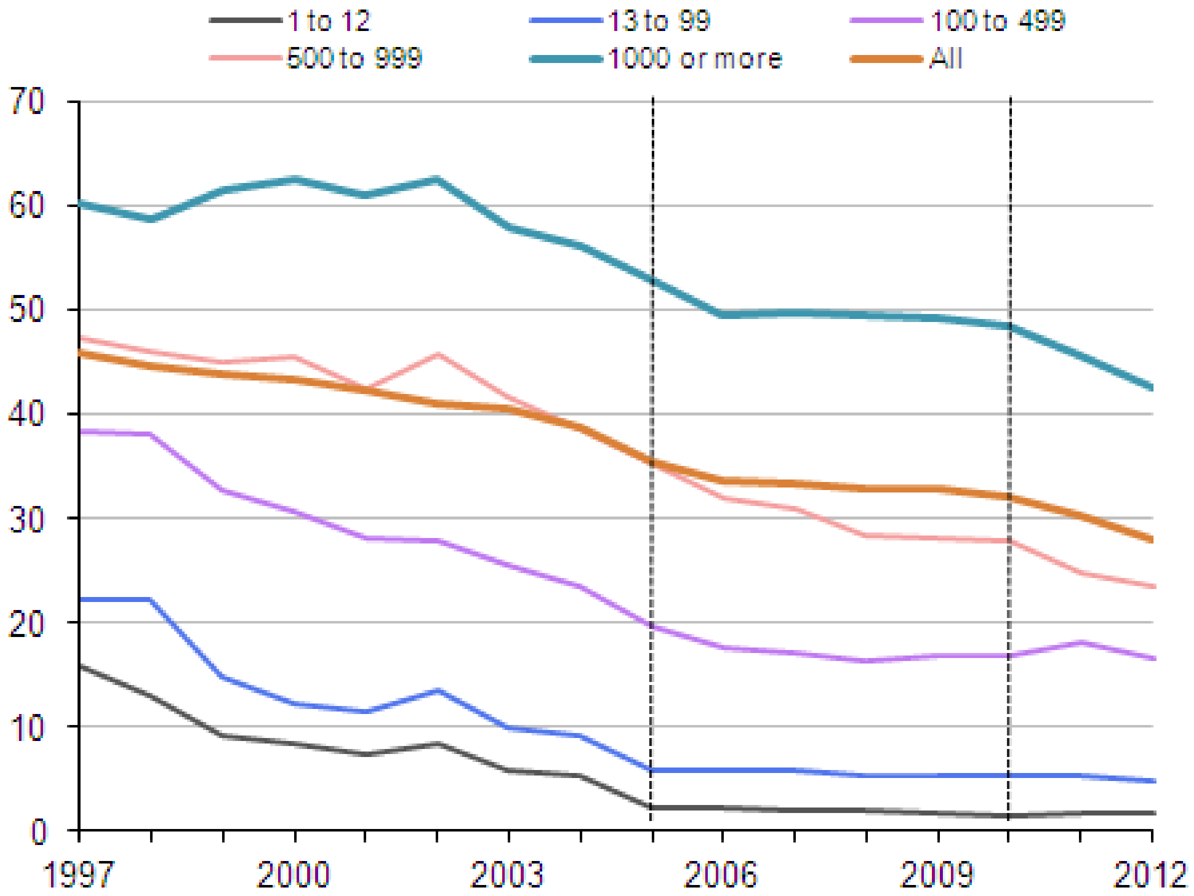
Figure 6.6 shows the 2011 distribution of active membership of open and closed private sector occupational pension schemes by scheme size (based on total membership) and benefit structure. DB schemes with 2 to 11 members made up less than 1% of active DB membership and DC schemes with 2 to 11 members accounted for around 6% of active DC membership. Membership was concentrated in the larger schemes, with 81% of active members of DC schemes belonging to those with 1,000 or more members. In 2011, 50% of active members of DC were in schemes with 10,000 or more members, a slight increase on the 2010 proportion of 44%.

The equivalent figures for DB schemes show that 93% of active members were in schemes with 1,000 or more members and 70% were in schemes with 10,000 or more members. DB schemes with 10,000 or more members accounted for nearly half (47%) of active membership of private sector occupational pension schemes in 2011.

Figures 6.7 and 6.8 use data from the Annual Survey of Hours and Earnings (ASHE) to examine trends in DB and DC workplace pension provision over time by size of employer.

Figure 6.7: Proportion of employees with a defined benefit workplace pension: by size of employer, 1997 to 2012.

United Kingdom, Percentages.



Source: Annual Survey of Hours and Earnings (ASHE) - Office for National Statistics

Notes:

1. Pension is arranged through an employer, main pension only.
2. The size of the employer is determined by the number of employees.
3. Results for 2005 onwards are based on a new questionnaire and may not be comparable with earlier results.
4. In 2011, the ASHE results were reweighted as a result of the introduction of the new SOC classification. Results for 2011 are presented on the SOC2010 basis. Estimates on the SOC2000 basis are less than 0.2 percentage points different from those presented in Figure 6.7.

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Figure 6.7 shows, for a given employer size, the proportion of employees who belonged to DB occupational pension schemes between 1997 and 2012. Overall, this proportion has fallen, from 46% in 1997 to 28% in 2012. Larger employers have a higher proportion of employees who are members of DB schemes than do smaller employers.

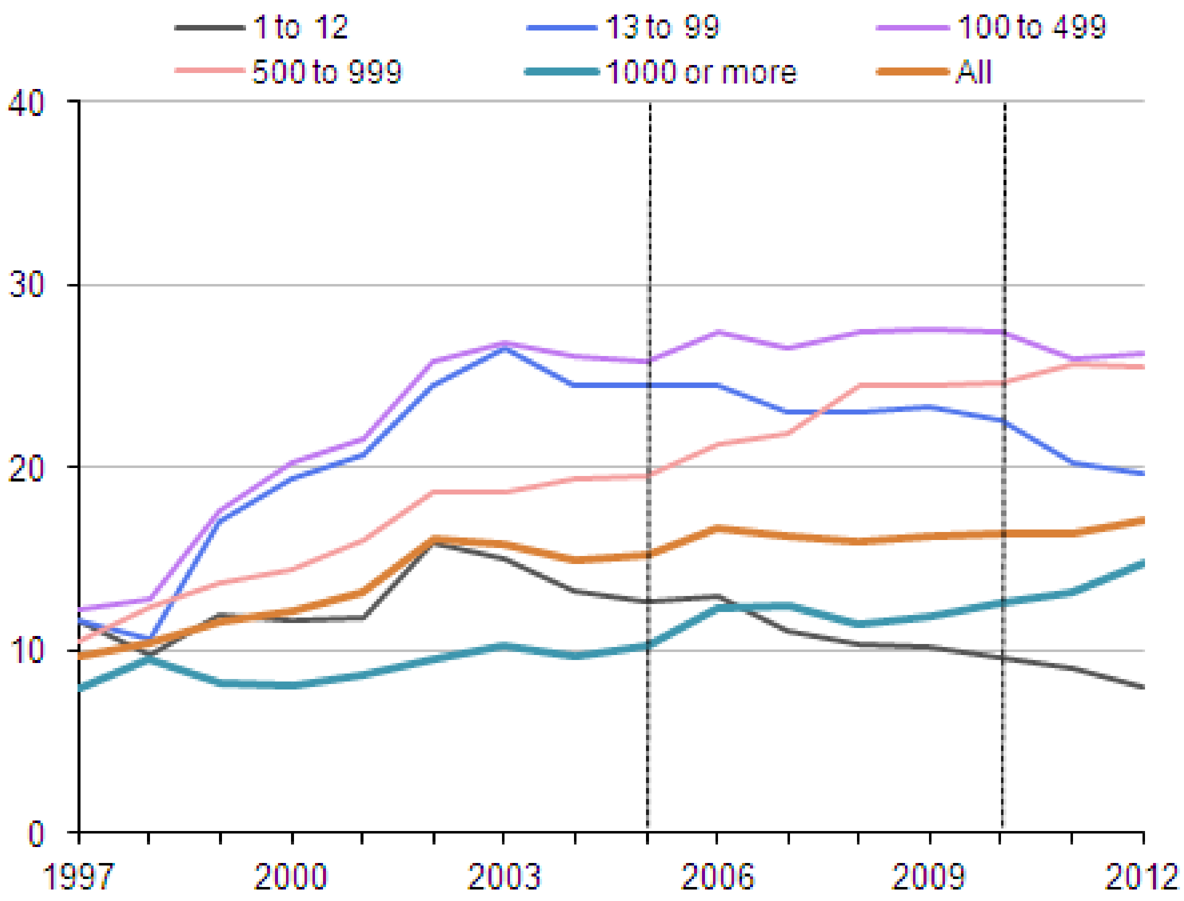
However, for employers with 1,000 or more employees, the proportion of employees who were members of DB occupational pension schemes has fallen from 60% in 1997 to 42% in 2012. For employers with 500 to 999 employees, the proportion has fallen from 47% in 1997 to 24% in 2012, while for employers with 100 to 499 employees, the proportion has fallen from 38% in 1997 to 17% in 2012.

At the same time, there has been an increase in DC pension provision in the workplace (DC occupational pension schemes, Group Personal Pensions (GPPs) and group stakeholder pensions). Figure 6.8 shows, for a given employer size, the proportion of employees with DC workplace pensions between 1997 and 2012. Overall, the proportion of employees with such pensions has risen from 10% to 17% over this period.

Most of the increase has taken place within companies that have between 100 and 999 employees. For employers with 100 to 499 employees, the proportion of employees with DC pensions increased from 12% in 1997 to 26% in 2012. For employers with 500 to 999 employees, the proportion increased from 11% in 1997 to 26% in 2012. The proportion of employees with DC pensions working for employers with 1,000 or more employees rose from 8% to 15%. Meanwhile, for employees working for small firms (with 1 to 12 employees and 13 to 99 employees), membership of DC pensions increased in the first part of this period, from 1997 to 2002 and 2003, before falling off in the second half.

Figure 6.8: Proportion of employees with a defined contribution workplace pension: by size of employer, 1997 to 2012.

United Kingdom, Percentages.



Source: Annual Survey of Hours and Earnings (ASHE) - Office for National Statistics

Notes:

1. Pension is arranged through an employer, main pension only.
2. Defined contribution (DC) covers occupational DC schemes, group personal and group stakeholder pensions.
3. The size of the employer is determined by the number of employees.
4. Results presented exclude membership where pension type is unknown, some of which will be DC membership.
5. Results for 2005 onwards are based on a new questionnaire and may not be comparable to earlier results.
6. In 2011, the ASHE results were reweighted as a result of the introduction of the new SOC classification. Results for 2011 onwards are presented on the SOC2010 basis.

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Public and private sector defined benefit scheme benefits

It is sometimes suggested that public sector schemes provide better pensions than private sector schemes. It is difficult to compare benefits in the two sectors because of their different structures.

The public sector is predominantly Defined Benefit (DB), while there is a mixture of DB and Defined Contribution (DC) provision in the private sector. However, one method of comparing benefits is to look at the 'accrual rate' for current employees in DB schemes in the two sectors. The accrual rate is the fraction of salary accrued by the employee for each year of service that will form the basis of the annual pension at retirement[1]. Table 6.9 compares the accrual rates of DB schemes in the public and private sectors.

Table 6.9: Proportion of active members of defined benefit occupational pension schemes: by accrual rate and sector, 2011.

United Kingdom

Percentages

	Private	Public
50ths or better	4	0
Between 50ths and 60ths	5	..
60ths plus an additional lump sum	2	12
60ths	38	36
80ths plus 3/80ths lump sum	26	48
Between 60ths and 80ths	14	4
80ths	8	..
Less generous than 80ths	2	0

Table notes:

1. Source: Occupational Pension Schemes Survey, Office for National Statistics.
2. Percentages are calculated excluding non-response.
3. Excludes schemes with fewer than 12 members.
4. .. indicates cells that have been suppressed to protect confidentiality.

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In 2011, 84% of public sector and 64% of private sector scheme members were accruing benefits at 60ths or at 80ths plus an additional 3/80ths lump sum (which is seen as comparable with 60ths in terms of benefits). Roughly the same proportion of scheme members, 12%, within both the public and private sector were accruing benefits at more generous rates than this. In the private sector, 24% of scheme members were accruing benefits at less generous rates than this, compared with approximately 4% of public sector scheme members.

Public sector schemes have traditionally had earlier pension ages[2] (age 60 or lower) than private sector schemes. Since the 1970s, OPSS results have shown that most private sector scheme members belong to schemes with a normal pension age of 65; in 2011, the figure was 74%. In the public sector, 56% of active members in 2011 were still accruing pension rights under rules which allowed them to retire at age 60 or before.

However, most public sector schemes have increased normal pension age to 65 in recent years, either for new entrants or for all members, so there will be increasing numbers of public sector employees to whom a normal pension age of 65 applies.

Recent legislation provides for the normal pension age for most public sector schemes to increase in line with State Pension Age (SPA). Some pension scheme members within the uniformed services will be exempt from this. For those members who are within schemes where the changes are applicable, such as those within the Civil Service pension scheme, this age is applicable to both new and existing members. However, those who are approaching their scheme's previous normal pension age will not be affected.

These changes were implemented as a result of recommendations in the 2011 report by the Independent Public Service Pensions Commission. The suggested changes were enacted by the 2013 Public Service Pensions Act, with Royal Assent on the 25th of April 2013.

Notes

1. For example, a 'final salary' defined benefit scheme might provide a pension based on an annual accrual rate of 1/80th: a person retiring after 40 years' service would accrue 40 times 1/80th or 40/80ths and, therefore, receive half of their final salary as a pension.

2. Normal pension age is defined as the age at which active members and deferred pensioners become entitled to receive their benefits.

Approaches to risk

Another important factor which helps to explain the structure of the private pension system, in particular the shift from Defined Benefit (DB) to Defined Contribution (DC) schemes in the private sector, is the approach to risk.

In DB schemes, the scheme rules specify or 'define' the rates of benefit to be paid. In funded DB schemes, the employer bears the investment risk and must pay out pensions at the agreed rate, regardless of the returns made on the invested contributions. Costs may be passed on to the next generation of employees in terms of reduced benefits, but current scheme members have a good idea of the pension that they will receive on retirement. This contrasts with the position of DC pensions, where current members' future pension benefits are not 'defined' and may be eroded by a fall in the value of pension fund investments. The stock market decline of 2008 was a reminder for many people with DC pensions that investment risk in such pensions is assumed by individual members rather than by their employers.

In addition to investment risk, employers providing DB pensions must account for longevity risk, the risk that the actual life expectancy of scheme members after retirement is different from that anticipated (see Pension Trends Chapters 2 & 3), and also for the cost of compulsory indexation to compensate for inflation in the case of deferred and pensioner members. For DC pensions, these and other risks, in particular those associated with purchasing an annuity, are borne by individual members rather than by employers. In recent years, people with DC pensions have faced declining annuity rates, which mean that their accumulated pension savings buy a smaller annual pension income than previously. More information about this can be found within Pension Trends Chapter 10 – Saving for Retirement. Further information about annuities in general can be found on The Money Advice Service's website.

DB schemes have to take account of risk in their funding strategies, and this has traditionally meant higher contributions from employers in order to be certain that the schemes can meet their projected pension liabilities. Employers with DC pensions do not have to make such payments because members are not guaranteed any particular level of pension.

Figure 6.10 shows the contribution rates for private sector occupational pension schemes, taken from the Occupational Pension Schemes Survey (OPSS). In 2011, employers with DB schemes paid 14.2% on average, compared with 6.6% for employers with DC schemes. Employees also contributed more into DB schemes on average than they did into DC schemes (4.9% and 2.8% respectively). The system of contracting out (at the time of the 2011 OPSS data collection) could account for some of the difference in contribution rates (see Pension Trends Chapter 8), but it may be that most of the difference can be attributed to the different approaches to risk management of DB and DC schemes.

Figure 6.10: Weighted-average contribution rates to private sector occupational pension schemes: by benefit structure and contributor, 2011.

United Kingdom, Percentages.

Source: Occupational Pension Scheme Survey (OPSS) - Office for National Statistics

Notes:

1. Includes schemes where standard contributions (from either the employee or the employer) were zero.
2. Excludes normal contributions paid as fixed amounts.
3. Includes reported rates for open, closed and frozen schemes.
4. Excludes schemes with fewer than 12 members.

Download chart

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(113 Kb)

Private sector schemes providing DB pensions and which have no Government guarantee must also pay an annual levy to the Pension Protection Fund (PPF) to protect members' pensions should the employer become insolvent. The PPF was set up under the Pensions Act 2004 to provide compensation to members of such pension schemes in cases when employers are declared insolvent and there are insufficient assets in the pension scheme to cover its liabilities.

De-risking and risk sharing

Given the rising costs of providing Defined Benefit (DB) pensions, which may be partly due to DB schemes' approach to dealing with risk and partly due to increasing longevity, a growing number of private sector employers have sought to 'de-risk' pension provision by closing DB schemes and replacing them with Defined Contribution (DC) schemes. More information on longevity and increasing life expectancy can be found within Pension Trends Chapter 3 – Life Expectancy and Healthy Ageing. This partly explains the shift in membership from DB to DC pensions in recent years. Also, some schemes have negotiated for existing DB liabilities to be permanently bought out by insurance companies and specialist buy-out firms (see Pension Trends Glossary (198.9 Kb Pdf)).

In addition, a variety of alternative retirement saving vehicles have emerged that attempt to offer a way of sharing the risks associated with workplace pension provision so that the risks for employers are smaller than in final salary DB schemes but do not fall entirely on the employee, as they do in DC pensions. Career Average Revalued Earnings (CARE) schemes (see **Definitions**), such as the Nuvos scheme for the Civil Service introduced in 2007, are an example of risk sharing.

Average member contribution rates to CARE schemes, at 5.4%, were higher than both the rates for DB schemes as a whole (4.9%) and for DC schemes (2.8%). Average employer contribution rates, at 11.5%, were lower than for DB schemes as a whole (14.2%) and higher than DC rates (6.6%).

Another risk sharing option involves providing a larger proportion of the final salary pension as a lump sum, or even providing the whole amount as a lump sum which the member has to annuitise or draw down. Here, the employer still bears the investment risk during the accumulation phase but avoids part or all of the post-retirement indexation and longevity risk. Hybrid pension schemes, which combine both DB and DC elements, are another way of sharing risk.

Further proposals for risk sharing can be found within a Department for Work and Pensions (DWP) paper produced in 2012 that is entitled, "Reinvigorating workplace pensions". In this, details are provided on new workplace pension arrangements known as Defined Ambition (DA), see Glossary (198.9 Kb Pdf).

Workplace pension reform

Although the UK has a well-established private pension system, there are concerns about funding retirement benefits for an ageing population (see Pension Trends Chapter 2). The Pensions Act 2008 put in place a framework for workplace pension reform designed to increase saving for retirement. This framework was amended slightly by the Pensions Act 2011 but, broadly, the reforms make the following changes:

- All eligible employees are to be automatically enrolled into a qualifying workplace pension scheme; and
- A new trust-based Defined Contribution DC pension scheme has been created, known as the National Employment Savings Trust (NEST), to assist employers with provision. NEST first started taking on new members at the end of 2011.

Starting in October 2012, with gradual roll-out to all employers by 2018, employers have a duty automatically to enrol all eligible employees into a qualifying pension scheme and to make contributions on their behalf. Workers will be able to opt out of their employer's scheme if they choose not to participate but, if they are still eligible, they will be re-enrolled after a three year period.

In order to qualify, most DC schemes will eventually have to make minimum contributions of 8% of an employee's qualifying earnings, of which at least 3% must come from the employer. However, there is a phasing in period, during which lower contributions are allowed (see Pension Trends Chapter 8).

The Pensions Act 2011 also introduced: an annual review of the auto-enrolment earnings trigger; an annual review of the upper or lower limits of the qualifying earnings band; and an optional waiting period of up to three months before an employee needs to be automatically enrolled into a workplace pension[1].

NEST meets the qualifying scheme standards and provides another option, in addition to the existing ones, for employers who do not have a scheme. It offers a choice of investment funds in addition to its default Retirement Date Funds for those members who do not make an investment choice[2]. Employees who join the scheme will be able to retain membership of NEST when they move jobs. Further details about this can be found within an explanatory note available on The Money Advice Service's website and within the **References** section of this article.

The 2012 reforms represent a major change in the UK private pension system, aiming to extend coverage to millions of employees who lack a private pension, in particular those in the target market of moderate to low earners. NEST, the option which is likely to be taken up by many employers who do not have a private pension scheme at present, has been set up on a DC basis. This is expected to increase the number of people contributing to DC pensions and it is thought that the primary users of NEST will be smaller employers.

Although the Pensions Act 2008 created NEST, other separate trust-based arrangements, known as master trusts (see Glossary (198.9 Kb Pdf)), have also been set up to facilitate auto-enrolment. Examples of these include Now Pensions and The People's Pension.

Further changes to private pension provision are being considered. For example, within the Department for Work and Pensions (DWP) report entitled, "Meeting future workplace pension challenges: improving transfers and dealing with small pension pots", some changes to the rules for the movement of small pension pots were considered. The proposals within this paper apply to DC pensions only. DWP have estimated that people will work for 11 different employers during their life and, as a result of auto-enrolment, they might acquire a number of small pensions from shorter periods of employment. One consideration is how easy these smaller values might be to annuitize in the current market. If this proves to be an issue, then it could possibly prevent people from obtaining the level of income they expect to receive in retirement. It might also be the case that some people may forget about the small pots they have acquired and so will receive no benefits from them.

Consequently, it has been proposed that smaller pension pots should follow people as they move jobs. It is thought that this will allow people to aggregate their pension saving into a pot which may have greater value when they retire. More information about this can be found in a DWP public consultation report and within the Pensions Bill 2013-14.

Notes

1. For the 2011 Pensions Act and for information on the latest earnings trigger and qualifying earnings bands.

2. See the NEST website for further details about this scheme.

Background notes

1. Details of the policy governing the release of new data are available by visiting www.statisticsauthority.gov.uk/assessment/code-of-practice/index.html or from the Media Relations Office email: media.relations@ons.gsi.gov.uk

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Supporting Information

Further information

Pension Trends – Chapter 7: Private Pension Scheme Membership, 2013 Edition
This chapter discusses membership of all types of non-state pension, referred to here as private pensions. These comprise occupational schemes for private sector and public sector employees; and personal pensions, including group personal pensions and stakeholder pensions.

Pension Trends Chapter 8: Pension Contributions, 2013 edition

This chapter looks at contributions to private (non-state) pensions using data from the Occupational Pension Schemes Survey, the Annual Survey of Hours and Earnings and from HM Revenue and Customs.

Related Internet Links

Pension Trends
consists of 14 chapters bringing together official statistics on pensions and retirement.

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5. Department for Work and Pensions Pensioner Income Series.

6. Pensions Act 2011.

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9. Public Sector Pensions Act 2013.

10. HM Revenue and Customs pension statistics website.

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