

# Pension Trends

## Chapter 6: Private pensions

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## Chapter 6: Private pensions

List of tables and figures		Page number	Type of information
Figure 6.1	Private pension system in the UK	6-3	NNS
Figure 6.2	Proportion of active members of private sector occupational pension schemes: by scheme's foundation date, status and benefit structure, 2009	6-5	NS
Figure 6.3	Active members of occupational pension schemes: by sector, funding approach and benefit structure, 2009	6-5	NS
Figure 6.4	Individuals contributing to personal pensions: by occupational status, 2008/09	6-6	NS
Figure 6.5	Active members of open occupational pension schemes: by sector, funding approach and benefit structure, 2009	6-6	NS
Figure 6.6	Distribution of active membership of private sector occupational pension schemes: by scheme size (total membership) and benefit structure, 2009	6-7	NS
Figure 6.7	Proportion of employees with a defined benefit workplace pension: by size of employer, 1997 to 2010	6-7	NS
Figure 6.8	Proportion of employees with a defined contribution workplace pension: by size of employer, 1997 to 2010	6-8	NS
Table 6.9	Proportion of active members of defined benefit occupational pension schemes: by accrual rate and sector, 2009	6-8	NS
Figure 6.10	Weighted-average contribution rates to private sector occupational pension schemes: by benefit structure and contributor, 2009	6-9	NS
Figure 6.11	Contribution rate required to bridge the pension gap in selected OECD countries	6-11	NNS
Figure 6.12	Contribution rate required to bridge pension gap in selected OECD countries with missing years of contributions	6-11	NNS
Figure 6.13	Contribution rate required to bridge pension gap in selected OECD countries by real rate of return on investment	6-11	NNS

### Note on the data presented in this chapter

#### Clickable tables and figures

All the tables and figures in this chapter are 'clickable'. This means that in the online version of the chapter, readers can click on any table or figure to download a spreadsheet containing the data used to create it.

#### Data sources and reliability

The data sources in this chapter are classed as National Statistics or as other types of official statistics ('Not National Statistics'). The **List of tables and figures** shows which classification

applies to each table or figure: National Statistics (NS) or not (NNS). Information quoted in the text is normally based on the tables and figures. Information in the text which is not based on a table or figure is classed as National Statistics unless otherwise stated.

The term 'National Statistics' is an accreditation quality mark which stands for a range of qualities such as relevance, integrity, quality, accessibility, value for money and freedom from political influence. Sources classed as National Statistics comply with the professional principles and standards set out the UK Statistics Authority's Code of Practice for Official Statistics. For further information on the Code of Practice, see: [www.statisticsauthority.gov.uk/assessment/code-of-practice/index.html](http://www.statisticsauthority.gov.uk/assessment/code-of-practice/index.html)

Data labelled as 'Not National Statistics' (NNS) does not comply fully with the required standards, but has still been deemed suitable for publication.

Further information on the sources used in Pension Trends can be found in the Guide to Pension Statistics at: [www.ons.gov.uk/ons/guide-method/method-quality/guide-to-pension-statistics/index.html](http://www.ons.gov.uk/ons/guide-method/method-quality/guide-to-pension-statistics/index.html)

# Private pensions

- In the UK, private pension schemes can be split into two main groups: occupational and personal. There are also differences between defined benefit (DB) and defined contribution (DC) schemes and funded and unfunded schemes (Figure 6.1).
- The latest official figures show 7.7 million active members of DB schemes and 7.4 million people contributing to DC (including personal) pensions (Figures 6.3 and 6.4).
- The number of people contributing to personal pensions fell from 7.6 million in 2007/08 to 6.4 million in 2008/09 according to the latest estimates published by HM Revenue and Customs.
- In 2009, 56 per cent of active members of private sector DB schemes were in schemes that were closed to new members; most public sector workers can still join a DB scheme (Figure 6.5).
- Employer and pension scheme size are related to benefit structure (DB/DC). The public sector – made up of large employers – has DB schemes, while the private sector – with a mixture of employer sizes – has a mixture of DB and DC schemes.
- In funded DB schemes, the employer bears the investment risk and must pay out pensions at an agreed rate. By contrast, investment risk in DC schemes is assumed by individual members.
- Workplace pension reforms will be implemented from 2012. They are likely to represent the biggest change in the UK private pension system since the 1980s, leading to a rapid increase in the number of people with DC pensions.
- The average gross ‘replacement rate’ – pension entitlement divided by average earnings – of mandatory pension systems in the 34 countries of the Organisation for Economic Co-operation and Development (OECD) is 57 per cent for average earners. Modelling by the OECD shows the contribution rates required by average earners with DC pensions to achieve this replacement rate (Figures 6.11 to 6.13).

This chapter looks at private pensions in the UK. By contrast with state pensions (see *Pension Trends* Chapter 5), which comprise the basic and additional state pensions (and related benefits such as Pension Credit), private (or non-state) 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.

The chapter provides an overview of the private pension system. It starts by comparing the UK system with that of other countries in the Organisation for Economic Co-operation and Development (OECD), and looks in some detail at the components of private pension provision. It then considers some of the key issues such as differences between provision in the private and public sectors, between funded and unfunded pensions and between defined contribution and defined benefit 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.

Some commentators argue that on average, public sector employees have better pension provision than private sector employees. A theme of this chapter is that the differences between public and private sector provision and the reasons for them are more complex than is apparent at first sight. The evidence suggests that the differences are associated with underlying factors, such as size of pension scheme (and employer) and approaches to management of risk.

## Replacement income

Pension systems are designed to provide 'replacement income' for those who are no longer earning an income through employment. The replacement rate is a measure of how effectively pension systems are able to replace earnings in retirement. The gross replacement rate is defined as gross pension entitlement divided by gross pre-retirement earnings<sup>1</sup>.

Pension systems are normally made up of two distinct components: a mandatory state component and a private (non-state) component. The relative importance of each component to the level of replacement income provided to an individual on retirement varies from one country to another. Some countries opt for pension systems designed to provide replacement income mainly through the state, while others place more emphasis on the private pension component. In some OECD countries such as Australia, Denmark, Iceland, Netherlands, Norway, Sweden and Switzerland, pension systems also include a mandatory private pension element.

In countries with relatively small mandatory pension components, individuals need to save on a voluntary basis to ensure that they have adequate incomes in retirement. In the 34 OECD countries, the average gross replacement rate provided by mandatory pension schemes for workers with average (mean) earnings is 57 per cent. This figure is based on cross-country modelling carried out by the OECD which relies on a number of simplifying assumptions<sup>2</sup>. This and the other figures quoted in this section are not National Statistics.

The difference between the OECD average and mandatory replacement rates that fall below this average is referred to as the 'pension gap'. The gross replacement rates of mandatory pension schemes for average earners range from highs of over 95 per cent in Iceland and Greece to lows of under 35 per cent for Ireland, Mexico, the UK and Japan. The UK, with a gross replacement rate of 32 per cent for average earners, has one of the largest pension gaps in the OECD, at 25 per cent.

It should be noted that in the OECD model, while the gross replacement rate for the UK mandatory (state) pension system incorporates the impact of state pension reforms under the Pensions Acts 1995 and 2007 (see *Pension Trends* Chapter 1), it does not take into account further changes which are currently being made or proposed by the UK Government such as moving indexation of state pensions from the Retail Prices Index (RPI) to the Consumer Prices Index (CPI), the introduction of the 'triple guarantee' for the Basic State Pension (uprating by average earnings growth, the CPI or 2.5 per cent – whichever is highest) further increases in State Pension Age, and the possible introduction of a single tier, flat-rate state pension<sup>3</sup>.

## 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 2008/09, over two-thirds of pensioner households in Great Britain (4.6 million) were in receipt of private pensions, although a significant number of pensioner households had low levels of private pension income.

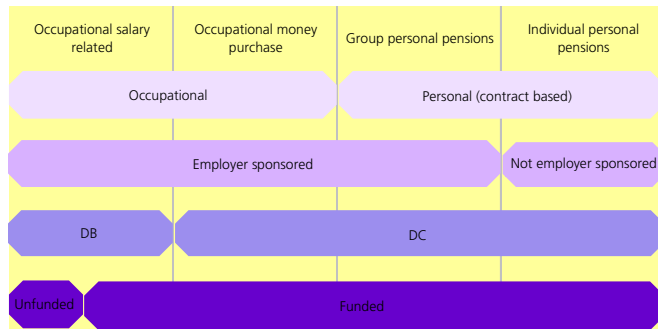
Voluntary private pension provision in the UK is encouraged by Government through the tax system<sup>4</sup>. Individuals' contributions to private pensions qualify for tax relief, as do the investment income and capital gains of pension funds. Many people can also take part of their pension as a tax-free lump sum when they retire<sup>5</sup>. In addition, employers receive tax and National Insurance relief on the contributions that they make towards employees' private pensions.

## 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: Adapted from 'Pensions: Challenges and Choices, the First Report of the Pensions Commission', Pensions Commission 2004

Occupational pensions are provided by employers (see Box: **Occupational pensions**). In 2009, there were 8.7 million active members of UK occupational schemes, according to the Occupational Pension Schemes Survey of the Office for National Statistics. 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 (see Box: **Personal pensions**). In 2008/09, 6.4 million individuals contributed to personal pensions according to data from HM Revenue and Customs.

Although group personal pensions (GPPs), group stakeholder pensions and group SIPPs may be sponsored by employers, with the employers facilitating payment of contributions for the members, the legal contract for all personal pensions is between the individual and the pension provider.

Workplace pensions comprise occupational pensions (provided by employers) and GPPs, group stakeholder and group SIPPs (facilitated by employers). It is not compulsory for UK employers to sponsor pension provision in the workplace or for employees to join pension schemes where they are offered. However, from 2012, employees will be automatically enrolled into workplace pension schemes (see below: **Workplace pension reform**).

Figure 6.1 shows that occupational schemes can be divided into defined benefit (DB) and defined contribution (DC) schemes (see Box: **DB and DC pensions**). All personal pensions are DC. The private sector has a mixture of DB and DC pensions, while all the main public sector schemes are predominantly DB.

Figure 6.1 also shows that private pensions can be classified according to the funding approach taken: funded or unfunded (see Glossary). Funded consists of private sector occupational pension schemes, individual and employer-sponsored personal pensions and the Local Government Pension Scheme 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, armed forces, National Health Service (NHS), teachers, police and firefighters. The benefits of unfunded public service schemes are financed from general taxation and employee contributions.

### 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<sup>6</sup> members with some preserved pension.
- **Pensioner members:** those receiving pension payments from the 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<sup>7</sup>.

## 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 and, if an annuity is taken, the 'annuity rate' (the factor used to convert the member's fund into a pension) at or after retirement.

**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. They have grown strongly since 6 April 2006 ('A-day'), when the rules were changed to encourage investment in SIPPs.

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 sponsored by employers, and are therefore a form of workplace pension, but 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. The most common DB scheme 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. These base the pension on earnings over the whole career.

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.

rates based on predicted estimates of a person's mortality and the rate of return on long-dated Government bonds (Gilts) to decide the level of payments made to an individual.

The amount of the annuity offered at retirement will depend on a combination of the size of the individual's fund, the annuity rate used and the type of annuity chosen. There are different types of annuity that can be purchased at retirement:

- **Level annuities** provide the same level of payments for the whole of retirement. Their real value is eroded over time by inflation.
- **Index-linked annuities** 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.
- With an **escalating annuity**, payments rise over time by a fixed amount every year; again, the starting point will be lower than for a level annuity.

## 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 per cent of a DC pension fund can be taken in this way).

Annuities are a financial instrument provided by an insurance company that pays 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. As some holders will die sooner than others, their funds will cover the payments for members whose life expectancy exceeds the average and whose pensions will need to be paid for a longer period. Insurance companies use annuity

Until 5 April 2011, people with DC pensions had to buy an annuity between the ages of 55 and 75. The alternative to buying an annuity before age 75 was an unsecured pension. 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 form of income drawdown for those aged over 75, suitable for individuals with a principled objection to pooling mortality risk which prevents them from purchasing a pension annuity.

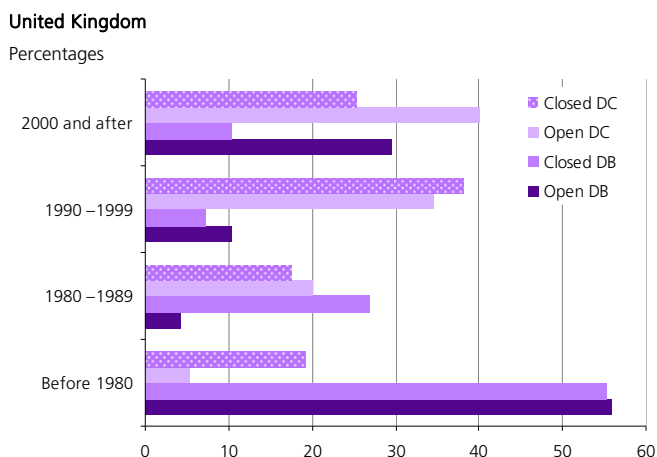
From 6 April 2011, however, people with DC pensions are no longer required to buy an annuity by age 75. At any time from age 55 they can either buy an annuity or opt for 'drawdown'. In either case, 25 per cent of the fund can be taken as a tax-free lump sum. The drawdown option allows people with a lifetime pension income of £20,000 or more the option of taking unlimited amounts out of their pension fund at any time ('flexible drawdown'), while people with less than £20,000 can take up to an amount equivalent to what they would receive from an annuity in any one year ('capped drawdown'). 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.

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

### The changing landscape

From the 1950s to the 1980s, most occupational pension schemes were 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 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**  
**Proportion of active members of private sector occupational pension schemes: by scheme's foundation date, status and benefit structure<sup>1</sup>, 2009**

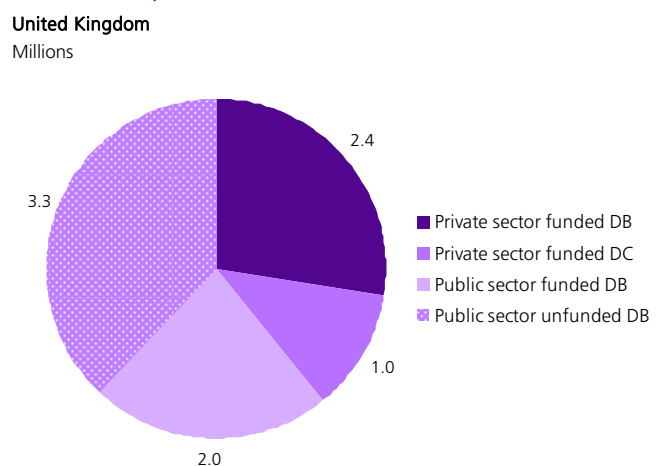


<sup>1</sup> Excludes schemes with fewer than 12 members.

Source: Occupational Pension Schemes Survey, Office for National Statistics

Figure 6.2 shows active membership of private sector DB and DC occupational schemes by their scheme foundation dates. It should be noted that results for DB schemes in the Occupational Pension Schemes Survey (OPSS) include hybrid schemes (see Glossary). Most active members of open DC schemes in the 2009 OPSS (95 per cent) were in schemes founded in 1980 or later and 40 per cent were in schemes founded in 2000 or later. By contrast, 56 per cent of active members of open DB schemes in the 2009 OPSS were in schemes founded before 1980. It is interesting to observe that 29 per cent of active members of open DB schemes were in schemes that were founded in 2000 and after, although some of these new schemes may have been replacements for existing schemes. Further analysis of the data shows that most of these new schemes were founded between 2000 and 2004.

**Figure 6.3**  
**Active members of occupational pension schemes: by sector, funding approach and benefit structure<sup>1,2</sup>, 2009**



<sup>1</sup> Open and closed schemes only.

<sup>2</sup> Excluding where funding status is unknown (less than 0.5 per cent of public sector active membership).

Source: Occupational Pension Schemes Survey, Office for National Statistics

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

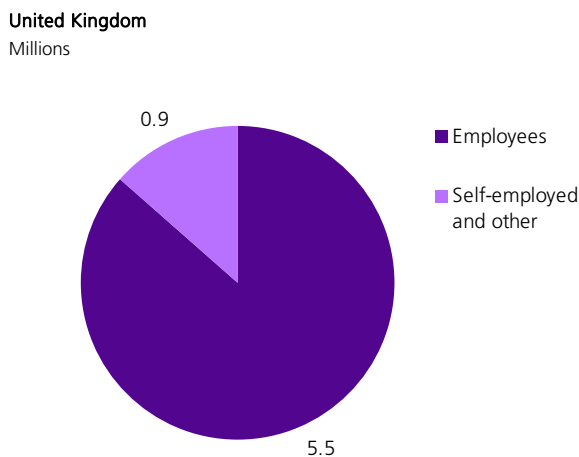
current pension system and its implications for the current generation of working age people when they retire.

In 2009, 89 per cent of active members of occupational pension schemes (7.7 million) belonged to DB schemes (Figure 6.3). Over two-thirds of this membership was in the public sector and less than one-third was in the private sector.

In the private sector, 29 per cent of active members of occupational schemes (1.0 million) belonged to DC schemes. According to figures published recently by HM Revenue and Customs (HMRC), there were 6.4 million individuals contributing to personal pensions in 2008/09 (Figure 6.4). If we add together the figures for active membership of DC occupational pension schemes and personal pensions, the total active membership of DC pensions (including personal pensions) can be estimated at 7.4 million. 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<sup>8</sup>.

The figures published recently by HMRC, which are based on a revised methodology<sup>9</sup>, show a sharp fall in the number of individuals contributing to personal pensions in 2008/09 compared with 2007/08, when 7.6 million individuals were estimated to be contributing. This was because many people who had made small contributions to personal pensions in 2007/08 stopped contributing in 2008/09, probably due to increased financial pressures during the recession.

**Figure 6.4**  
Individuals contributing to personal pensions: by occupational status<sup>1</sup>, 2008/09



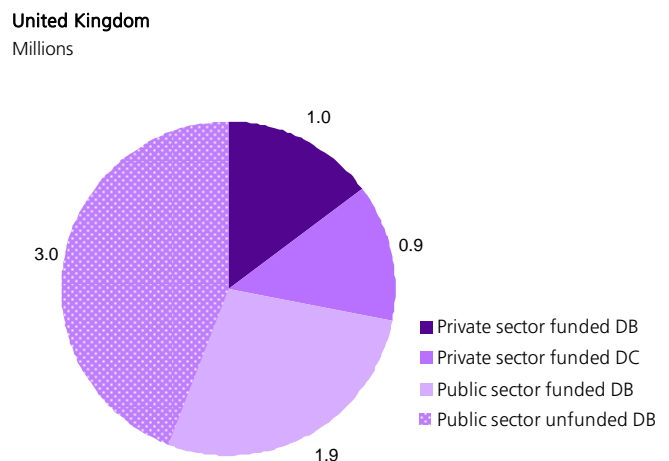
<sup>1</sup> Personal pensions include stakeholder pensions.

Source: HM Revenue and Customs

Figure 6.3 also shows that in 2009, 62 per cent of active members of occupational pension schemes belonged to funded schemes. Funded private sector schemes accounted for 38 per cent of active membership, while funded public sector schemes accounted for 23 per cent of active membership and nearly two-fifths of active membership in the public sector<sup>10</sup>. Unfunded public sector schemes accounted for 38 per cent of all active membership in 2009, and 62 per cent of active membership in the public sector.

Figure 6.5 focuses on open schemes, which new members can join. A comparison of the results with those shown in Figure 6.3 (open and closed schemes) shows that for the younger generation the option of joining a private sector DB scheme is much reduced: in 2009, there were only 1.0 million active members of open DB schemes in the private sector, compared with 2.4 million active members of private sector DB schemes as a whole (open and closed); 56 per cent of active members of private sector DB schemes were in schemes that were closed to new members. On the other hand, most public sector employees can join DB schemes – even if some options (old DB schemes or sections) are not available to new members.

**Figure 6.5**  
Active members of open occupational pension schemes: by sector, funding approach and benefit structure<sup>1</sup>, 2009



<sup>1</sup> Excluding where funding status is unknown (less than 0.5 per cent of public sector active membership).

Source: Occupational Pension Schemes Survey, Office for National Statistics

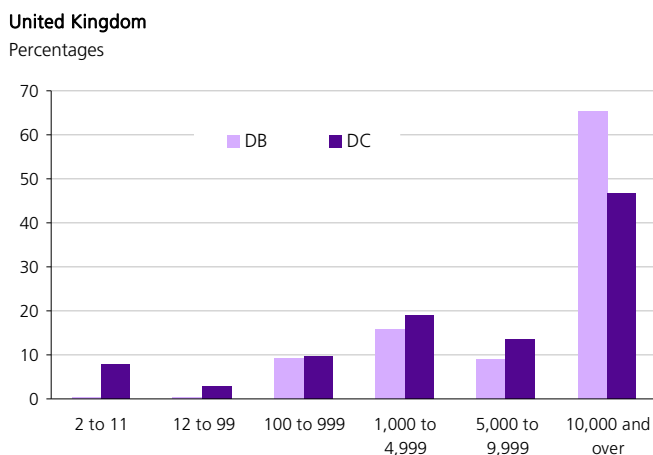
**The importance of size**

One of the most important factors explaining the structure of the private pension system in the UK is size of pension schemes, which is usually associated with size of employer. DB schemes are traditionally associated with large employers (although they also work for small employers), while DC schemes are

frequently favoured by smaller employers. Thus, it is not surprising that the public sector – made up of large employers – has DB schemes, while the private sector – where there is a mixture of large and small employers – has a mixture of DB and DC schemes.

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 from 2012 as many employers enrol their employees into the National Employment Savings Trust (NEST), which is a large occupational pension scheme (see below: **Workplace pension reform**).

**Figure 6.6**  
**Distribution of active membership of private sector occupational pension schemes: by scheme size (total membership) and benefit structure<sup>1</sup>, 2009**



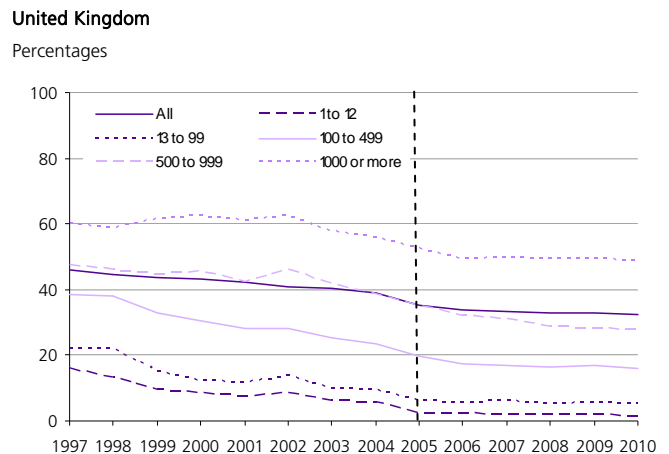
1 Open and closed schemes only.

Source: Occupational Pension Schemes Survey, Office for National Statistics

Figure 6.6 shows the distribution of active membership of open and closed private sector occupational pension schemes by scheme size (based on total membership) and benefit structure in 2009. DB schemes with 2 to 11 members made up less than 1 per cent of active DB membership and DC schemes with 2 to 11 members accounted for 8 per cent of active DC membership. Membership was concentrated in the larger schemes, with 79 per cent of active members of DC schemes belonging to schemes with 1,000 or more members and 47 per cent to schemes with 10,000 or more members. The equivalent figures for DB schemes show that 90 per cent of active members were in schemes with 1,000 or more members and 65 per cent were in schemes with 10,000 or more members. DB schemes with 10,000 or more members accounted for nearly half (46 per cent) of active membership of private sector occupational pension schemes in 2009.

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<sup>1,2,3,4</sup>, 1997 to 2010**



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 Results may be a slight underestimate of the proportion with DB pensions because some employees are recorded as 'pension type unknown', and this category may include DB pensions.

Source: Annual Survey of Hours and Earnings, Office for National Statistics

Figure 6.7 shows, for a given employer size, the proportion of employees who belonged to DB occupational pension schemes between 1997 and 2010. Overall, this proportion has fallen, from 46 per cent in 1997 to 32 per cent in 2010. Larger employers have a higher proportion of employees as members of DB schemes than 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 by 12 percentage points to 49 per cent in 2010. For employers with 500 to 999 employees, the proportion has fallen by 20 percentage points to 28 per cent in 2010, while for employers with 100 to 499 employees, the proportion has fallen by 22 percentage points to 16 per cent in 2010.

At the same time, there has been an increase in DC pension provision in the workplace (DC occupational pension schemes, 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 2010. Overall, the proportion of employees with such pensions has risen from 10 per cent to 16 per cent over this period. Most of the increase has taken place in medium-sized workplaces. For employers with 100 to 499 employees, the proportion of employees with

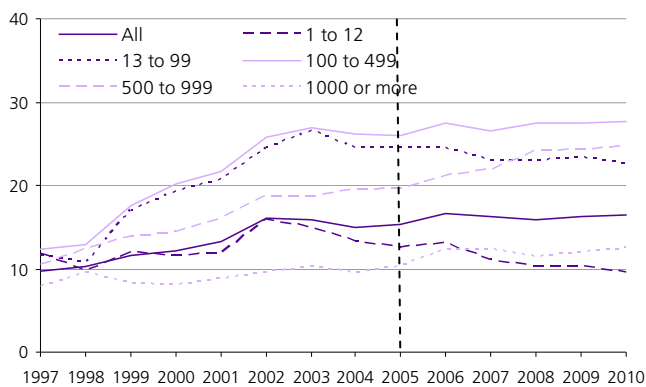
DC pensions increased from 12 per cent in 1997 to 28 per cent in 2010. For employers with 500 to 999 employees, the proportion increased from 11 to 25 per cent. The proportion of employees with DC pensions working for employers with 1,000 or more employees rose less rapidly, from 8 to 13 per cent. Meanwhile, 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 2002-03, before falling off in the second half.

## Figure 6.8

### Proportion of employees with a defined contribution workplace pension: by size of employer<sup>1,2,3,4,5</sup>, 1997 to 2010

United Kingdom

Percentages



- 1 Pension is arranged through an employer, main pension only.
- 2 Defined contribution occupational pension schemes, group personal pension schemes and stakeholder pension schemes.
- 3 The size of the employer is determined by the number of employees.
- 4 Results for 2005 onwards are based on a new questionnaire and may not be comparable with earlier results.
- 5 Results may be a slight underestimate of the proportion with DC pensions because some employees are recorded as 'pension type unknown', and this category may include DC pensions.

Source: Annual Survey of Hours and Earnings, Office for National Statistics

## Public and private sector DB scheme benefits

It is often 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 DB while there is a mixture of DB and DC provision in the private sector). However, it is possible to compare pension benefits for current employees in DB schemes in the two sectors by looking at the 'accrual rate'. This 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<sup>11</sup>. To examine whether public sector schemes provide better pension benefits than their private sector equivalents for

the current generation of employees, 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<sup>1,2,3,4</sup>, 2009

United Kingdom

Percentages

	Private sector	Public sector
50ths or better	5	0
Between 50ths and 60ths	4	..
60ths plus an additional lump sum	11	9
60ths	47	22
80ths plus 3/80ths lump sum	16	53
Between 60ths and 80ths	10	4
80ths	6	11
Less generous than 80ths	0	0

- 1 Percentages are calculated excluding non-response.
- 2 Excludes schemes with fewer than 12 members.
- 3 .. indicates cells that have been suppressed to protect confidentiality.
- 4 A 'new look' Local Government Pension Scheme (LGPS) for local authority employees was launched in England and Wales from April 2008 and in Scotland from April 2009. One of the key changes was to amend the benefit structure so that future accrual of pensions was based on rates of 1/60th (previously 1/80th).

Source: Occupational Pension Schemes Survey, Office for National Statistics

On the basis of the results shown in Table 6.9, it would be difficult to judge which of the two sectors had more generous accrual rates. In 2009, 76 per cent of public sector and 63 per cent of private sector scheme members were accruing benefits at 60ths or at 80ths plus an additional 3/80th lump sum (which is seen as comparable with 60ths in terms of benefits). However, 20 per cent of private sector scheme members were accruing benefits at more generous rates than this, compared with less than 10 per cent of public sector scheme members.

Public sector schemes have traditionally had earlier normal pension ages<sup>12</sup> than private sector schemes (age 60 or lower). Since the 1970s, the OPSS results have shown that between three-fifths and three-quarters of private sector scheme members belong to schemes with a normal pension age of 65; in 2009, the figure was 70 per cent. In the public sector, the majority of active members in 2009 (62 per cent) 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 are increasing numbers of public sector employees to whom a normal pension age of 65 applies. As a result of recommendations outlined in the recent report of the Independent Public Service Pensions Commission chaired by Lord Hutton of Furness<sup>13</sup>, those still accumulating rights under

rules which allow them to draw a pension in normal circumstances at age 60 are likely to be moved into schemes with a normal pension age of 65 (increasing in future in line with proposed increases in State Pension Age) by the end of this Parliament.

## Approaches to risk

Another important factor which helps to explain the structure of the private pension system – in particular the shift from DB to 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 forceful 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 greater than anticipated (see *Pension Trends* Chapter 3) – and also the cost of compulsory indexation to compensate for inflation for 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 less pension income than previously. 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 pay such risk premia because members are not guaranteed any particular level of pension.

Figure 6.10 shows the contribution rates of private sector occupational pension schemes. Employers with DB schemes paid 16.5 per cent on average in 2009, compared with 6.4 per cent for employers with DC schemes. Employees also contributed more into DB schemes on average than they did into DC schemes (5.2 per cent and 2.9 per cent respectively). The system of contracting out (see Glossary) accounts for some

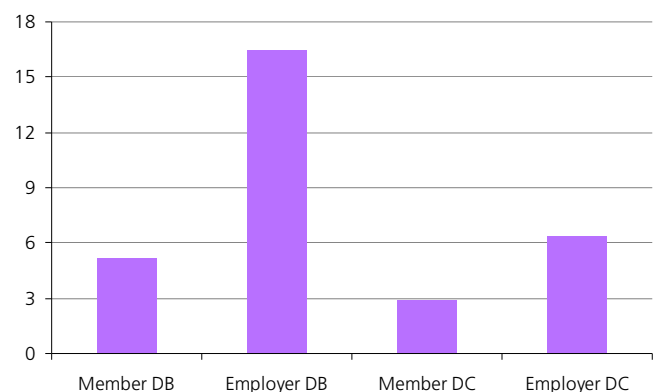
of the difference in contribution rates (see *Pension Trends* Chapter 8), but most of the difference can be attributed to different approaches to risk management of DB and DC schemes.

**Figure 6.10**

### Weighted-average contribution rates to private sector occupational pension schemes: by benefit structure and contributor<sup>1,2,3,4</sup>, 2009

United Kingdom

Percentages



1 Includes schemes where standard contributions were zero.

2 Excludes normal contributions paid as fixed amounts.

3 Includes rates for open, closed and frozen schemes.

4 Excludes schemes with fewer than 12 members.

**Source: Occupational Pension Schemes Survey, Office for National Statistics**

Private sector employers with no Government guarantee who provide DB pensions must also pay an annual levy to the Pension Protection Fund (PPF) to protect members’ pensions should they 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 DB pensions because of DB schemes’ approach to dealing with risk, a growing number of private sector employers have sought to ‘de-risk’ pension provision by closing DB schemes and replacing them with DC schemes. This 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.

In addition, a variety of alternative retirement saving vehicles have emerged that attempt to offer a way of sharing the risks associated with employer-sponsored provision so that the risks for employers are smaller than in final salary DB schemes but do

not fall entirely on the employee, as in DC pensions. CARE schemes (see Box: **DB and DC pensions**), such as the Nuvos scheme for the civil service introduced in 2007, are an example of risk sharing. The Independent Public Service Pensions Commission chaired by Lord Hutton has proposed that all public sector schemes move to a CARE model. 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 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.

Pensions industry groups such as the National Association of Pension Funds (NAPF) and the Association of Consulting Actuaries (ACA) have called on the Government to encourage risk sharing options in the private sector. They argue that this would increase predictability of future pension commitments for employers and improve stability for pension scheme members.

### Workplace pension reform

Although the UK has a well-established private pension system, there are concerns about the cost of providing state 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. There will be two main changes to the UK private pension system from 2012:

- the automatic enrolment of all eligible employees into a qualifying workplace pension scheme; and
- the introduction of a new trust-based DC pension scheme known as the National Employment Savings Trust (NEST) – formerly ‘personal accounts’.

Parliament is currently debating the Pensions Bill 2011 which proposes to amend the legislation to incorporate recommendations from a review of automatic enrolment carried out by the Government in June to October 2010. However, the proposed changes do not involve a major departure from the Pensions Act 2008<sup>14</sup>.

Starting in October 2012, with gradual roll-out to all employers by September 2016, employers will have a duty to automatically 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 they will be re-enrolled after three years (the Pensions Bill 2011 proposes three months’ flexibility either side of the scheduled re-enrolment date). In order to qualify, DC schemes will have to make minimum contributions of 8 per cent

on a band of earnings, of which at least 3 per cent must come from the employer. However, there will be a phasing in period, when lower contributions will be allowed (see *Pension Trends* Chapter 8). DB schemes that are contracted out of the State Second Pension will need to hold a contracting out certificate. DB schemes that are not contracted out will need to have an accrual rate of at least 1/120th of qualifying earnings for each year’s service (up to a maximum of 40 years).

NEST will meet the qualifying scheme standards and provide another option (in addition to the existing ones) for employers who do not have a scheme. It will offer a choice of investment funds in addition to its default Retirement Date Funds for those members who do not make an investment choice<sup>15</sup>. Employees who join the scheme will be able to retain membership of NEST when they move jobs.

The 2012 reforms are likely to be the biggest change in the UK private pension system since the 1980s, as they should extend coverage to millions of employees who currently lack a private pension, in particular those in the target market of moderate to low earners. It is significant that NEST – the option which is likely to be taken up by many employers who do not have a private pension scheme at present – is being set up on a DC basis. This is expected to increase the number of people contributing to DC pensions, as discussed in the next section.

### The future of private pensions

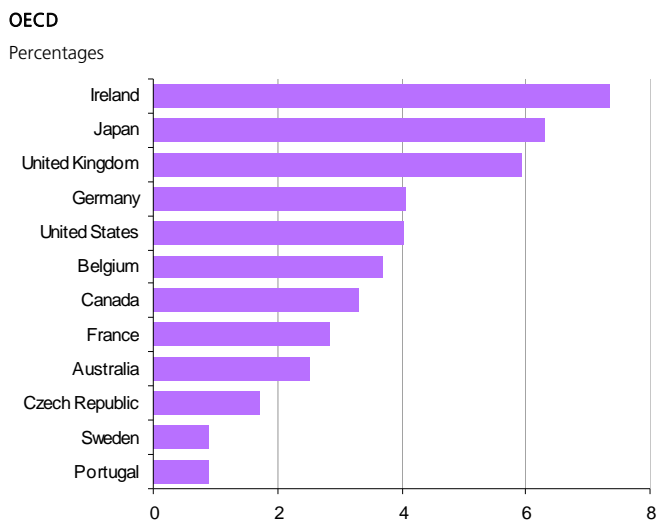
The 2012 workplace pension reforms are designed to increase coverage of private pensions, particularly for private sector employees who are not making adequate provision for old age. Assuming, as appears likely, that most of the expansion in coverage will take place through NEST and other DC pensions, the reforms could double the membership of DC pensions.

The likely result is that by the end of this decade the majority of active members of private pension schemes in the UK will be in DC pensions, by contrast with the current situation where there are more active members of DB than of DC pensions (see above: **The changing landscape**). This raises the question of whether DC pensions will be capable of providing sufficient pension income for future generations of pensioners.

Figure 6.11 builds on the idea of the ‘pension gap’ (see above: **Replacement income**) to explore the contribution rates required in voluntary pension systems to achieve the average gross replacement rate of OECD mandatory pension systems (57 per cent). For simplicity and comparability, the OECD calculations assume that people with voluntary pensions have a private DC pension plan. The analysis also assumes full work

histories: people enter the labour market in 2006 at age 20 and work continuously until State Pension Age (SPA), which differs from country to country. As the model assumes unbroken work histories, it does not take into account the variations which exist between countries in average length of work histories.

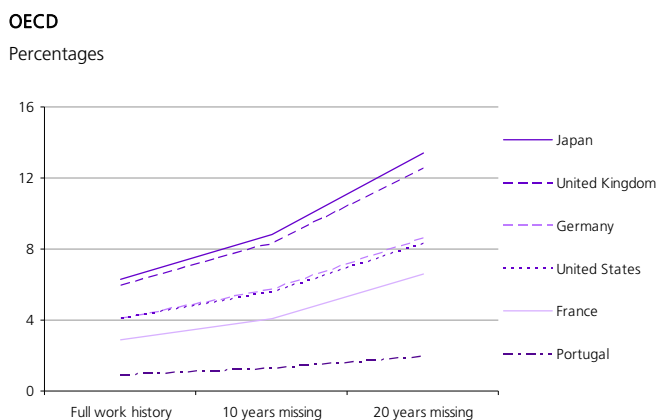
**Figure 6.11**  
**Contribution rate required to bridge the pension gap in selected OECD countries<sup>1,2,3</sup>**



- 1 Contribution rates required by average earner with DC pension to reach OECD average gross replacement rate from mandatory pension schemes.
- 2 Assumes 3.5 per cent real investment return net of administrative charges.
- 3 Assumes a full work history from age 20 in 2006 to State Pension Age, which differs from country to country. Length of full work history is assumed to be 45 years for the majority of countries but 41 years for France and 47 for the United States and Belgium.

Source: OECD pension models

**Figure 6.12**  
**Contribution rate required to bridge pension gap in selected OECD countries with missing years of contributions<sup>1,2,3</sup>**



- 1 Contribution rates required by average earner with DC pension to reach OECD average gross replacement rate from mandatory pension schemes.
- 2 Assumes 3.5 per cent real investment return net of administrative charges.
- 3 Length of full work history is assumed to be 45 years for the majority of countries but 41 years for France and 47 for the United States.

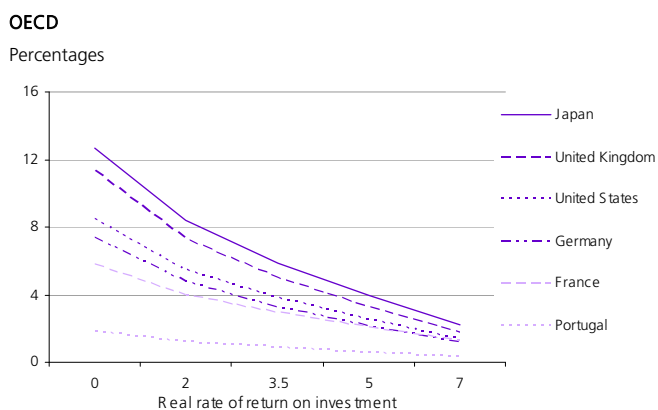
Source: OECD pension models

In the OECD pension model, the UK has one of the largest pension gaps of OECD countries, at 25 per cent. This means that it needs relatively high private pension contribution rates to close the gap. Assuming a real rate of investment return of 3.5 per cent net of administrative charges, the contribution rate required for average earners in the UK with a full work history (assumed to be 45 years) is 5.9 per cent (Figure 6.11), below those of Japan and Ireland but higher than the contribution rates which would be needed in most other OECD countries.

Figure 6.12 shows the effect of reducing the number of years for which contributions are made. Assuming a real investment return of 3.5 per cent (net), an average earner in the UK with ten missing years of contributions would need to pay 8.3 per cent of earnings into a DC pension scheme in order to bridge the pension gap. With 20 missing years, contributions would need to be made at 12.5 per cent of earnings.

Figure 6.13 shows how different investment returns can affect the level of contributions that average earners with full work histories need to make to DC schemes to bridge the pension gap. The lower the rate of investment return, the higher the contribution rate required to bridge the gap. With a real rate of investment return at 2 per cent, an average UK earner with a full work history would need to contribute 7.3 cent of earnings throughout their career to achieve the OECD average gross replacement rate from mandatory pension schemes. With a real rate of return of 7 per cent, the level of contributions needed falls to 1.7 per cent of earnings.

**Figure 6.13**  
**Contribution rate required to bridge pension gap in selected OECD countries by real rate of return on investment<sup>1,2,3</sup>**



- 1 Contribution rates required by average earner with DC pension to reach OECD average gross replacement rate from mandatory pension schemes.
- 2 Real rates of return are net of administrative charges.
- 3 Assumes a full work history from age 20 in 2006 to State Pension Age, which differs from country to country. Length of full work history is assumed to be 45 years for the majority of countries but 41 years for France and 47 for the United States.

Source: OECD pension models

The OECD analysis is based on models of possible outcomes, using different assumptions to illustrate scenarios. It is not possible to establish with any certainty what the results will be in specific cases, or whether individual DC members will do better or worse 'on average' than DB members in terms of pension outcomes. This is because DC outcomes depend on a number of different factors, and vary between individuals.

This variability of DC pensions may be an issue for the future of the private pension system. In DC pension schemes, risk is assumed by individual scheme members (see above:

**Approaches to risk**). Some individuals may do better than expected, while others may do worse, particularly if the performance of the funds in which their pensions are invested is poor. Therefore average DC pension outcomes are not sufficient as a measure of whether DC pensions are delivering the benefits expected by pension savers. Even if people with DC pensions do well 'on average', the system as a whole may fail to meet people's expectations if significant numbers of individuals receive below-average pensions from DC pension schemes.

## References

- 1 Individual lifetime average earnings for an average earner with a full career re-valued in line with economy-wide earnings growth.
- 2 For further details, see Antolín and Whitehouse (2009) and OECD (2011) in Sources and further reading.
- 3 See Department for Work and Pensions (2011).
- 4 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.
- 5 People belonging to defined contribution pension schemes (see Glossary) can take up to 25 per cent of the accumulated pension pot as a tax-free lump sum. Those belonging to defined benefit schemes (see Glossary) can take part of their pension as a tax-free lump sum if scheme rules permit.
- 6 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
- 7 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. For further information, see: [www.pensionprotectionfund.org.uk](http://www.pensionprotectionfund.org.uk)
- 8 According to estimates from the Family Resources Survey, less than 3 per cent of individuals in the UK who had a pension had both an occupational or other employer-sponsored pension and a personal pension in 2009/10. It should be noted that there is no public/private sector split available for personal pensions. 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.
- 9 For further information, see [www.hmrc.gov.uk/stats/pensions/changes-july11.htm](http://www.hmrc.gov.uk/stats/pensions/changes-july11.htm)
- 10 The Local Government Pension Scheme for local authority employees is the only major public sector scheme that is funded.
- 11 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. It is a legal requirement that the accrual rate is constant over the entire period of service in a given part of the scheme.
- 12 Normal pension age is defined as the age at which active members and deferred pensioners become entitled to receive their benefits.
- 13 The final report of Lord Hutton's review of public service pensions, published in March 2011, is available at [www.hm-treasury.gov.uk/indreview\\_johnhutton\\_pensions.htm](http://www.hm-treasury.gov.uk/indreview_johnhutton_pensions.htm)
- 14 The key changes on workplace pension reform contained in the Pensions Bill 2011 are:
  - the introduction of an optional waiting period of up to three months before an employee needs to be automatically enrolled into a workplace pension
  - automatic re-enrolment will not happen more frequently than once every two years and nine months (amended from three years)
  - annual review of auto-enrolment earnings trigger and the upper or lower limits of the qualifying earnings band
  - employers given some flexibility with regard to the date they re-enrol employees who have opted out

Further information is available at [www.dwp.gov.uk/policy/pensions-reform](http://www.dwp.gov.uk/policy/pensions-reform) and [www.publications.parliament.uk/pa/bills/cbill/2010-2012/0183/en/11183en.htm](http://www.publications.parliament.uk/pa/bills/cbill/2010-2012/0183/en/11183en.htm)
- 15 See NEST press release, 25 March 2011, for details: [www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/news/NEST-sets-out-investment-approach.html](http://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/news/NEST-sets-out-investment-approach.html)

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