THE PURPOSE OF PENSIONS
AN AGENDA FOR A FAIR, GREEN PENSIONS SYSTEM THAT SUPPORTS A PRODUCTIVE ECONOMY

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1. EXECUTIVE SUMMARY

Both major UK political parties are intent on significant reform of the UK pensions system, with a focus on boosting investment in the UK. While ensuring the pensions system supports a stronger, more balanced, inclusive and resilient economy is very important, this paper argues that more ambitious reform is needed given that the system is not delivering decent, secure retirement incomes for all, or playing a big enough role in delivering a just, green transition.

This paper is intended as contribution to this debate. It provides an assessment of a wide range of potential policy solutions to these major problems and sets out an ambitious but achievable framework for policy reform that would make the pension system work for pensioners and pension savers, the environment, and the economy.

1.1 The current system

The paper first summarises the structure of the existing pensions system in the UK, which has two main ‘pillars’: a taxation-funded state pension designed to provide a universal minimum retirement income, and a private “occupation-linked” pension system to significantly top this up. The state pension is low compared to many peer countries, though it has been rising gradually thanks to the “triple lock” policy of uprating it by inflation, average wage increases or 2.5% - whichever is highest.

The UK’s private pensions system is one of the largest in the world. Private pensions are largely occupation-linked, with contributions made by individuals and employers. Over the past 20 years there has been a major shift in how these are provided. The old “defined benefit” (DB) schemes provided pensioners a set level of retirement income, based on years of service and/or salary, until death. These are largely closed to new entrants. They have been replaced for most people by ‘defined contribution’ (DC) schemes, which are akin to tax-free savings accounts, where your pension pot is dependent upon the amount built up through contributions and returns on investment. DC pension savers must also make their own decision about how to access their pensions savings when reaching retirement, which entails its own complications.

The majority of employees have been automatically enrolled in such pensions since 2012, with minimum contributions to individual pension pots set at 8% of earnings. However, significant numbers of people still do not benefit from this increased occupation-linked pension coverage, including those living on very low-incomes, the self-employed, and people who cannot work.

The rest of the paper is structured around the three goals identified that we believe the pensions system should deliver against: (i) securing a decent, secure retirement income for all; (ii) supporting a balanced and resilient economy; and (iii) ensuring environmental
sustainability by default. For each, we analyse the current problems and potential solutions.

1.2 Securing a decent and secure retirement income for all

The comparatively low level of the state pension and often inadequate private pensions means that many future pensioners face insecure futures. One estimate is that 81% of DC savers are not saving enough to ensure minimum levels of income in retirement (Cominetti and Odamtten 2022). This situation is driven by three factors: low coverage, with many groups not contributing to any private pension; low contribution levels for many more; and insufficient returns and volatility of pension fund investments.

As a result, the system is highly unequal, with the bottom half of the population holding less than 1% of total pension wealth (Office for National Statistics 2022), and with groups such as women, people of colour and the disabled disproportionately affected. We find that the current system offers little hope that this picture will change significantly in the coming years without any intervention – indeed, it may get worse. We have identified five categories of solution:

(i) Growing private pension savings.

There are three main ways this could be done, either as standalone measures or together:

- Increase coverage significantly by expanding the numbers eligible for auto-enrolment to include those on low incomes and younger people, and by including the self-employed;
- Increase contributions, either from individuals or their employers or both, potentially with top-ups from the government for certain groups, or more progressive employer contribution rates;
- Generate higher returns from pension pots (which is covered in more detail Section 4 of this paper).

We find that these proposals are necessary, in particular increasing employer-contributions, but likely insufficient on their own to deliver extensive change to overall retiree outcomes. We note it will be hard for employees on low incomes to increase their own contributions, and many self-employed would struggle to make contributions without state assistance.

The basic inequity of the system, with insufficient incomes in old age for those at the bottom end of the earnings scale, would remain unchallenged. Interventions such as a progressive remodelling of contributions - where lower earners receive proportionally larger employer contributions with an absolute minimum set at a reasonable level - or increased government contributions for some categories of people, would be the key
change that could help tackle these issues. However, these solutions cannot undo the insecurity that people with small pension pots and unknowable life expectancies will face in old age under the current system, where DC pensions are the default.

(ii) Expanding Collective Defined Contribution (CDC) schemes or other ways of reducing risks for individuals.

CDC schemes are a relatively new concept in the UK, with only one currently approved by the regulator. They involve pooling all members contributions, as well as sharing longevity risk and investment risk. They then offer a retirement income throughout all of later life based on years and amount of contribution. This income is targeted but flexible as CDC plans can alter promises to their members periodically depending on fund performance. Saving and accessing retirement income are both done within the collective scheme.

The main built-in advantage is to offer greater security of retirement income than pure DC pensions, particularly for those without significant savings. There could also be benefits of a longer-term investment horizon for CDC funds, and - depending on how they are set up - more professional management. The familiar problem of unequal outcomes and insufficient pension income for the poorest might be further tackled through progressive design that could ensure the low earners pay in less but gain a relatively higher level of accrual than higher earners, for example, to ensure that all can reach a minimum income level in retirement. Moving from DC as the norm to CDC as the norm would therefore be sensible, but care should be taken to preserve and if possible expand defined benefit (DB) schemes which offer the greatest protection to individuals from risk, as the employer shoulders the longevity and investment risk rather than the individual.

(iii) Improving the state pension

Maintaining the triple lock or some other kind of automatic uprating mechanism will gradually improve the basic state pension. Targets could be set for the state pension as well: for it to match a percentage of the living wage, for example. Those who currently receive less than the full state pension amount could be granted a full state pension by reducing or eliminating National Insurance contribution requirements and replacing this with residency requirements. This would benefit individuals like those who have taken time off work to meet caring responsibilities. These proposals could be partly paid for through reducing tax relief for higher income pension-savers, for example by reinstating the Lifetime Allowance.

1.3 The need to support a balanced and resilient economy
The scale of pension fund assets means their investment choices have a significant impact on the UK economy. Low levels of investment in UK equities and other asset classes in favour of a strong preference for safer assets like bonds has been a feature of recent pension fund investment. This has partly been driven by accounting, tax and regulatory changes, but it is also true that the current dynamics in the pensions landscape – with DC assets growing while most DB funds wind down – have resulted in cautious investment approaches and low levels of return for savers. Like all financial systems, there is also the potential for instability and crises in the pensions ecosystem that can have major economic effects, as the recent LDI crisis showed. We have identified four categories of solution:

(i) **Consolidation**

The creation of Canadian or Australian-style professional ‘superfunds’ managing hundreds of billions in assets has been promoted as a way of both driving more professional management, but also in promoting longer-term investment. Ensuring that such funds are not-for-profit could help protect beneficiary interests and support stability. However, the impact of this approach alone could be limited and would depend on the structure and governance of such funds.

(ii) **Voluntary investment initiatives**

Voluntary initiatives such as the government’s “Mansion House Compact”, which encourages signatory firms to invest five per cent of default funds to unlisted equities, could be built upon. However, it is quite likely that such approaches will have only limited impacts from a systemic perspective.

(iii) **Mandatory Investment targets**

Government could set binding targets, for example, related investment in the UK. These would have to be balanced against the priority of ensuring the best interests of savers are safeguarded – which would be easier to do if they were aligned with savers’ strong interest in a safe climate and environment.

(iv) **Other pension fund models**

More novel proposals include a “People’s Pension” for investment in public infrastructure, or Social Pension Funds based on the French ‘Solidarity Investment Fund’ which requires employers and pension providers to offer pension savers access to this Fund where a proportion of capital is channelled to social investment.
1.4 Ensuring sustainability by default

Pension funds are the UK’s largest institutional investors, and their beneficiaries are very exposed to the risks of climate change and environmental destruction. However, pension funds continue to be major funders of fossil fuels and nature destruction, and they are some way off making a significant contribution to the investment needs of the just green transition. The pace of change is slow and most pension funds do not even have adequate climate policies and targets in place. We have identified four categories of solution:

(i) Improving pension fund governance and management

A key proposal is to reform the fiduciary duty of pension fund trustees, either to ensure they understand that they are currently responsible for climate risks that affect their beneficiaries, or to include the impacts of their investments in their assessment of the ‘best interests’ of pension savers. A second, complementary approach would be for the government to support or mandate the upskilling and professionalisation of trustee boards, and ensure better standards in the advice they receive from advisors and investment managers on climate matters. Increasing transparency and accountability to members could also play a role in improving performance.

Also important would be enabling or requiring better integration of environmental understanding into decision-making and management, with tougher stewardship approaches, and enhanced data and reporting requirements. The government could mandate or model step-change improvements in risk understanding and management based on deeper understanding of climate science and the likelihood of unpredictable but major impacts such as tipping points. Government could also investigate how to ensure that incentive structures in the industry are geared towards the longer-term and sustainability, and could conduct rigorous climate stress tests of the UK pensions system.

(ii) Incentivising green investment by pension funds

The tax regime, public subsidies or varied charge caps could be used to reduce risks and increase rewards for pension fund investment in targeted green sectors. The government could go further and require pension funds to make a proportion of their investments through green funds or institutions (such as the UK Infrastructure Bank), or into green assets such as green bonds. Targets could be increased over time, or could start as voluntary agreements before becoming mandatory.

(iii) Ending climate-damaging investment
Progressively banning pension fund investment in new fossil fuels and companies that are still expanding fossil fuel production, starting with the worst examples, would be a logical and important place to start. The government could also examine whether altering accounting standards and practices could play a role in reflecting the true costs of climate-damaging investments. Regulators could also introduce capital requirements like ‘one-for-one’ rules that reflect the risk of investing in environmentally damaging assets on pension funds’ balance sheets. Other proposals include introducing a tough regime for climate harm akin to those in place for financial crimes, and strengthened due diligence to prevent investment in illegal nature destruction.

(iv) Embedding longer-term time horizons

As noted above, CDC pension schemes would tend to have longer-term investment horizons than DC schemes, and it is possible that consolidation of smaller funds and resulting professionalisation could help improve standards.

We note that for investment in the green transition, regulation and policy targeted at increasing the supply of finance is only one half of the equation. An effective, forward-looking broader policy environment delivered by government - such as a green industrial strategy that expands the demand for such finance in the real economy - will also be needed. We also note that regulators could adopt a more precautionary, far-sighted approach to their work with regards to climate risk and the pensions landscape. They could also be given stronger, statutory-level mandates on climate and nature to move these issues up their priority list.

1.5 The way forward

Our conclusions, set out in Section 6 of this paper, represent an ambitious but achievable way of solving the interlocking problems of the UK pensions system.

First, we suggest a continued improvement of the state pension based on the triple lock, aimed at providing a decent floor for retirement income, with consideration given to what an adequate, acceptable target level should be. Crucially, we argue that those with low contribution records should be guaranteed a decent state pension, through for example, adopting years of residency rather than years of National Insurance contributions as the benchmark for provision.

Second, we set out how private occupation-linked pension pots could be increased so that everyone can expect a decent level of income in retirement. Reaching a target of 12-15% of income on average, largely through increasing employer contributions will be part of the answer. Crucially important will be making the system progressive, by, for example, setting higher levels of employer contribution for those on lower incomes and
ensuring a minimum absolute contribution, offset by lower required contributions for those on high incomes. Also vitally important will be carefully designing ways of including those who are currently excluded, including the self-employed and those unable to work.

Third, we argue for a move to pension fund models that share longevity and investment risks, and embed longer-term investment horizons. This could mean making CDC pension schemes the norm for new joiners, rather than DC schemes, and for transitioning existing DC schemes to CDC schemes, for example when consolidation occurs. Existing open DB schemes should be protected, or expanded if possible. As noted above, CDC schemes should be progressively calibrated, to help those on low incomes aim for a decent retirement income.

Fourth, it is clear that we need to proactively and rapidly green the pensions system. Setting targets for green investment, supported by a green industrial strategy or other plan that helps facilitate this would be a sensible step forward. We also need to begin excluding fossil fuel investment from pension fund portfolios, starting with direct investments in fossil fuel expansion. Giving regulatory bodies stronger mandates to focus on the climate and nature impacts of the pensions system would help align regulation with key goals. Examining how to improve fiduciary duty, and the accountability of all actors in the pensions chain to the interests of beneficiaries – including their interest in a safe climate and thriving nature – will be important. Finally, driving improvements in risk assessment by pension funds and regulators will be a critical step to align decisions with climate science.

Finally, we argue that these reforms would be beneficial for the UK economy as a whole, including through boosting the spending power of pensioners and enlarging the pool of capital for investment in the just, green transition in the UK. Appropriate consolidation could be used to help drive the system towards these goals, with not-for-profit models being the norm to ensure that bigger funds maintain a focus on the true interests of pension savers.

We hope that this comprehensive review of how to fix the major problems in the UK pensions system, and proposals for a way forward are a useful contribution towards creating a system that truly works for pensioners and pension savers, the economy and the environment.
2. INTRODUCTION

The UK’s pensions system is undergoing significant reform, and more may be on the horizon. In July 2023, the Chancellor of the Exchequer used his annual Mansion House speech to announce a programme of pensions reform aimed at boosting both the UK economy and savers’ pension pots. This was followed up by announcements in his November Autumn Statement with a focus on driving further consolidation in the pensions market in order to “improve pension savers’ returns and boost [economic] growth.”

Meanwhile, Labour Shadow Chancellor Rachel Reeves has stated that she wants to go further than the Conservatives to “unlock” more pension fund capital to support UK growth. Reeves has committed to a full review of the entire pensions landscape if the party wins the next general election. The political appetite for pensions reform is larger than it has been for some time.

Initiatives to improve the pensions system are definitely warranted, but these proposals are not yet commensurate with the very significant problems facing UK pensions. As this paper explores, the UK pensions system is currently: not delivering for all retirees, a problem that is likely to get worse in the future; not delivering the significant shifts in investment needed to preserve a safe climate and protect nature; and not fulfilling its full potential in supporting a prosperous, inclusive and sustainable economy.

In light of the recent interest in reform, and recognising the problems identified above, this paper examines a broad array of policy proposals to reform the pensions system. It assesses these proposals against the three key goals the pension system should help deliver:

(i) A decent and secure retirement income for all;
(ii) supporting a resilient and productive economy; and
(iii) environmental sustainability by default.

By “a decent and secure retirement income for all”, we argue that a good pension system should provide sufficient and secure income for every retiree to live in dignity and reasonable comfort for as long as they live.

“Supporting a resilient and productive economy” recognises the fact that the pension system should put capital to work and deliver return for savers in a way that supports an inclusive, sustainable economy that is orientated toward the long-term. This also means minimising the threat of financial crises arising from the pensions system, while

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delivering investment that benefits the UK’s real economy and supports UK jobs and regions.

“Sustainability by default” reflects the dire environmental times in which we live. We contend that all pensions systems should ensure all investments are sustainable for our planet. This means sustainable in both a positive sense, with pension funds invested in a just and fair transition to a green economy; and a negative sense, by ensuring that pension capital is not invested in assets that fuel the degradation of our climate and environment. This is a key principle in itself, but it also recognises that unless we solve the severe climate and environmental challenges we face, future pensioners face a bleak retirement, and the economy will be severely damaged.

In critically assessing proposals for reform under these three goals, this paper aims to stimulate discussion regarding what an ambitious but achievable package of reforms to the UK pensions system would look like. The paper does not cover every conceivable policy idea in UK pensions, but it highlights the key proposals for reform that could tackle the deep-seated problems of the system. It also tries to bring together the three goals outlined above in a way that much of the pensions literature to date does not. This is because all three goals should be considered vital to the long-term suitability and sustainability of our pension provision.

2.1 The current UK pensions system

Types of pension provision

The two major pillars of the UK pensions system are the state pension and occupation-linked private pensions. The state pension is a government provided universal old-age benefit which has been a universal benefit and constituent part of the welfare state since 1948. Occupation-linked pensions are individual, ‘private’ pensions built up through contributions made during years in employment - they take different forms which can deliver quite different outcomes, as explored below. These two pillars are the source of the majority of retirement income for most in the UK and are the focus of this paper.

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3 National pensions were first introduced in 1908, but these were means tested.
4 In this paper we use “occupation-linked” as shorthand for all pensions which are saved for via contributions from employment income and employers, and fall under the “second pillar” of the typology presented in Figure 1. This catch-all term does not reflect the complex picture of differing and overlapping legal categories of private pension in the UK which, alongside the limitations of “pillar” typologies, is covered comprehensively in Berry (2021). However, for the purposes of this paper, it serves as a simple way to group together the key constituent parts of the UK private pensions landscape. We also note that the term “occupation-linked” pensions has specific connotations in the continental European context where it is associated with industry-specific schemes, and variable outcomes by occupational status. We are not referring to these specific schemes when we use “occupation linked” as a shorthand in the UK context.
The third pillar is private, voluntary non-occupation-linked pensions. This category of pension savings is not unsubstantial but provides a relatively small proportion of retirement income – OECD data from 2018 suggests it has accounted for less than 20% of older people in the UK’s income (Harker 2022; OECD 2021). It is also a less suitable target for policy interventions both given its discretionary nature, and because those benefitting from third pillar pensions, in the form of products such as Self-Invested Personal Pensions, are generally wealthier individuals who will typically also have significant pillar two savings.\(^5\)

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<th>Retirement income pillars</th>
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<td><strong>Pillar one</strong></td>
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<td>State-funded pensions and pensioner benefits</td>
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*Figure 1: typology of pensions provision, based on broad categories used by the World Bank (1994). Pillars one and two are the central elements of the UK pensions system from a public policy perspective.*

The state pension is taxpayer funded and a flat-rate benefit for all who have made the requisite years of National Insurance contributions, currently set at 35. The UK state pension is low by international standards – it has been reported as the OECD’s least generous state pension (OECD 2017) – but it is supplemented by other retirement benefits such as the winter fuel payment, and is uprated annually. Currently, the full state pension is £203.85 per week for a single person. For those with insufficient years of National Insurance contributions, Pensions Credit provides a means-tested top-up to ensure a minimum income of £201.05 for a single person.\(^6\) At its core, the state pension is therefore currently designed to provide a basic low-level income for all retirees, but it is not primarily intended as a standalone source of income.

Private occupation-linked pensions are therefore expected to provide a significant tranche of retirees’ incomes above and beyond the state pension. Occupation-linked

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\(^5\) Only 4% of pensions savers in the period 2018 to 2020 were saving solely in a third pillar personal pension (Office for National Statistics 2022)

\(^6\) Pensions Credit is a tax-free weekly benefit for people who are living on low incomes and guarantees all pensioners an income above a certain level.
private pensions are built up through peoples’ years of work during which both the worker and the employer make contributions.

Defined benefit, defined contribution & collective defined contribution

The most common type of occupation-linked pensions is now defined contribution (DC) schemes. In 2020, 69% of working-age private sector employees were participating in a DC scheme, as Figure 2 shows (Cribb et al. 2023). In such a scheme, both employer and employee must pay in a statutorily defined minimum percentage of a worker’s income, which is then invested as part of a pension fund. Both employer and employee are able, but not compelled, to put more in than the minimum if they wish.7

In simple terms, in a DC scheme, the final size of a retiree’s pension pot depends on how much has been put in over the individual’s working life, and how successful the pension fund’s investments have been in growing the size of the pot. This means, of course, that wider societal inequalities are both reflected and magnified in the accumulation of pension wealth and in the accessing of it in older age, creating a highly unequal picture.

For new entrants to occupation-linked pension plans, DC schemes have largely replaced the older defined benefit (DB) schemes. In 2020 only 12% of working-age private sector employees were saving in DB scheme (Cribb et al. 2023). In a DB scheme, the pension provider is responsible for providing a certain level of retirement income to the retiree based on their earlier in-work earnings. Under this model, the pension provider assumes the financial risk of individual pensioners taking out more than they put in.

7 The statutory minimum pension contribution for DC schemes is 8% of an employee’s “pensionable earnings” (i.e., their earnings as a basic salary, before bonuses, overtime, commission etc.). This is split between the employer (minimum 3%) and the employee (minimum 5%). These contributions are tax exempt. The 2023/24 the tax-free annual limit is of contributions is 100% of an employee’s salary or £60,000, whichever is lower.
While private sector DB schemes are now generally closed to new members – only 9% were open to new joiners in 2022 (The Pensions Regulator 2022) – private firms’ legacy DB schemes remain an important part of the UK pensions landscape. The former dominance of DB pensions is reflected in the distribution of pension assets between DC and DB: according to the latest Global Pension Asset Study, in 2022 DB pensions held 81% of all pension assets in the UK, compared with just 19% held in DC pensions (Thinking Ahead Institute 2023).

While the private sector has largely shifted towards DC, in the public sector DB schemes – such as the Local Government Pension Scheme and the Police Pension Scheme – remain common. A small number of these, notably the Local Government Pensions Scheme, are funded – built up through contributions into a pension fund - while most are not, meaning they are paid for out of current spending. The funding of public sector schemes is explored in Section 4 of this paper.

A relatively newer model, also discussed later in this piece, is the collective defined contribution (CDC) scheme. CDC can bring some of the benefits of a DB scheme to a DC-based model. In the UK, so far only one CDC pension scheme, the Royal Mail Collective Pension Plan, has received approval from The Pensions Regulator (Mirza-Davies 2022).

Recent reforms

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8 In a funded DB scheme, members and employer pay into an invested pension fund which ultimately provides pension benefits (of a defined value) to beneficiaries. In an unfunded DB scheme, no investible pension fund is built up – pension benefits are simply paid out to members by the employer as they fall due (known as “pay as you go”).
Recent years have seen major reforms to both the state pension and private occupation-linked pensions. With regard to the state pension, there was a significant move in 2016 towards a flat-rate “new” state pension (described above) away from the “old” state pension which had an earnings-related tranche. This move should be seen in tandem with the introduction in 2012 of auto-enrolment to private occupation-linked pensions.

Auto-enrolment means that the majority of employees are automatically put into a private occupation-linked pension by their employer.9 Workers can opt out of these pension plans if they wish, but most remain opted-in.10 Auto-enrolment has been has been very successful in increasing the number of private pension savers (Cribb et al. 2023).

Considered together, these two changes are indicative of the basic design principle behind the UK pensions system – that the state should provide a basic low level of income via the state pension and other benefits, but that individuals should be expected – and supported – to save enough via their employment to provide income in retirement beyond that provided by the state.

UK pensions in comparative context

An outcome of this approach is that UK private pensions savings represent a very significant pool of capital. The UK pension industry's assets under management are fourth in the world – only the US, Japan and Canada have more private pension wealth than the UK (Thinking Ahead Institute 2023).11

This substantial pool of pensions capital has important links to the real economy. As explored in Section 4, pensions can provide significant investment capital through, for example, their equity investments. However, as will be explored, over time UK pension funds have become more disposed to investment in low-risk assets such as government bonds.

In this context it is worth noting that the UK system is just one system of many. For instance, many EU countries have far more generous state pensions but comparatively

9 All employees must be auto-enrolled providing they meet the following thresholds: (a) they are older than 22 years of age; and (b) their pre-tax earnings are at least £10,000 annually from a single source of employment.
10 The “opt out” rate for auto-enrolment pension plans fluctuates. The Department for Work and Pensions estimates that the opt out rates (i.e., the number of employees who left an auto-enrolled pension within one month of joining) showed a long-term increase through 2020 to 2022. In January 2020 the opt out rate was estimated at 7.6%, increasing to 10.4% in August 2022 (DWP 2022). However, this still represents around 90% of workers opting to remain in a pension plan immediately after being auto-enrolled.
11 Until relatively recently UK pension assets were second in the world, only behind those of the US (Thinking Ahead Institute 2022). Part of the reason for the relatively decrease in UK assets versus other jurisdictions is the heavy investment of UK funds in bonds which have performed badly over the recent past (Thinking Ahead Institute 2023).
smaller private pension savings. The particular institutional set-up of the UK pensions system represents its own unique development, as well as a political choice of a less statist, more individualised and market-driven approach to retirement income. In the European context, the UK pensions system is perhaps most similar to the Dutch, Swiss and Danish systems in terms of the ratios of retirement income derived from the state compared to private savings.

The combination of the three pillars of the UK pensions system described above mean that the UK sits below the OECD average in terms of pension replacement rates (OECD 2021). The ‘replacement rate,’ a key metric in assessing how adequate retirement incomes are, is the percentage of former salary that an average retiree can expect to be replaced by their retirement income. Replacement rates are important in looking at how pensions smooth income over life, with high rates meaning there is no sudden drop in income at retirement.\textsuperscript{12} Figure 3 shows how the UK’s replacement rate based on pillars one and two is typically ranked by the OECD compared to the replacement rates of other member countries.

There are, however, limitations with such methods of comparative analysis of pensions outcomes, in part because efforts to categorise national pension systems using broad categories of provision or typologies, such as the pillars used in this introduction, can fail to accurately capture the experience of any individual country (Berry 2021).

In this instance, Figure 3 ranks countries based on the ‘mandatory’ portion of retirement income replacement, but the ‘voluntary’ aspect is a fundamental and significant component of retirement systems in countries like the US or Ireland, meaning their real replacement rates are substantively higher than the UK’s despite their lower ranking. If we include both mandatory and voluntary schemes, the UK’s replacement rate ranking falls from 21\textsuperscript{st} to 28\textsuperscript{th} out of 38.

Moreover, Figure 3 takes auto-enrolled schemes as a mandatory element of the UK pensions system, when in reality, the ability to opt out and limits to coverage (explored below) mean that this categorisation is not strictly accurate – auto-enrolment is quasi-mandatory at best.

Accordingly, comparative analysis such as this, although instructive to a point, can conceal the both the scale and the nuances of the problems in UK pension provision. As this paper explores, there are major existing and emergent systemic deficiencies with the UK pensions system which require commensurate policy responses.

\textsuperscript{12} While replacement rates are a useful metric, it should be noted that living standards vary between countries. A country with low living standards during working life but a high replacement rate may not necessarily be “doing better” with regard to providing for its elderly population than a country with higher living standards during working life but a lower replacement rate.
Figure 3: net pension replacement rates from mandatory (public and private) and voluntary pension schemes in OECD countries. Based on 2020 OECD data, taken from Harker (2022)
2.2 Structure of this paper

The analysis in this paper is based on the three goals identified above which we believe the pensions system should deliver against: (i) a decent and secure retirement income for all; (ii) supporting a balanced and resilient economy; and (iii) environmental sustainability by default.

Under each of these goals in turn, we identify the extent to which the current UK pensions system is succeeding or failing to deliver. We then set out some of the main policy proposals in the literature that look to rectify deficiencies in these regards. We then assess how well the proposals could help deliver a pensions system that meets the identified goals.

3. A DECENT AND SECURE RETIREMENT INCOME FOR ALL

For any pension system to be judged as successful it must deliver a decent and secure retirement income for all. This means a pension system that gives all retirees financial security and a reasonable standard of living throughout the whole of their later lives. At the moment, the UK pension system does not guarantee this. Some pensioners enjoy much greater financial security than others, and there are major concerns about whether many of today’s pension savers will be able to benefit from the level of pension income they will need for a decent life in retirement.

3.1 Current problems

As outlined, the core elements of the UK’s pensions system are a state pension that is intended to protect retirees from absolute poverty, and private pension provision which is intended to top-up the state pension to provide retirees with a reasonable retirement income.

The low state provision means that those retirees who have not managed to build up a substantial private pension during their earlier lives face a very low income throughout their later years. This is somewhat ameliorated by other retiree-only benefits such as the Winter Fuel Payment. Further to this, the UK’s state pension is improving in both absolute and relative terms because since 2011 the state pension has been uprated with the “triple lock”, with the exception of one year. The triple lock is a commitment that the full state pension will rise each April in line with the highest of three factors: earning

13 There is debate over what exactly constitutes an acceptable level of retirement income. Later in the paper we look at different ways to benchmark what a suitable level of retirement income should be. Suffice to say, the works cited conclude that the current status quo will not deliver what most define as a comfortable retirement income for most people without significant change to the pensions system.
growth figures between May to July the previous year; Consumer Prices Index inflation from the previous September; or 2.5%.

According to the Institute for Fiscal Studies (IFS), if the state pension had only risen in line with inflation rather than the triple lock since 2011, a full state pension would now be worth 11% less than its current value (Cribb, Emmerson, and Karjalainen 2023).

**Insufficient private occupation-linked pensions**

While some current and future retirees will enjoy substantial private pension pots, on average private occupation-linked pension savings are currently insufficient. One estimate finds that only 19% of workers (and 1% of low-earning workers) in DC schemes are saving enough each year to be on track to achieve what the public thinks is a minimum acceptable retirement income (Cominetti and Odamtten 2022).

There are three key factors that underpin this low level of private pensions savings:

- **Low coverage** – many people have no private pensions savings; these people are not covered by the key private component of the UK pensions system. This is a particularly acute problem within some groups – for instance, less than one in five self-employed people are saving in a pension (Cribb et al. 2023).

- **Low contributions** – even those who have occupation-linked private pensions are not necessarily putting enough in, and neither are their employers. Private pension pots are built up by both employer and employee contributions. The minimum contributions are low and most employers and employees do not put in more than the statutory minimum. Moreover, contributions are based on a proportion of income – thus inequality in contributions broadly reflects inequalities in income.\(^{14}\)

- **Insufficient returns and volatility** - private pension pots should grow via investment. Sometimes the returns on investments made with private pension capital are too low to significantly grow individuals’ retirement savings. Savers may also suffer from volatile returns, whereby their pension pot does not grow in a consistent or predictable manner due to the volatility of the underlying investments.

These three factors, along with the relatively low state pension and the generational shift away from DB to DC schemes, combine to create a pensions system that is highly unequal. Groups that aren’t covered by any private pensions savings (such as many carers, self-employed, or long-term unemployed people) will experience much worse retirement outcomes than those who build up healthy pensions savings. To a lesser extent, the same is true of groups that cannot contribute much to their private pension.

\(^{14}\) As evidenced later in this piece, those benefitting from above minimum employer contributions are also overwhelmingly in high-paying roles.
The interaction of these factors differs between demographic groups – this results in the considerable gender, ethnicity, and disability disparities in private pension savings visible in the data (Office for National Statistics 2022). Put simply, these stark differences in the ability to build and then access private pension wealth then generate big differences in retirement income, with women, people of colour and people with disabilities faring worse.

The gender pension gap is stark. Women typically have lower in-work earnings than men, and they are more likely than men to take time off work for caring responsibilities. These and related factors mean that on average women today are forecast to receive 37% smaller private pension pots at retirement than men: approximately £150,000 compared to £235,000 in today’s money (Scottish Widows 2023b).

Differences in the accumulation of private pension wealth have resulted in huge inequalities in the distribution of private pension wealth in the country. Figure 4 below shows how wealth is shared between individuals when split into 10 equally sized groups (deciles), sorted by private pension wealth and total net wealth. It shows how pension wealth distribution is even more unequal than total net wealth distribution.

Between April 2018 and March 2020, the top decile held 64% of all private pension wealth while the bottom five deciles held less than 1%. Median private pension wealth in the top decile was £637,500 compared with £0 in the first three deciles, £1,200 in decile 4 and £7,800 in decile 5 (Office for National Statistics 2022).

This distribution of pension wealth will likely change over time. Given the relatively short space of time since the introduction of auto-enrolment, many previously not covered by occupation-linked pensions have now started saving in one, but they will have

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15 Indeed, in the short-term pension wealth can be quite sensitive to fluctuations in interest rates. Recent high rates have led to low bond prices, which have depreciated the book-value of DB pension wealth in particular.
been making contributions for only a few years. These low earners’ pension wealth should build with time. However, income inequality means we will not see a major rebalancing without policy change. Moreover, the April 2023 decision to abolish the Lifetime Allowance will only increase the wealth accumulated at the top of the distribution by allowing those with already very substantial pensions savings to continue to benefit from significant tax benefits on further savings.\footnote{The Lifetime Allowance is the total amount of pension wealth savers can accumulate tax free over their life. In April 2020 it was set at £1,073,100, but in the April 2023 budget the Chancellor announced it is to be scrapped altogether. There is also a tax-free Annual Allowance which was previously set at £40,000 but was increased to £60,000 in the same budget.}

A worsening problem

It is likely that the trend of most individuals under-saving for retirement is likely to get worse into the future. Many future retirees will likely live longer than current retirees and thus will need to set aside more savings for a longer retirement. They may also need to work until later in life than previous generations. Moreover, future retirees are set to be far more likely than current pensioners to be renters rather than owner-occupiers and thus many will have significant housing costs that the average pensioner today does not have (Cribb et al. 2023).

One relatively recent estimate predicts that a median earner who owns their property outright could expect to maintain their living standards on a pension pot of £260,000, while someone who rents privately would need to almost double this to £445,000 (Royal London 2018).

While auto-enrolment has boosted the numbers of people who are saving, it does relatively little to address underlying inequalities. Not only is auto-enrolment not applicable to significant numbers of people – for example, non-workers, self-employed and the lowest earners – but as contributions are based on percentages of income, it replicates the effects of the UK’s high inequalities in income.

The disparities described above are compounded by a substantial generational divide. Older workers and current retirees are more likely to benefit from DB pensions schemes whereby the risks associated with providing an income until death falls upon employers. Younger people, if they have a private pension, are far more likely to be saving in DC schemes, where the risks associated with providing for an income until death fall upon the saver. Thus, while auto-enrolment has led to a significant expansion in occupation-linked pension coverage, this expansion has been largely driven by the proliferation of often inadequate DC pensions for younger workers.

The state-funded first pillar of the UK pensions system should provide a safety net, but it also faces demographic and fiscal challenges. Despite the UK’s relatively low state pension, the costs associated with providing it are growing. The UK has an ageing
population, which means the dependency ratio (the size of the working-age population relative to the retired population) is shifting, as the number of people claiming state pension is growing faster than the labour force whose tax receipts help fund it (OECD 2021). Even at present, over half of all government welfare spending goes on pensioners, and this spending demand is expected to increase if current demographic trends continue (Cribb et al. 2023). The ongoing funding of the state’s pillar one provision has links to the tax treatment of private pensions which is discussed later in this piece.

**Capability and engagement**

There are also broader issues around financial capability which prevent the current pensions system from delivering a good retirement income for all, particularly given that mandatory contribution rates are low. Most do not fully understand pensions, or are unaware of how much they need to save for a good retirement. Recent Ipsos MORI research carried out on behalf of the Department for Work and Pensions found that most occupation-linked members’ engagement with their pension is characterised by “detachment, fear and complacency” (Department for Work and Pensions 2023).

Capability and engagement issues are made more acute by the propensity of individuals far from retirement to tend toward “present bias”. This cognitive bias leads working-age individuals to prioritise short-term consumption over long-term saving (Thaler and Benartzi 2004). Such behaviour is entirely understandable, particularly during periods where real wages are falling, or where incomes are low - hence the introduction of welcome but insufficient measures such as auto-enrolment.

### 3.2 Solutions assessment

A number of potential solutions have been suggested to the problem of low and insecure retirement income. We explore these grouped into the following categories: increasing private pensions savings in the current system; expanding collective defined contribution schemes or other risk sharing mechanisms; and increasing state provision.

#### 3.2.1 Significantly growing private pension savings within the existing system

Significantly growing private pension savings in the current model could be one route toward generating better outcomes for retirees. There are three main ways this could be done, either as standalone reforms or in conjunction. The first is to increase coverage by bringing into the private occupation-linked pension system those who are currently not included. The second is to increase the total amount going into the pension pots of those who are already occupation-linked private pension savers. The third is to generate higher returns from all pension pots, which is discussed at greater length in Section 4 of this paper.
Increasing coverage

There are two clear routes to increased coverage of private occupation-linked pensions within the current system:

- **Expanding auto-enrolment.** Changing the auto-enrolment criteria - both lowering the age of auto-enrolment applicability and the reduction or abolition the minimum earning threshold - could result in more workers saving in private pensions. This could be combined with deducting contributions from the first pound of earnings (Harrop 2022).\(^{17}\)

- **Including the self-employed.** Some in the pensions industry have suggested that the government should increase private pensions coverage by introducing an equivalent to auto-enrolment for the self-employed (Scottish Widows 2023a). Others have suggested the government create a new self-employment private pension collected through the tax system to serve as a counterpart to the auto-enrolled plans which applicable employees benefit from (Harrop 2022; Wright 2023).

A more novel proposal would be for the state to guarantee some level of basic, starter level of pension savings. The cheapest way to do this – given the lifetime of compound interest that would result – would be to give all new-borns a one-off payment into their own pension account which they would be unable to access until their reaching pension age. Additional contributions could also be made into this account throughout the individuals' working age life.

Increasing contributions

Alongside increasing coverage, there are a number ways to increase the money going in to existing occupation-linked pension pots:

- **Increasing employee contributions** - the government could legislate to increase the statutory minimum contributions (currently 5% of pensionable earnings) that individuals must make to their workplace pensions. This could be done in a staggered fashion, for example by specifying that contributions are automatically increased with pay uplifts or with age.

- **Increasing employer contributions** - similarly, there have been calls to match bigger employee contributions with bigger contributions from employers (Harrop 2022; Wright 2023). Employer contributions might also be increased as a standalone measure, which would be particularly helpful for the lowest earners for

\(^{17}\) Currently employees are auto-enrolled if: (a) they are older than 22 years of age; and (b) their pre-tax earnings are at least £10,000 annually. Even if an employee meets those criteria, contributions are not deducted from the first £6,240 of earnings.
whom employer contributions only might be the only feasible route to building greater savings.

- **Matching contributions to minimum retirement income** - one way of benchmarking how much to increase employer and employee contributions by could be via the introduction of a Living Pension standard, building on the principles of the Living Wage (Finch and Pacitti 2021). This would provide a clear, widely agreed target which minimum contributions could be calibrated to. The Living Wage Foundation currently sets its Living Pension annual savings benchmark at £2,800, equivalent to 12% of a full-time living wage salary.\(^{18}\)

### Assessment of these proposals

**Expanding auto-enrolment**

Bringing more workers into the scope of auto-enrolment would have a clear positive impact in terms of increasing coverage of occupation-linked pension savings. As of June 2023, more than one-in-ten UK workers were earning less than the current £10,000 auto-enrolment earnings threshold (Office for National Statistics 2023). Women are significantly more likely than men to miss out on the benefits of auto-enrolment due to this threshold (TUC 2023).

There are also hundreds of thousands of workers aged 18 to 21 are excluded from auto-enrolment due to their age. There will be some overlap between these two figures, but this represents a significant number excluded from auto-enrolment who could be brought in. Indeed, the impact of removing the age threshold would be inherently limited if it were not done alongside removing the £10,000 earnings threshold. At present, in the 18-21 age bracket, 36% of women and 15% of men would not earn enough to require their employer to enrol them (TUC 2023).

The effect would be further increased by ensuring that contributions are taken from the first pound of earnings. Under the current rules, someone earning at the current £10,000 threshold will only have contributions taken from £3760 of earnings if an employer calculates contributions on ‘qualifying earnings’. At an 8% contribution rate, that means £301 in pensions savings per year, rather than £800 if contributions are taken on the whole income. Removing the qualifying earnings threshold would ensure contributions are taken from the whole income.

These changes to auto-enrolment are easy to implement, with low impacts on affected businesses given the predicted minimal additional contributions they would be expected to make. In March 2023, ministers committed to reducing the auto-enrolment lower

\(^{18}\) [https://www.livingwage.org.uk/living-pension](https://www.livingwage.org.uk/living-pension)
earnings limit and to lower the age threshold to 18. A consultation on enacting these changes is expected in the coming months.\textsuperscript{19}

However, while ensuring that more very low earning employees are opted into a private occupation-linked scheme would give them at least some level of private pension saving, the net effects will be limited in eventual retirement given these low earnings will typically mean low contributions and low aggregation of pensions saving over a lifetime.

Moreover, workers on the lowest incomes will feel the impact of any pension contribution taken from their paycheque more than higher earners.\textsuperscript{20} Any move to increase the employee tranche of contributions from these workers could result in a higher opt out rate for this cohort, reducing the effectiveness of removing or lowering thresholds.

Bringing in the self-employed

Creating a self-employed equivalent to auto-enrolment, or some other kind of specific self-employed pension administered through the tax system, might provide a similar benefit to changing auto-enrolment criteria but for a different category of currently under-pensioned people. As of March 2022, there were approximately 4.2 million self-employed people in the UK (Brown, Welsby, and Roberts 2022); the IFS has separately estimated that fewer than 20% of self-employed workers are saving in a pension (Cribb et al. 2023).

We would expect such a policy should include ‘gig economy’ workers, whose legal status as either ‘self-employed’ or as a ‘worker’ is often unclear, but who generally do not benefit from the current pensions system in any case.

The introduction of an equivalent new default pension arrangement for the approximately 3.3 million self-employed non-pensions savers would represent an important improvement on the current situation. However, if any new default self-employed pension followed the employee auto-enrolment model of contributions with a minimum 8% contribution of pensionable earnings, the average pension pot amassed by most self-employed workers would not be particularly large.

On average the income of the self-employed is significantly lower than that of employees.\textsuperscript{21} When questioned as part of the Wealth and Assets Survey, 39% of self-


\textsuperscript{20} Marginal propensity to consume (the ratio of the change in aggregate consumption compared to the change in aggregate income) is higher for poorer individuals than wealthy individuals given basic necessities such as food, shelter and clothing make up a larger fraction of a poor person’s income.

\textsuperscript{21} A 2016 government study, for instance, estimated that in the financial year 2013/14 the median annual earnings from self-employment was £10,800 compared to estimated median annual earnings of £20,000 for employees. A similar ratio of earnings for self-employed versus employed was estimated back to the financial year 2007/08 (Department for Business, Innovation and Skills 2016).
employed people not paying into a pension cited affordability of contributions as their primary reason for not saving (Office for National Statistics 2022).

Accordingly, while no doubt positive, such a policy would not on its own be hugely transformative in terms of delivering a decent retirement income for all self-employed people. There would be some differences and difficulties in policy delivery versus auto-enrolment given self-employed individuals are personally responsible for declaring income and paying tax. The simplest solution could be for pension contributions to be deducted alongside national insurance contributions.

A more fundamental issue is that there would be no employer/employee split in contributions. Either the self-employed would have to be responsible for all their contributions (which would likely decrease support for the initiative, and increase the opt out rate), or there would have to be a role for the state in providing some level of contribution. State provision of some level of self-employed contributions would come with associated costs for the taxpayer. One way of bearing this increased cost (explored later in this paper), would be via changes to pensions tax relief.

If the government were to successfully encourage half of self-employed workers to save towards a pension, and remove the earnings and age thresholds on DC pensions auto-enrolment, one estimate is that private pensions coverage would increase to 83% of the workforce – up from 71% today (Wright 2023).

The under-pensioned

Even with a maximally expanded auto-enrolment and a self-employed private pension system, there will still be a significant group of ‘under-pensioned’ individuals who lack the requisite years of work to build up pensions savings. This includes people who have taken time off work due to sickness, caring responsibilities, or for childrearing. This is part of the reason for the substantial gender pension gap described in Section 3.1. Without some intervention to fill in these individuals' gaps in contributions, a key shortcoming in private pensions provision will remain

Child pension payment

Giving all children a small pension payment at birth would be a positive move in terms of guaranteeing blanket private pensions coverage, but there would be a very significant time lag until the policy feeds through to cover the population at large. Making the payment at birth would give the individual the benefit of accumulating compound returns until retirement, and thus also reduce the amount the state would need to put in to achieve any desired pension pot at retirement.

22 Another way to limit the fiscal impact and better target the policy would be to taper the state contribution such that the lowest earning self-employed people gained a higher proportion of state contribution than higher earning self-employed people.
For those growing up in the very poorest households, such a payment would likely be the only long-term savings a child would have. There might be a benefit in terms of normalising the idea of saving for retirement from a young age. Parents are already able to make payments into a child’s pensions and benefit from favourable tax treatment; this policy would make a small step toward democratising this advantage which is typically only exercised by the wealthy at present.

However even a £500 one-off pension payment for each of the approximately 600,000 babies born in the UK in 2022 would have cost the government upwards of £300m which is a significant expenditure. Though small compared to a total UK government benefit spending of circa £230bn in 2022/23, to input enough to create any decent level of pension pot in retirement would be far more expensive.23

Increasing contributions for current occupation-linked pension savers

Most savers are not saving more than the current minimum 8% pension contributions annually. Indeed, nearly nine in ten private sector employees are contributing less than the 15% of income recommended by the 2005 Pensions Commission report which led to the introduction of auto-enrolment (Cribb et al. 2023).

Employer contributions

Recent analysis by the Fabian Society suggests that total contributions of 12% of income should be sufficient to provide an acceptable retirement income for low earners, provided they save this throughout their working life (Harrop 2022). Capital markets industry body New Financial also suggests 12% contributions as a more suitable minimum contribution than the current 8%, citing this would bring the UK closer to comparable markets (Wright 2023). Raising minimum pension contributions from 8% to 12% could increase the value of typical pension pot over 30 years by £42,000 in today’s money (Wright 2023). Both rightly argue that employers should shoulder most of this increased burden, and that its implementation should be graduated.

Increasing employer contributions would be a small step toward redressing the imbalance in responsibilities and risk distributed between the individual to the employer. This is important given those employers that have moved from DB to DC schemes have gained significantly, as this has transferred risk from the employer to the individual.

Whatever the specific percentage chosen, there is a clear case for employers contributing more specifically for middle and lower earners. The IFS finds that:

“A key difference between high earners and those on middle or lower earnings is the role played by employer contributions [...] higher earners make higher individual contributions (as a percentage of their – higher – salaries) but also receive considerably more in employer contributions, averaging over 8% of total earnings for the highest-paid fifth from employer contributions alone, compared with 5% for the middle-earning fifth and less than that for the lowest earners” (Cribb et al. 2023).

A bolder solution than simply increasing the minimum percentage of a pension savers’ salary that employers must contribute would be to progressively remodel the employer minimum contribution. The employer contribution could be set such that the minimum percentage is higher for those on lower salaries than those on higher salaries. This would make the system relatively more generous for lower earners, and further disincentivise opting out within those groups. In the context of the disparities outlined in Section 3.1, this could be an important change for the benefit of the low-waged.

Employee contributions

While there is strong rationale for employer contributions to increase, the situation is less clear with regards to employee contributions. While savers might benefit in the long-run from an increase in their statutory minimum contributions, the groups who would benefit most from an uplift in contributions are the lowest earners who are least able to afford it. There is a real risk that increasing employee minimum contributions would increase opt out rates. Government data shows opt outs increased notably during the period 2020 to 2022, which coincided with increased economic hardship for many low-earners (Department for Work and Pensions 2022). Mandating any significant rise in employee contributions could be potentially counterproductive in terms of increasing savings for those on low-incomes.24

A broader limitation to increasing flat-rate minimum contributions under the current model – in which they are linked to a proportion of income – is that any option would do little to tackle fundamental inequalities in retirement savings. Bringing the very lowest earners in to the occupation-linked private pension system for the first time will increase the retirement income of the lowest paid workers, but retirement incomes across the board will remain extremely stratified. This is compounded by the fact that the current regime of pensions tax reliefs – especially when considered alongside the recent decision to abolish the Lifetime Allowance – confers significant benefits to high-earners at a significant cost to the Exchequer.

Risk and ‘decumulation’

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24 This unintended outcome might be mitigated to some degree be ensuring any increase in employee contribution has an “opt-down” built in, such that individuals could revert to the historic minimum contribution if they deemed the new level too high.
Fundamentally, in isolation, the changes discussed above would not significantly reduce the risks most retirement savers face under the dominant DC scheme model the UK has adopted in recent years. Bigger pension pots might mean a greater ability to absorb investment shocks, but ultimately all DC savers are beholden to the volatility of the market, and to potential future economic or financial crises, including those caused by climate change, in a way that means the adequacy of retirement income is never fully guaranteed. DC savers’ very direct exposure to risk has arguably led to DC schemes seeking more certain returns via assets such as government bonds, but with the trade-off that returns are lower and thus pension pot growth insufficient.

Moreover, even with higher contributions, DC savers can never be fully sure of their own longevity, so they are forced to make their own decisions about how to best ensure their retirement pot will best serve them until end of life. They may misjudge and run out before their death, or they may overestimate their own longevity and not utilise their savings to the fullest in their later years. Both are sub-optimal outcomes from a retirement income perspective.

Converting a DC pension pot into a retirement income or a lump sum (or a combination of the two) is a process referred to as ‘decumulation’. The lowest risk decumulation option – purchasing an annuity – offers the certainty of full life income, but is itself a complex financial decision to make where making the right choice for an individuals’ circumstances is difficult to know. Moreover, annuities are expensive and therefore do not provide a sure route to a decent income for those without substantial savings. Drawing down a lump sum also involves complex trade-offs and careful consideration – again, greater wealth lowers the stakes for individuals making these decisions at retirement. The evidence suggests most occupation-linked pension savers have limited knowledge and capabilities to navigate these choices (Department for Work and Pensions 2023).

Government initiatives such as the Money and Pensions Service aim to help soon-to-be retirees navigate these often daunting financial choices, but ultimately in the DC model the individualisation of risk leaves it to the individual to find the best way to turn their accumulated wealth into a decent retirement income in in later years. This will lead to good outcomes for the majority who are likely to have relatively low savings, even with higher lifetime contributions, high risks will remain.

Other impacts

Beyond going some way to improving retiree income, increasing savings in private occupation-linked pensions could have some positive impacts on the other pensions system goals explored by this paper: (ii) supporting a balanced and resilient economy; and (iii) environmental sustainability by default. It is possible that bigger pension funds with expanded pools of pension capital could offer more long-term investment in the
green transition and the real economy, and possibly achieve economies of scale if the right governance and regulatory frameworks are in place (explored later in this paper).

3.2.2 Ensuring better risk-sharing through expanding Collective Defined Contribution (CDC) schemes or other mechanisms

As noted above, the dominant DC pension scheme models mean that individuals face both investment risk – as their pension pots could shrink dramatically if bad investment choices or wider crises collapse their value – and longevity risk, as they do not know how long they will live, but remain responsible for ensuring that their pension savings support them until they do. There are three main ways these risks could be reduced:

- **Introducing Collective Defined Contribution schemes.** CDC schemes – sometimes called ‘pensions for life’ - represent a new form of pension arrangement in the UK which involve a pooling of all scheme members' savings and employers' contributions. One of the key features of a CDC scheme is risk-sharing. Investment risk is shared collectively, which means that members' retirement benefits are not entirely dependent on the performance of their individual accounts. Instead, they are influenced by the overall performance of the fund. This sharing of risk helps mitigate some of the volatility associated with pure DC plan. More importantly, CDC members share longevity risk. As a result, CDC schemes have a target benefit that members can expect to receive upon retirement until death. This target benefit is communicated to members, and the scheme aims to achieve it over time through investments and contributions. However, unlike traditional DB plans, there is no guarantee that the target benefit will be reached.

- **Expanding DB schemes:** DB schemes could be considered as the gold standard of investment and longevity risk reduction for individuals, as they transfer this risk to the employer. Ways of incentivising larger employers, who are more likely to be able to shoulder this risk, to adopt or maintain these schemes could be examined.

- **Reforming DC schemes.** Some steps could be made towards improving the way that DC schemes operate. For instance, to reduce the likelihood of DC pension savers from running out of savings in retirement, the government could restore the requirement to take part of the retirement benefit as an income stream – a requirement scrapped as part of Pensions Freedoms (Knox 2022). The government could also set up an agency to provide annuities at cheaper and less volatile prices than insurers currently do (Berry 2021). Ways of sharing investment risk within larger DC schemes could be examined.

As a result of longevity risk sharing, CDC schemes are designed to prevent individual savers from running out of pension savings in retirement by specifying that annuitising is done within the scheme. They therefore give greater security of retirement income than pure DC schemes, and free individuals from complex decisions around decumulation. The target benefit and contributions may be adjusted periodically to reflect the fund’s performance, changes in investment strategies, and other economic factors. These
adjustments help maintain the scheme’s financial stability - but this may sometimes involve cutting pension payments.

CDC pension schemes are designed to strike a balance between the predictability of DB plans and the flexibility of DC plans. They aim to provide retirement security while distributing risk among members and employers, which is appealing in a world of changing economic conditions and generally lengthening life expectancies.

There have been some calls to proceed with the roll-out of CDC schemes, including multi-employer CDC schemes (Pitt-Watson, Mann, and Hall 2021; Harrop 2022), but so far only one has received regulatory approval. There has been noted resistance from parts of the pensions industry to the idea of CDC becoming a major part of the pensions landscape.25

Assessment of these proposals

In terms of providing a decent retirement income for savers, CDC schemes are advantageous in mitigating some of the risks borne by individual savers in a pure DC scheme, and it is not clear how DC schemes could be reformed in a way that would do as much as CDC schemes to do this. Individuals who are not able to save much through their working lives are particularly sensitive to the risk of running out of retirement savings before the end of their lives. Their smaller pension pots also mean they are particularly sensitive to investment risk and the potential underperformance of their pension fund. A CDC scheme is likely to improve the probability that those with lower savings receive a decent income throughout their whole retirement.

To achieve a decent retirement income from a pure DC pension plan, even with healthy savings, those on the cusp of retirement make complex financial decisions around drawdown or annuity purchases. CDC schemes lift the responsibility for these decisions from individuals. In doing so they may limit individuals’ agency with regard to their savings, but they also reduce the scope for ill-advised decisions which might lead to poor retirement outcomes. The fact that CDC schemes will have to accommodate the so-called ‘Pensions Freedoms’ may complicate broader CDC adoption.26 At present, these ‘freedoms’ mean CDC scheme members would be able to take their savings out of the scheme, potentially undermining the collectively that underpins their function. Reforms or roll-back of Pensions Freedoms will be needed, and indeed justified, to facilitate broader CDC roll-out or to reduce longevity risk under reformed DC models.

25 For example, see coverage in Pensions Age: https://www.pensionsage.com/pa/PLSA-AC-significant-challenges-to-commercial-providers-offering-CDC.php
26 “Pensions Freedoms”, introduced in 2015, have given individuals aged 55 and over more choice over how to use their retirement savings. There is no obligation to take any of the savings as an income stream (savers can, for example, take all savings as a lump sum).
As discussed, it is this collectivity that means that CDC schemes are able to accommodate members’ varying life expectancies, mitigating longevity risk for individual members. Retirees who live longer may continue to receive income from the pooled fund, which provides longevity protection and thus increases the chances of a decent retirement income being secured for all savers in the plan. There is, as with DB arrangements, the potential for inequities resulting from this approach: given that affluence is a key predictor of longevity, it is possible that shorter-living lower earners in a CDC scheme may end up subsidising the longer retirement of longer-living higher earners in the same scheme.27

For those in CDC schemes, individuals target benefits will still reflect their contributions which will remain highly stratified as long as contributions are still closely tied to working income. However, contribution rates for CDC could also be calibrated more progressively. The simplest way would be to have a progressive contribution scale whereby employers put in higher contributions for lower earners, possibly linked to a minimum target level. Alternatively, CDC schemes could be designed such that lower-earners pay less for the same level of accrual as higher earners via higher earners cross-subsidising lower earners.

Retaining or expanding DB schemes would be a welcome way of reducing longevity and investment risks and should also be examined.

As well as providing greater security in retiree income, expanding CDC schemes or protecting and expanding DB schemes could have secondary impacts on ensure pensions are compliant with this papers’ goals (ii) and (iii). CDC schemes could create pension funds with risk-sharing that could allow different approaches to investment to existing funds. This could lead to more effective investment in the green transition and the real economy, provided other policy changes explored later in this paper are considered in tandem.

Multi-employer CDCs could also achieve greater scale that might also facilitate such investments. Such schemes are more likely to become the norm with coordinated government efforts in collaboration with employers, trade unions, civil society groups and the industry to establish them.28

3.2.3 Increasing state provision

27 An industry actor claims that low earning CDC savers could subsidise the retirement income of wealthier members by as much as 30%. See: https://www.hymans.co.uk/media-centre/press-releases/commentary/cdc-risks-exacerbating-social-inequality/ To be clear, the same phenomenon is a reality in DB schemes, and in the pricing of annuities purchased by pure DC savers.
28 The Department for Work and Pensions has recently consulted on multi-employer CDCs, see: https://www.gov.uk/government/consultations/extending-opportunities-for-collective-defined-contribution-pension-schemes/extending-opportunities-for-collective-defined-contribution-pension-schemes
There will inevitably be significant numbers of people who are unable to save sufficiently or indeed at all throughout their lives to ensure a decent income in retirement. Therefore, the state pension will always be necessary to provide a baseline level of income in retirement. As noted above, the UK full state pension is low compared to European peers, but thanks to the triple lock it has risen over the past decade more than if it was pegged to just prices or earnings (Cribb, Emmerson, and Karjalainen 2023).

There are a number of proposals to improve pensioner income via more robust state provision. Groups representing pensioners and older people have consistently argued in favour of maintaining the triple lock. Some have suggested additional benchmarks for the state pension rate - for instance, that the state pension should be set at 70% of the living wage (National Pensioners Convention 2018).

Given only half of those currently claiming state pension claim the full amount, some proposals would see more retirees eligible for the full state pension, for instance by reducing or eliminating the National Insurance contribution threshold for full entitlement and replacing it with a residency requirement, which is used in several other European countries (Bonizzi, Churchill, and Dutta 2023). Moreover, even working until state pension age can be difficult or impossible for some so proposals have been made to offer some to take their state pension early (Age UK 2023).

The state could also play a bigger role in ensuring adequacy of retirement income by making broader changes to the social security system. For example, the New Economics Foundation has suggested that the government introduce universal credit auto-enrolment and a weekly national allowance which would guarantee pensioners (as well as the working-age population) a minimum level of income (Pollard et al. 2022).

**Assessment of these proposals**

**The triple lock and uprating state pensions**

Retaining the triple lock will maintain a steadily increasing baseline of income for pensioners that will increasingly protect many pensioners from absolute poverty. Since the triple lock was introduced, the state pension has risen in line with inflation six times, by 2.5% three times, and in line with earnings growth three times. As a result, the state pension has risen by 60% in cash terms between 2010 and 2023, compared with prices rising by 42% and earnings rising by 40% (Cribb, Emmerson, and Karjalainen 2023).

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29 The triple lock applies to the basic and single-tier state pension. Many current retirees are covered by the State-Earnings Related Pensions Scheme (SERPS) or the Second State Pension (S2P) (different forms of state pension) without triple lock protection. See this Age UK factsheet for an explanation of different state pensions: https://www.ageuk.org.uk/globalassets/age-uk/documents/factsheets/fs19_state_pension_fcs.pdf
Given that the UK’s state pension remains low compared to European peers, and that it remains low in absolute terms compared to what the public regards as acceptable minimum levels of income in retirement, the case for maintaining some kind of automatic uprating mechanism remains solid for the foreseeable future. However, over time, the fact that the triple lock means that pensions rise in real terms may lead to concerns about affordability.

Under the current model, it is today’s government revenue that pays for today’s state pensions, meaning that questions of intergenerational fairness may also arise, particularly if real wage growth remains poor. Revenue to support a continued uprating of the state pension might most equitably be sought by reforming the existing pensions tax reliefs (discussed below).

Analysis from the Resolution Foundation shows that younger cohorts are now accumulating wealth at a much slower rate than older age groups were at the same age (Broome and Leslie 2022). These trends might be seen as justification for a move away from triple lock-type mechanisms which guarantee income increases of pensioners regardless of extraneous factors, but also indicate that another means of funding more generous state provision might be via taxation of wealth.

Regardless of the funding mechanism, maintaining the triple lock or a similar measure – at least until the UK’s state pension has become as generous as peer countries – will be beneficial for current workers in the long-run as it means that when they come to claim their state pension, they should benefit from more generous provision than they would enjoy if the measure were scrapped (Berry 2021).

Moreover, the UK is far from eliminating pensioner poverty – the country is 15th highest for pensioner poverty out of 35 OECD countries based on data from 2017 to 2019 (Harker 2022). Any changes in private pensions savings will take time to feed through into retirement incomes, underlining the importance of maintaining state provision.

Fiscal impacts might be offset to a greater or lesser degree by reducing or eliminating the tax reliefs on private pension contributions - worth some £48bn in 2020/21 - which disproportionally benefit higher earners (Bonizzi, Churchill, and Dutta 2023; Berry 2021). Alternatively, changing current reliefs to a flat-rate relief would offer some redistributive effect and could offer tax savings which could go toward supporting the state pension.30

Other benchmarks for state provision, such as the 70% of living wage proposed by the National Pensioners Convention, have similar benefits in terms of avoiding absolute pensioner poverty but lead to similar fiscal trade-offs.

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30 A complete exposition on the long-term sustainability of funding for the state pension and other government spending would require a deeper look at the tax system (including, as alluded to above, examining wealth taxes) which is beyond the scope of this paper.
Other proposals for state provision

Ensuring more pensioners received the *full* state pension by altering or removing National Insurance contribution thresholds would deliver a welcome income boost for those with irregular records of contribution. This would rectify two problems. First, only some reasons for not working are eligible for the state paying your National Insurance contributions, including claiming unemployment or carers benefit or being on maternity leave. However, other reasons do not receive these state credits, only allowing for the individual to top up their gaps themselves, including being a full-time parent, or being a carer who does not qualify for carer’s support. This disadvantages women who are more likely than men to have taken time out of work for such caring responsibilities. Second, some may have not claimed the credits to which they are entitled. Moreover, there is likely a very significant overlap between those with incomplete National Insurance records and those who have limited or no private pensions savings.

Unlike the UK, not all state pension systems require a contribution record to access state pensions. There is evidence to suggest that countries with state pensions that do not require a record of contribution are more effective in reducing old age poverty (Bonizzi, Churchill, and Dutta 2023). Additionally, simplifying access to the full state pension might reduce demands on other forms of benefit pensioners can claim, thus dampening the fiscal impact of greater headline claims on full state pension.31

The New Economics Foundation proposal for Social Security For All looks to combine aspects of both a Universal Basic Income and a Minimum Income Guarantee (Pollard et al. 2022). Policies such as this could act as an important and significant supplement to the current state provision for retirees and, if properly calibrated, could provide a safety net in guaranteeing a decent retirement income for all. However, the significant taxation and spending implications of such policies, as well as their substantial impacts on other parts of the welfare state, mean detailed analysis of their implications are beyond the scope of this paper. Suffice to say, in the longer-term it is entirely possible that such policies - alongside a root-and-branch rethink of the UK’s social security regime - might be necessary in the face of continued demographic, employment, and technological changes.

In isolation, changes to state provision for retirees is unlikely to significantly impact the other pension system goals identified in this paper, though the increased spending power of low-income pensioners could contribute to stronger economic outcomes.

31 Similarly, as per Age UK’s (2023) recommendations, allowing certain groups such as long-term sick or carers to access their state pension early in specific circumstances might smooth the transition to retirement income for those unable to work until state pension age without a significant fiscal cost given the likelihood of individuals in such groups to be making claims elsewhere in the welfare system. Illustratively, DWP data shows that the number of 50-to-64-year-olds claiming long-term sickness related benefits is on the rise (Kirk-Wade and Harker 2023).
Assessment of these proposals

Restoring the requirement to take at least some retirement benefit as an income stream would be a beneficial change given the risk of running out of savings associated with allowing individuals full discretion on how they access their savings. A DWP study on the impact of Pensions Freedoms found that:

“Consistent with other research, people in the age group for this study, ranging from aged 50 to 72, tended to underestimate their potential life expectancy and focused more on the early, independent, phase of retirement [when making decisions about decumulation]” (Department for Work and Pensions 2020)

It is reasonable to impose somewhat more restrictive limits on how savers access their pensions savings in return for ensuring they have some form of guaranteed income safety net beyond the state pension. This is particularly important in light of the increase in pension scams witnessed since the introduction of Pensions Freedoms. £30million worth of pension scams were reported to Action Fraud between 2017 and August 2020, and this is likely a substantial underestimate of the problem given historic underreporting (Work and Pensions Committee 2021).

Income stream requirements would also mean that the pensions tax relief savers benefit from is – at least to some extent – used as intended to fund a suitable pension, in line with the reliefs’ policy intentions.

A state-run option for the provision of annuities would also represent a positive change if DC is to remain the norm for pension savers going forward. It would give DC savers access to a fairly-priced way to access their savings in a low-risk manor, and should make decisions easier and lower-stakes for DC members approaching retirement. It would be particularly beneficial for less wealthy retirees given their increased sensitivity to annuity pricing.

Consolidation of smaller pension funds could – if done correctly – deliver better retirement incomes for those saving in private occupation-linked pensions. The outcomes of consolidation as a policy lever are explored in more detail later in this paper.
4. A RESILIENT AND BALANCED ECONOMY

As well as holding vital savings for the population, the significant scale of UK pension funds means they play a substantial role in the economy in the broadest sense. Indeed UK pension funds’ assets under management in 2022 were estimated at $2,568 billion – the fourth largest pool of pension assets in the world (Thinking Ahead Institute 2023). Accordingly, much of the recent interest in pensions reform has been centred around the idea that pension fund capital might deliver more investment into UK businesses, infrastructure and regional economic growth.

While this objective has merit, it must of course be underpinned by a recognition that pensions should be managed and invested in a way that enhances financial and economic stability. It should also be tempered by an understanding that while investment in the UK is key, climate change is a global phenomenon and the investments needed to protect our climate and nature will not all be within this one jurisdiction. Nevertheless, as a basic principle, the UK’s pensions should support a resilient and balanced economy across the country. There is certainly more that can be done to support this goal.

4.1 Current problems

The type and scale of investments made by UK pension funds has been under increased scrutiny of late. In recent years, funds have typically made big investments in government bonds and other low-risk assets, but this has been at the price of lower pension fund investment in equities and the UK’s real economy. Compared to some countries, UK funds’ investments in bonds has been comparatively high, and their investments in equities comparatively low, as shown in Figure 6.

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32 We also recognise, as covered later in this piece, that securing returns for investors will also mean looking beyond just the UK.
This increased pension fund investment in low-risk low-return safe assets such as gilts and other bonds at the expense of equities or the real economy is put down to:

- **DB schemes winding down** – as most DB schemes are closed to new members, they have generally adopted lower-risk investment strategies as they no longer have to seek high returns. This, however, has a significant aggregate effect given the combined size of the legacy DB funds (81% of all pension assets in the UK in 2021 (Thinking Ahead Institute 2022)). The UK’s specific approach to the shift away from DB has involved the government requiring firms to effectively underwrite their closing DB schemes (as compared to the Netherlands where DB schemes have generally stayed open but gradually diluted their promises and become CDC). This has resulted in a split market in the UK, comprising a mature, large and de-risked DB sector, and an immature, small DC sector.

- **Accounting, tax and regulatory changes** – a number of reforms in these areas made in the late 1990s and early 2000s – with the intention of protecting scheme members – have on aggregate made UK pension funds significantly more risk averse.\(^3\)

Critics of funds’ current approach to investment say this is both bad for UK businesses (reducing their valuations and limiting their access to growth capital), but also bad for savers, as returns have been consistently amongst the lowest in the industrialised world (Kakkad, Madsen, and Tory 2023). This trend is also said to have led to UK firms to rely

\(^3\) These changes and their impact over the subsequent two decades are too detailed to be fully explored in this paper but are explained in Kakkad, Madsen, and Tory (2023).
on overseas investment for much of their funding – around 60% for growth companies (Wright 2023).

This trend has come alongside a growing acceptance that the UK’s low investment rates have stymied economic growth. Particularly outside of London and the South East, we have seen regions starved of business investment. For some, pension funds could and should be doing more to invest across the UK in businesses and infrastructure over the long-term.

Benefits from legacy DB schemes have played a significant role in maintaining consumption in some of the areas that have been hit worst by deindustrialisation and low investment over recent decades. As the beneficiaries of these DB schemes pass away, the increasing need for productive economic activity to support these areas will only become more apparent.

There is also a real and currently unmet need for a major scale-up of long-term investment to drive the green transition. The Climate Change Committee has estimated that the UK will have increase its low-carbon investment by around £40bn per year by 2030 (Climate Change Committee 2020). Clearly there could be a big role for the UK’s large pools of pension capital to fill this gap - this issue is covered in more detail in Section 5.

Efforts to get UK pension funds to invest more in a way that would be more immediately beneficial for the UK economy and the regions - for example, the Pensions Infrastructure Platform initiative - have so-far failed to move the dial.

There is also a growing acceptance that the UK could be doing better based on how pension funds in other countries invest. The large ownership stakes of Canadian or Australian pension funds in UK infrastructure or high-growth firms are often cited as proof that domestic funds should be doing more to support the domestic economy. Five of the UK’s six main energy companies, all of the UK’s gas-distribution, and much of the UK’s water and rail industries are today under overseas ownership with foreign pension funds staking significant claims (Kakkad, Madsen, and Tory 2023).

34 For example, the Institute for Public Policy Research argues that decades of underinvestment have left the UK in a “doom loop” of low growth. See: https://www.ippr.org/blog/now-is-the-time-to-confront-uk-s-investment-phobia
35 See this blog for novel analysis of this phenomena: https://flipchartfairytales.wordpress.com/2022/01/26/levelling-up-the-role-payed-by-disappearing-occupational-pensions/
36 For instance, Chancellor Jeremy Hunt namechecked Canadian pension funds’ investments in UK start-ups at a recent pensions summit. See: https://www.ft.com/content/090da37c-4d5b-461b-bb73-e7ac1d3bfaa4. Hunt also compared UK pension funds’ underinvestment in unlisted equities unfavourably to Australian funds’ investments during his July 2023 Mansion House speech. See: https://www.gov.uk/government/speeches/chancellor-jeremy-hunts-mansion-house-speech
Moreover, the 2022 liability-driven investment (LDI) pension fund crisis revealed that the UK pensions industry has the potential to act as a source of instability in the economy and to precipitate financial crisis. As large pools of pensions capital continue to grow and pension funds become increasingly important to the global financial system, the potential for negative shocks in pensions rippling outward will only become more important to mitigate (Gudjonsson and Jensen 2023).37

4.2 Solutions assessment

We identify a number of ways the economic outcomes generated by the UK pensions system might be improved. These are categorised and explored below under the headings of: increasing savings and expenditure; embedding longer investment horizons; aligning pension fund investments with national priorities; and consolidation and professionalisation.

4.2.1 Increasing savings and expenditure

It is important to note that many of the reforms examined in this paper, particularly in Section 3, would increase overall pension savings and hence the savings rates for the whole economy, in some cases significantly, and also boost incomes and hence expenditure in retirement. For example, increasing minimum contributions to auto-enrolled private occupation-linked pensions to 12 or 15% of income would significantly grow the scale of assets in pension funds over time. Therefore, a secondary outcome of increasing individuals’ savings would be to provide a much larger savings pool for funds to invest, with knock-on effects for the broader economy. Of course, the extent to which this would boost growth, productivity, inclusivity or sustainability in the economy would depend on how those funds were invested, which is the subject of the rest of this chapter.

There could also be significant economic benefits from the additional spending power retirees would have if the pension system were made more secure and progressive. Moving towards a pension system that guarantees decent, secure incomes in retirement, the subject of Section 3, could boost the consumption of retirees, and make it more resilient over time. Focussing on making the system more progressive would boost, in particular, the incomes of those towards the bottom of the income scale whose consumption is currently least likely to hold up in retirement.38 This could benefit the

37 To be clear, LDI strategies were a product of DB schemes winding down, not by the growth of pension funds. But what the LDI crisis does show is that unexpected instability can emanate from the pensions system, and that caution is necessary with regard the regulation and supervision of the pensions industry,

38 Research by the IFS suggests that current pensioner households with above-average incomes have an increasing profile of spending in their 60s and 70s, with spending falling slightly for those in their 80s. On the other hand, pensioner households with incomes below the median have a slightly declining profile of spending in their 60s and their spending remains flat at older ages. See: https://ifs.org.uk/publications/how-does-spending-change-through-retirement-0
broader economy, particularly in areas with high numbers of retirees and fewer employment opportunities.

Assessment of these proposals

All else being equal, higher rates of pension capital accumulation should have positive economic outcomes by increasing the scale of capital that funds can invest toward productive ends. As noted above, the exact level of positive impact will depend on other factors that guide investment choice.

Increasing pensioner spending power would also represent a potentially significant economic net positive, provided increased saving rates do not significantly impact workers take-home wages and consumption. Employers bearing most of the increase in contributions would be one way to minimise this risk.

4.2.2 Embedding longer investment horizons

As discussed above, the current pensions landscape, largely made up of growing DC schemes and closed or closing DB schemes leads to a tendency toward shorter-term investment horizons in aggregate. Various ways of restructuring the pensions system could incentivise funds to adopt long-term investment strategies. This requires them to have long-term investment horizons.39

The investment horizon for closed DB schemes is relatively short term and shrinks every year as the fixed number of beneficiaries age and die. DC funds have tended to have shorter-term horizons for a number of reasons. First, they do not collectivise the risks and rewards of investment and so they are likely to reflect the lower risk preferences of beneficiaries, who tend to prioritise security of outcomes (Work and Pensions Committee 2018). This also means that as beneficiaries approach retirement age their investments move into more liquid and secure, lower return assets. The introduction of Pension Freedoms, which allow the drawdown of pension assets at an earlier age, has contributed to this development. Second, DC schemes make no specific promises to individual beneficiaries and so are not incentivised to reach a particular growth target as DB schemes are, for example.

Proposals to embed long-term investment horizons into the private pensions system include:

- **Making Collective Defined Contribution (CDC) schemes the norm** - as covered in Section 3, the focus on sharing of longevity and investment risks

39 A time horizon or an investment horizon is the time period over which an investor expects to hold an investment for a specific goal.
and the targeting a set level of income in retirement helps embed long-term investment horizons into CDC schemes.

- **Reforming DC schemes to make the default fund long-term** - in theory, if DC schemes are large enough to have a stable balance of members across all ages, it could be possible to embed a longer-term investment horizon into the default fund option via the investment strategy pursued as part of this default fund. In other words, the fund members of a DC scheme are auto-enrolled in could be invested in such a way that it seeks longer-term returns. If members wanted to take a different approach and, for example, invest in more liquid, less risky assets, they would have to actively change the fund they are invested in.

- **Revitalising DB schemes** – almost ten per cent of private sector employees remain in DB schemes, as do a significant number of public sector employees. Reform could aim to maintain and increase this percentage through, for example, reforming the accounting rules that have tended to make these schemes very expensive for employers (see below).

### Assessment of these proposals

We have assessed CDCs in the previous chapter; we argue they present a good option for embedding long-term investment horizons by virtue of their design. They therefore could facilitate more long-term investment to benefit the wider economy, but this would be best guaranteed in conjunction with other measures discussed in this section.

Reforming DC schemes could also work to the same end, but pure DC schemes would not have the same inbuilt long-termism incentives that CDC or DB schemes have because DC plans do not make any specific promise to the beneficiary to deliver or aim to deliver a targeted income in retirement. Individualisation of outcomes is largely built in to DC schemes.

DB schemes remain an excellent option for embedding long-term investment horizons particularly given they aim to guarantee a target income in retirement and so have strong incentives for growth. However, there is limited appetite for any significant expansion of such schemes. There are many reasons for the shift in pensions provision away from DB to DC.\(^{40}\) Employers are unlikely to acquiesce to reversing this shift, partly due potential high costs for them in establishing and running DB schemes. Demographic and employment changes also make the expansion of DB schemes less feasible than in the past. In the current environment, the widespread roll-out of new DB schemes is therefore an unlikely development, but this could still be examined, in addition to ways of protecting existing DB schemes.

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\(^{40}\) See Berry (2021) for a full account of the UK’s move from DB to DC.
4.2.3 Aligning pension fund investment with national priorities

As a part of a more targeted approach to increasing pension support of the economy, policy could be developed to further encourage pension funds to provide a key source of investment to support national economic priorities. This could, for example, be done as part of the country’s green industrial strategy. Proposals to align pension fund investment to national priorities include:

- **Voluntary targets** - at the core of Chancellor Jeremy Hunt’s July 2023 Mansion House announcement on pensions was the “Mansion House Compact”. The compact is a voluntary agreement between nine of the biggest DC pension providers to “to allocate at least 5% of DC default funds to unlisted equities by 2030 in a way that is consistent with the requirement to act in the best interests of our savers”. Investing in unlisted equities, the proposal suggests, will mean providing capital to small but high-growth private British firms. The opposition Labour Party has also indicated its support for voluntary initiatives to incentivise pension funds into investing in different asset classes with the hope of delivering better macroeconomic outcomes. The Labour proposal began with a commitment to a £50bn “future growth fund” through which DC pensions would be encouraged to invest in smaller private companies. Labour’s proposal also offered funds the chance to de-risk their investments through a framework which would ensure the British Business Bank co-invest.

- **Mandating investment in specified priorities** - the potential role of specific requirements to invest in certain assets or through specific vehicles is discussed in Section 5 with specific regard to green investment. In the broader economy context, some kind of mandate could be envisaged to require a set percentage of overall pension fund investment in – say – UK equities, or UK growth strategic sectors. Given the UK taxpayer offers billions of pounds annually in tax reliefs on pensions contributions, one might argue that some kind of quid-pro-quo is justified. A less blunt approach could be to establish voluntary targets and allow them time to work, only making them mandatory if the industry fails to meet voluntary commitments.

- **Introducing ‘People’s Pensions’ to invest in public infrastructure** - in the early 2000s the New Economics Foundation proposed a new People’s Pension. The People’s Pension project proposed the creation of new pension funds which would invest directly in new public infrastructure projects such as schools, hospitals, and transport projects. The People’s Pension funds would then own these utilities and rent them back to the users in order to generate returns for the fund (Murphy, Hines, and Simpson 2002). In practice, a People’s Pension fund might build a

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41 The full text of the compact is available here: https://www.theglobalcity.uk/PositiveWebsite/media/Research-reports/Mansion-House-Compact-Signatories-The-Global-City.pdf

hospital for an NHS trust, then rent the hospital back to the trust for a period of 30 years after which the trust would take full ownership of the hospital.

- **Introducing ‘Social Pension Fund’ options to invest in social enterprises** – a more recent proposal is for Social Pension Funds as advocated by the Social Market Foundation. The Social Pension Funds would be based on the French ‘Solidarity Investment Fund’; they would form part of the DC landscape and the government would encourage their uptake by requiring employers to offer a DC a social fund option as part of the pension plan. These social funds would channel some proportion of their capital toward social investment that might take the form of growth finance to social enterprises. (Keohane and Rowell 2015).

**Assessment of these proposals**

**Targets and mandates**

Voluntary initiatives are welcome insofar as they recognise that the status quo does not deliver for the UK economy. However, as a policy response it is likely they lack the teeth necessary to be transformative. The failure of the Pensions Infrastructure Platform to significantly change investment practices is illustrative of the limits to voluntary approaches.43

With reference to the current government proposals, one senior industry figure has expressed scepticism that the specified 5% would be invested only in the UK, noting that – given the risky nature of private equity – asset owners would want to diversity their portfolio, including by investing globally not just in the UK.44

Moreover, it appears that Labour implicitly recognises the strong chance that voluntary initiatives will not be enough – Shadow Chancellor Rachel Reeves has refused to rule out mandating investment if voluntary agreements don’t deliver.45 And there has been outright resistance from some in the industry with regards to such efforts. NEST CEO Elizabeth Fernando has publicly stated “We want proven business models [to invest in]. Our job is not to support levelling up. It is to build retirement funds”.46

If voluntary initiatives prove ineffective at significantly transforming how pension funds invest for the broader economy, it is also unlikely they will have large impacts on

43 The Pensions Infrastructure Platform was established in 2012 by a number of pension schemes to encourage pension investment in infrastructure. It was been particularly impactful in the round and was sold to an investment management firm in 2020. See: https://www.foresightgroup.eu/about-us/our-managers/pip-manager-limited
45 See: https://www.ft.com/content/03593281-2a22-4e9a-919b-cc346384e455
46 See: https://www.ft.com/content/c853d587-ac35-4766-a377-bef2831b5f97
securing good long-term pensioner income (i) or the climate and nature sustainability of pensions (iii).

As discussed later in Section 5, mandates could have substantial impacts but they would have to be limited and well designed. Any investment mandate would have to recognise the primary objective of the pension fund as delivering returns and retirement income for savers and be designed to promote longer-term outcomes that are also in their interests, such as a safe climate. Mandates would also have to be developed in such a way that governments are not tempted or able to use pension capital as an easy way to fund spending that they should do themselves. Any mandated percentage would have to be low, and it would have to be difficult for governments to both enact and change any investment mandate.47

Mandates would probably have to be limited to larger pension funds given their greater ability to shoulder risk, and the better quality of investment management they should enjoy. And a mandate’s design would have to include some form of override in order to extricate a fund from its requirements should the fund be at risk of not delivering on its core fiduciary duties.

Nevertheless, even a very limited mandate which led to 5% of the value of UK pensions invested in a way directed to strategically support the UK economy would currently mean approximately £105 billion delivered to that end.48 The assets and vehicles used in any mandatory scheme would have to be carefully designed to ensure that the objectives of the scheme are met – whether this be ensuring that companies invested in have impact in the UK or are delivering truly sustainable investment. This is covered further in the sustainability chapter.

A significant shift toward CDC models as the norm instead of DC schemes the across the UK pensions landscape might be a necessary prerequisite for the imposition of any mandatory investment targets. In a pure DC context, whereby individual members are ultimately responsible for their own investments, forcing investment toward collective goals - beyond a certain degree of asset allocation for prudential purposes - is more difficult to justify. In a CDC context, mandates could be deemed more appropriate due to inbuilt acceptance of the collectivisation of outcomes and risk sharing.

As discussed, mandates could play a role in delivering on the sustainability of the pensions system as per goal (iii) explored in Section 5 of this paper. Mandates could only be a feasible policy if they were designed such that any risk to the retirement income of beneficiaries - relating to goal (i) of this paper - were fully taken into account.

47 Further, evidence suggests that it is not only assets that matter in portfolio diversification that matters, geographical diversification is also key to fund performance. This is another reason why any UK mandate would have to be limited (World Bank Group 2017).
48 Calculated on figures from the Global Pensions Assets Study 2023 (Thinking Ahead Institute 2023).
Novel fund models

The People’s Pensions would likely be an expensive way to deliver public investment given the high returns needed to satisfy pensioner income needs. Moreover, the significant potential for new infrastructure project budgets to balloon and for building to overrun make such investments highly unsuitable for small, undiversified pension funds to commit their capital to.

Social Pension Funds could be helpful at the margins in increasing capital to social enterprises, but social enterprises are fundamentally limited in how much they can deliver with regards to economic rebalancing across the country. Moreover, opt ins to such funds would likely be limited unless they were either made default or appeared to offer significantly better returns than the status quo, both of which seem unlikely.

4.2.4 Consolidation and professionalisation

Consolidation of the UK’s fractured pensions landscape, starting with legacy DB schemes and then moving on to DC schemes, has been proposed by The Tony Blair Institute (TBI), capital markets think tank New Financial, and others (Kakkad, Madsen, and Tory 2023; Wright 2023).

Fundamental to this vision is that folding smaller pension funds into consolidated ‘superfunds’ will achieve economies of scale and allow bigger investments to be made by well-informed investment professionals. It is assumed these investments will be more diversified than at present, allowing for a degree of higher-risk investments and longer investment time horizons. These changes in risk appetite and investment strategy should then mean consolidated funds diversify pensions investments away from reliance on bonds and toward investment in listed and unlisted UK equities, infrastructure, and other growth opportunities which could benefit the UK economy.

To encourage the consolidation of smaller funds or undiversified funds, the continued tax privileges pension funds enjoy might could be made conditional on, for example, achieving a minimum fund size, or on a certain proportion of investments in UK companies and qualifying infrastructure assets (Kakkad, Madsen, and Tory 2023).

Alongside the consolidation of existing smaller pension funds, TBI and New Financial also see a role for moving public sector pension schemes, such as the Civil Service

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49 The Tony Blair Institute argues that the Pensions Protection Fund (PPF), which is where the DB schemes of failing firms are folded into, should provide the basis for fund consolidation. The PPF has achieved consistent good returns through its approach to investments and has outperformed most DB schemes over time (Kakkad, Madsen, and Tory 2023).

50 The mandate element of this incentive is mentioned in Section 5 with regards to mandating green investment, and again in 4.2.3 as part of investment mandates as a standalone policy.
Pension Scheme and the NHS pension scheme, onto a funded basis. As with the consolidation of smaller funds, the net result of funding these schemes could be to create one or more additional superfunds with the same investment abilities of the private consolidated funds.

Assessment of these proposals

There are many thousands of pension schemes and more than 50 million individual pension pots in the UK (Wright 2023). It seems entirely reasonable to assume that consolidation of some of these smaller schemes, as well as professionalisation of their running, could help facilitate investment strategies that deliver better macroeconomic outcomes than the current fractured model.

However, the scale of the impacts is likely to be dependent on having the right governance and regulatory frameworks in place to guide any new superfunds to make better investment decisions in the round. Moreover, the focus of consolidation reforms is on freeing up the supply of pension fund capital by amassing it in bigger, lower-friction and more efficient pools. They say less about the demand side – a paucity of good investment opportunities in the UK could well send much of this capital overseas in search of returns. Consolidation could help ensure the pensions industry supports a more balanced and prosperous economy, but it will depend on factors including how the wider policy and regulatory environment facilitates a positive ecosystem of good investment opportunities (discussed in Section 5), the approach such funds have to risk and investment which we have seen is also linked to the kind of fund they are (DC, CDC or DB) and if consolidated funds are able to maintain good governance and member engagement.

A degree of caution is also warranted in expecting that consolidation of smaller UK funds will necessarily deliver the kind of investments in the UK’s infrastructure that the big overseas funds are seen as providing. Some of what the Canadian and Australian pension funds do is provide debt-based financing for infrastructure projects, essentially as part of

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51 Currently these public sector schemes are unfunded. Contributions are made by employer and employee but there is no fund to pool and invest contributions. In its March 2023 forecast, the OBR predicted unfunded public sector pensions spending in 2023-24 will be equal to £7.9 billion (meaning £53.1bn of total pension benefit payments, less £45.3bn of contributions). See: https://obr.uk/forecasts-in-depth/tax-by-tax-spend-by-spend/public-service-pension-payments-net/

52 Overall, there are circa 34,000 schemes in the UK, but many of these are very small executive and Small Self-Administered Schemes where the savers themselves are trustees. These would not be suitable for consolidation. However, there are a very large number (somewhere between 8,000 and 10,000) of occupation-linked DC and DB schemes which would be.

53 For the avoidance of doubt, we are clear that some level of investment overseas by consolidated funds will be necessary and welcome, but the proportion of new investment that will be made overseas will be an important consideration as regards the success of these reforms form the UK economy.

54 We note, though do not discuss here at length, that consolidation could be executed in different ways. For example, investment vehicles could be government-backed and consolidated, but funds themselves could remain legally distinct while channelling their capital via these shared vehicles.
a low-risk, fixed-income strategy. One could argue that this is not what UK pension funds should be overly focussed on, and indeed in many instances the state may be a more appropriate source of direct investment for such projects than the pensions industry.

There are also dangers around consolidated funds pursuing riskier strategies. Any superfund investment that is overly involved in – for instance – private equity could be a source of concern given the inherent risks in such investments.\(^{55}\) Moreover, questions might justifiably be asked regarding whether private equity is a suitable business model for pension funds to invest in if a main motivation is a desire to deliver broad-based economic and social benefits.\(^{56}\)

Consolidation and professionalisation also leads to considerations with regard to financial stability. It is likely any superfund, by virtue of it holding the assets of many millions of pensions savers, will be implicitly backstopped by the state. In effect, superfunds would have to considered be ‘too big to fail’.

This has implications both in terms of the significant fiscal costs for the state if a superfund were to require rescue, and in terms of moral hazard arising from the implicit backstop itself.\(^{57}\) This reinforces the need for strong regulatory and governance frameworks to ensure the safe and effective running of any consolidated funds. The TBI suggests that such funds should be not-for-profit entities as one way of reducing this risk (Kakkad, Madsen, and Tory 2023).

While these proposals have some merits, they would also be a substantial undertaking for any government. Consolidation in the DC market is already happening, with the occupational DC market consolidating by nearly 40% in the ten years to 2022.\(^{58}\) However, there are considerable vested interests in the status quo, and building and scaling the superfunds would be a process that would stretch well beyond one electoral cycle. If undertaken, it will take commitment and concerted efforts to achieve and maintain buy-in from the pensions sector and savers themselves. Current consolidation

\(^{55}\) There is ongoing discussion of the merits of pension fund investment in private equity, particularly after the Chancellor’s Mansion House proposals (covered later in this piece) which has increased pressure on pensions with regard to buying into private equity. See: https://www.pensions-expert.com/Investment/Private-equity-or-bust-Why-the-Mansion-House-pension-compact-needs-detail-and-circumspection

\(^{56}\) There are many critiques of the potential for negative impacts from private equity deals. Recently attention has been focussed on the role of private equity firms in the UK’s water infrastructure. For example, see: https://www.ft.com/content/ba0bc8df-e760-4cee-b291-21708be28c6f

\(^{57}\) Moral hazard is a situation where an economic actor has an incentive to increase its exposure to risk because it will not bear the full costs of that risk if it materialises.

could be accelerated via the imposition of measures such as explicit Value for Money tests which would largely impact smaller funds not benefiting from economies of scale.\(^{59}\)

A guardedness for unexpected consequences would also be necessary for this reform to work well. A shift away from bonds would have to be partial, as well as gradual and controlled to maintain the stability of the bond market.\(^{60}\)

In terms of delivering on goals (i) and (iii) for the pensions system, these reforms could be broadly positive if they are used to help accelerate other changes that benefit pension savers and the environment. Specifically with respect to ensuring a decent, secure retirement income for all, a well-executed consolidation policy could deliver better net returns and lower costs for some savers, depending on the current performance of their existing fund. For those private sector savers that end up benefitting from better returns, all else being equal, consolidation would mean healthier retirement incomes.

However, moving unfunded public sector pension schemes into this model would transfer new risk to those pension holders by moving many of them from a DB arrangement to a pure DC or CDC scheme, depending on the chosen consolidated model.\(^{61}\) Accordingly, it would be more sensible to see consolidation as a mechanism of rapidly getting rid of poor performing private sector funds, and of potentially accelerating a transition from DC to CDC as the norm.

The aspects of the reforms which could allow for better investments in the UK economy should also provide for more of the kind of investments that would deliver greater sustainability in the pensions system – but this would require some of the measures discussed in Section 5 to be implemented to fully realise this potential.

Prevention of crises, consumer protection, financial integrity and social impacts

In addition to focusing on the three key goals that the pension system should deliver against; it is important to also ensure that the pensions system does not expose the economy to the risk of financial crises. More prosaically, it is also key that consumers are well protected and that the overall financial system, including the pensions system, does not facilitate economic crime or tax avoidance and evasion. Finally, we are aware that pension fund investments can have significant social impacts, for example on human rights or employment practices. We do not cover these issues at length in this paper, but

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\(^{59}\) There are already some value for money requirements on DC scheme trustees which could be adapted to ensure non-consolidated DC schemes offer value for money vis-à-vis larger consolidated schemes. See: https://www.thepensionsregulator.gov.uk/en/trustees/governing-the-scheme/value-for-members

\(^{60}\) Not to mention, some level of pension fund investment in gilts is a good thing. As well as offering a low-risk asset to funds, government’s revenue raising partly relies on its ability to sell gilts, and pension funds are a key part of this market.

\(^{61}\) Moving unfunded public sector pensions to a funded basis would also likely be resisted by government due to the impact on the balance sheet as the accounting rules for unfunded schemes render them relatively cheap to services.
recognise that they are also critically important aspects of the economic impacts of pensions that regulation and policy need to focus on.
5. ENVIRONMENTAL SUSTAINABILITY BY DEFAULT

As explored above, pension funds are the largest institutional investors in the UK financial ecosystem and therefore have significant environmental impacts. Their beneficiaries also have uniquely long-term time horizons as the investments pension funds make today need to provide for their retirement incomes many decades in the future. This means that beneficiaries are very exposed to the risks of climate change and environmental destruction, both in terms of the financial impact on their pension assets, and in terms of the impact their lives in in retirement which will be shaped by how well the world responds to the climate crisis.

The sheer scale of pension fund capital means pensions can have extreme environmental impacts either in terms of funding climate- and nature-damaging activities or in financing the just green transition. For these reasons, it is vital that our pension system embrace *environmental sustainability by default* – all pension fund investments should be contributing to the just transition, and they should not be funding climate damage.

5.1 Current problems

Pension funds continue to fuel climate change and nature destruction via their investments. For example, there is an estimated £300 billion in UK pension capital invested in companies with a high risk of driving deforestation (Make My Money Matter 2022) and UK pension funds are estimated to have invested over £88bn into the fossil fuel industry, ten times their equity stakes in FTSE 350 clean energy stocks (Make My Money Matter 2023).

The Climate Change Committee has projected that the UK will have to increase its low-carbon investment each year from a £10 billion baseline in 2020 to around £50 billion by 2030 (Climate Change Committee 2020).

Pension funds should be a key source of capital for this investment, and also for global investment in the just green transition, but they are not yet doing this at sufficient scale. Only 4% of the industry’s assets are invested in climate solutions (Phoenix Group and Make My Money Matter 2023). These poor investment decisions are underpinned by other problems affecting the industry’s ability to deliver on sustainability, including: low accountability to members; limited transparency; lack of skills amongst trustees; and poor advice.

The pace of change in the industry is very slow. Of the 20 providers in Make My Money Matter’s 2022 Climate Impact Report, 60% had not published 2025 emissions reduction targets, none had explicit policies for ending fossil fuel expansion, while 80% had not made public commitments to eliminate deforestation from their portfolios (Make My Money Matter 2022). This is despite the fact that not only are all pension funds
exposed to climate-change related risks, including physical risks, transition risks and litigation risks (Thurley 2021), but also that all beneficiaries are exposed to extreme risks if the climate crisis is not averted.

In relation to Section 4, it is also important to note that there is significant evidence that ensuring environmental sustainability in the short- to medium-term has benefits for the economy, particularly in avoiding economic problems in the long-run (Elkins and Zenghelis 2021). Bearing this in mind is very important as we move to considering how to make pension fund investments sustainable.

5.2 Solutions assessment

A number of potential solutions to the problems of environmentally unsustainable pension fund investments have been suggested. These are grouped together under four broad categories which we cover in turn: improving pension fund governance and management; incentivising green investment; ending climate-damaging investment; and embedding longer-term time horizons. This paper also recognises that a far wider range of policies and activities - beyond the immediate purview of pensions policy - are needed to support pension funds in making this change and to enabling the just green transition.

5.2.1 Improving pension fund governance and management

Improving the way pension funds are governed and managed could help strengthen their focus on sustainability and the longer-term interests of their beneficiaries. There are a number of ways that government policy could help, including: reforming and clarifying the duties of trustees; upskilling or professionalising trustee boards; increasing accountability to members; integrating environment into decision-making; and improving risk-management frameworks.

Reforming and clarifying the duties of trustees

Trustees play a key role in ensuring a pension scheme is well run and members' benefits are secure. As such, they are key actors in the sustainability of pension funds. However, they must operate in line with their fiduciary duty to beneficiaries, which means that policy could focus on how they interpret and act of these duties. For instance, policy could be directed toward:

- **Clarifying fiduciary duty** - in so far as climate change poses physical, transition and litigation risks to pension funds, trustees already have a fiduciary duty to
protect their beneficiaries. They can also take account of non-financial factors if they believe members share the concern and there is no risk of significant financial detriment to the fund (Thurley 2021). A starting proposal would be to ensure that the guidance that authorities give on how fiduciary duty should be interpreted, and the way trustees interpret it, are crystal clear so that all trustees know they ought to take social and environmental factors into account in investment choices (Gordon 2023).

- **Reforming fiduciary duty** - a more ambitious proposal is to clarify and expand in law the definition of pension savers’ ‘best interests’ to give greater latitude or requirements to trustees to act on sustainability *impacts* – not just risks. By encouraging or requiring trustees to act on sustainability impacts, including collaboratively with other schemes, this reform would recognise pension funds’ collective responsibility for the longer-term systemic environmental implications of their investments. These have major impacts for their beneficiaries. This would also help ensure that trustees fulfil their existing duties to consider sustainability-related financial risks and opportunities more comprehensively. It would also better align pension trustees’ duties with existing obligations for company directors.

- **Ensuring pension funds’ agents align with fiduciary duty** - many pension schemes, particularly smaller schemes, are reliant on asset managers and advisers to design or decide how assets are ultimately invested. Both of the above proposals – either clarifying or reforming fiduciary duty – would benefit from ensuring that all actors in the pensions chain fulfil that duty. Examining how to do this would be an important feature of either of the above reform paths (McLaughlin 2023).

**Upskilling or professionalising trustee boards**

Pension trustees are not always adequately skilled or experienced with regards to green investment, or with regard to climate and nature issues more broadly. They might help drive better outcomes with regards to sustainability with the right skills and with more professionalised boards. Though we focus on the environmental sustainability benefits of these proposals here, it is important to remember that such improvements could also be important for enhancing overall outcomes for beneficiaries. To these ends, policy could be focussed on:

- **Raising Trustee capability** – a lack of capacity and expertise is documented as a barrier to pension funds engaging with environmental risks (Wilkinson 2021). Moreover, lack of diversity on trustee boards can encourage groupthink. The

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62 This has been reflected in recent government requirements including for pension funds to set out their approach to financial material considerations, including climate, and produce an implementation statement on it, report on TCFD, and for larger funds to set climate targets (Thurley 2021). The government’s 2023 Green Finance Strategy includes a commitment to engage with stakeholders on this topic.
government could set out further guidance, advice, support and requirements to rectify this. It could require better training of trustees, ensuring that essential skills and knowledge of environmental issues are improved. Other recommendations in this section would also support or require upskilling by trustees to be effective.

- **Professionalising trustee boards** - consolidation and increasing size of pension funds, which could be encouraged by government policy (covered in Section 4), could lead to more professional management of pension funds. This could offer opportunities to better embed environmental issues. The risk of further entrenching existing problems such as a lack of diversity of background and experience would have to be guarded against, and the opportunity to improve the capabilities, diversity and independence of boards taken.

- **Getting better advice and services** – the current system, comprising a large number of pensions schemes governed by non-professional boards, gives a major role to advisors and investment funds who are employed to assist these boards in their decision making. Requiring improvements to the information they supply, and the ability of boards to replace them, could be beneficial for the running of the schemes.

**Increasing accountability to members**

Though evidence suggests the priority for pension savers will be the size and stability of their pension pots, it is also clear that a large number of pension savers also believe that the sustainability of their pension fund is important.\(^{63}\) Recent polling found that 66% of all pension holders support their scheme’s investments in renewable energy, 68% support investments in companies that protect natural habitats, while only 19% support their scheme’s investments in fossil fuels (Phoenix Group and Make My Money Matter 2023). Giving pension fund members greater power and ability to their pension provider to account could therefore help to drive support positive change. Policy proposals include:

- **Improving transparency and disclosure to members** – disclosure measures could require pension funds to provide better information to members on their climate strategies and impacts, and their AGM voting intentions and record, and could give opportunities for those members to hold trustees to account.

- **Giving beneficiaries enhanced representation** - mandating worker representatives, or advocates for ESG issues, on pension boards could increase beneficiaries’ influence on climate and nature issues. There is currently a risk of losing the member voice provided by member-nominated trustees as they are only required for single employer schemes, not multi-employer schemes.

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\(^{63}\) Surveying has suggested 50% of 22-29 year olds think sustainable pension options are moderately or very important, falling to 36-37% for those over the age of 60 (Wilkinson 2021).
• **Encouraging members to switch to greener providers** – in Australia and some other jurisdictions, individuals can choose their pension provider, while in the UK their employer effectively makes this choice for them. The government is currently consulting on changes to this approach including a potential 'pot for life.' This could be combined with better information and incentives to switch to a greener provider.

Integrating environment into decision-making and management

Greening pension funds will involve ensuring that nature and our climate is considered throughout their whole business models and operations throughout the pensions chain. Proposals to bring such concerns more squarely into decision-making and management include:

- **Improving stewardship approaches** - pension funds can use their voting power and engagement – either directly or through an asset manager – with the companies they invest in to try to improve how they are run (Thurley 2021). Funds are required to articulate their policies on stewardship, and the government provides pension funds with non-statutory guidance on their approach to stewardship, voting and engagement. They are also encouraged them to sign up to the Stewardship Code (Sackers 2023). Non-statutory guidance, however, does not carry the same weight that statutory guidance would. Some countries have introduced mandatory or more stringent stewardship expectations. The UK’s approach could be strengthened by:
  - requiring integration of ESG impacts into stewardship processes and decisions (see fiduciary duty above);
  - embedding stewardship into the process of selecting and monitoring asset managers;
  - ensuring alignment with clients’ or beneficiaries’ sustainability preferences;
  - introducing stronger board level responsibilities and monitoring mechanisms; and
  - expanding guidance to asset classes beyond listed equity (PRI, The World Bank Group, and Chronos 2023).

Requiring fund managers to give information to pension schemes on the exercise of all voting rights on their behalf in a standard format could improve stewardship approaches, and would also be necessary for improvements in accountability to members.

- **Improving data and reporting requirements** - a lack of clear and consistent data has traditionally been a problem for funds that want to take climate risks seriously (Wilkinson 2021). Since 2021 pension funds have been required to report on the exercise of all voting rights on their behalf in a standard format could improve stewardship approaches, and would also be necessary for improvements in accountability to members.

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64 Individuals can opt out of their employer’s pension scheme, but they have no right to the employers’ contribution if they opt out.

their strategic approach to climate change risk, and since 2022 to provide metrics for the degree to which they aligned with Paris agreement goals (Sackers 2023). Improving pension funds’ abilities to understand and report on their environmental impacts is of course tied up with wider reforms that affect the whole financial system, including transition plans and green taxonomies. Ensuring that mandatory transition plans are high-ambition and complied with, and that the green taxonomy is stringent, will therefore be important for pension funds, as well as the financial system as a whole. Ensuring that the data from investee companies is also reliable and consistent will also be crucial (McAteer and Jarvis 2023).

Improving risk and impact understanding and management

Ultimately, pension funds must deal with and mitigate risk and uncertainty to provide a retirement income for their savers. Climate is a huge and growing risk for these funds, so there are ideas to ensure climate risk is better understood and managed:

- **Better integrate climate science into pension fund governance** - recent Carbon Tracker research shows how poorly pension funds and their advisors understand climate science and the potential impacts of climate change (Keen 2023). The Carbon Tracker report focuses on what pension funds themselves could do to improve, but the recommendations could be used to design broader policy proposals. The report suggests that climate scientists become key advisors to pension funds. As the paper documents, the existence of tipping points makes climate impacts unpredictable and potentially far worse than anticipated – this could be taken as a premise for better government guidance and regulation.

- **Requiring better understanding, governance, strategy and metrics on climate related risk** - better understanding of the risks and benefits of a ‘environmental sustainability by default’ approach will require improved risk models and understanding, which the government could support or mandate. Similar to the recent Carbon Tracker report, research by the Institute and Faculty of Actuaries finds that commonly used climate models employed by the financial services industry, including by pension funds, significantly underestimate the economic risks, and fail to anticipate how quickly such risks could materialise. It recognises that regulators have played a key role in driving the adoption of climate risk models, but there is a clear need to significantly improve both the models used, and how they are interpreted and used (Trust et al. 2023).

- **Stress tests for pension funds** - the Bank of England has undertaken climate stress tests for banks and has proposed introducing them for insurance companies. Pension funds could also be subject to such tests to assess the extent to which their risk management frameworks are consistent with differing future climate scenarios. However, stress tests would need to be robust if they are to be a useful tool. EIOPA, the EU pensions regulator, conducted stress tests in 2022, finding an overall worsening of financial positions by 3%. But EIOPA only used a
single extremely limited climate change scenario based on transition risks rising
due to a sudden increase in the carbon price.\textsuperscript{66}

- **Aligning remuneration and incentive structures to sustainability.** Only an
  estimated 27\% of senior managers in asset management firms – widely used by
  pension funds – have financial incentives relating to sustainable investment
  (Vrublevskis and Zorila 2023). The government could review how incentives could
  be improved to drive more sustainable choices.

**Assessment of these proposals**

**Fiduciary duty**

Fully clarifying fiduciary duty would be a step forward that could encourage some
pension funds to take climate risks more seriously. As with all efforts to work through the
existing system, this relies on the willingness and capabilities of pension funds to act,
which is undermined not just by lack of skills and expertise – a significant problem,
given the very large number of small pension schemes – but also by entrenched views of
what fiduciary duty means which could take some time to shift.

In addition, an approach that relies on individual pension funds to think about the risks
for their investments cannot take account of the collective risks that the industry as a
whole faces from climate change. Illustratively, equity investments in fossil fuel
companies that are expanding production can offer good dividends and returns, and
therefore might represent a good, high yielding and liquid investment opportunity for
individual pension funds. For the industry as a whole though – and for pension
beneficiaries in the long term - the impact of financing fossil fuel expansion will be
catastrophic.

Given the urgency and need to shift the system at scale, a more ambitious redefinition of
fiduciary duty would be a response commensurate with the problem. However, it is not
clear that putting this systemic responsibility onto the shoulders of pension fund trustees
would be the best approach – mandating changes to the whole system, discussed next,
might be a better way forward given that they put the systemic responsibility squarely at
the door of the government to force or incentivise pension funds to act differently.
Relying solely on the way that climate and environment affect financial returns is itself a
limited approach, which is why some argue that a key part of truly embedding
sustainability into investment decisions will be considering issues and risks that have
traditionally been considered as non-financial (Robinson 2014).

**Skills, accountability and stewardship**

\textsuperscript{66} For details of EIOPA stress test see: https://www.eiopa.europa.eu/publications/2022-iorp-climate-stress-

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\textsuperscript{66} For details of EIOPA stress test see: https://www.eiopa.europa.eu/publications/2022-iorp-climate-stress-
test-report_en
Whatever reforms are made, it is clear that there will need to be an improvement in the understanding and skills of pension trustee boards and their agents on climate and sustainable investments. Again, this shift is unlikely to happen rapidly or cover the entire industry unless government policy and regulation provides greater support, incentives and penalties. Consolidation and professionalisation of the industry could be a supportive condition, depending on how this is done. Consolidation is covered in more detail in the Section 4.

Increasing accountability to members could offer a useful signal to the industry, if enough members were willing and able to act. This will likely depend upon them having not just greater information, but also greater opportunity to do so: encouraging members to switch pension funds could be a useful mechanism in this regard.

Requiring improvements in stewardship approaches, including linking these to requirements to divest from companies that are financing fossil fuel expansion, covered in 5.2.3, could help pension funds become greater agents for change in the wider financial ecosystem. Though there are a number of inherent limitations (including the fact that pension funds and their asset managers often own small stakes in companies and might follow passive investment strategies such as index tracking), these should not be used as an excuse to absolve funds from responsibility for the impacts of their investments. The fact that no pension fund has excluded fossil fuel expansion, even though fossil fuel companies have not shown themselves to be much influenced by engagement strategies, provides the case for intervention to make stewardship approaches more effective in driving change.67

Improving the industry’s understanding of climate science and how it deals with climate risk will obviously be absolutely crucial to ensuring the sustainability of pensions. This is needed for pension funds as well as their advisors and agents. There is also a clear role for government policy and regulators to embed high standards across the industry in this area. Regulators should also lead the way itself themselves through improving their own models and introducing rigorous stress testing of a wide variety of scenarios for pension funds and the industry as a whole. As discussed later, moving to a precautionary approach for regulation would be a major and welcome shift in this regard.

However, given that the current system is dominated by DC and closed DB funds which are focussed on shorter-term horizons, the fundamental incentives of the majority of the industry are not currently aligned to thinking long-term, or to integrating climate risks effectively. Sustainable pensions reform would therefore that that the system aligns pension funds with the long-term interests of their beneficiaries in a safe climate. This is covered more detail in Section 4.

67 In 2022, just 1% of the oil and gas industry’s cash spending went on investment in clear technologies (International Energy Agency, quoted in Make My Money Matter 2023).
5.2.2 Incentivising or mandating green investment by pension funds

As noted above, fiduciary duty means pension funds can already take some steps towards greener investment on the grounds of risk to their beneficiaries. This includes by having tilted funds which increase exposure to investments which have strong ESG scores (Thurley 2021). However, government policy could do much more to incentivise a stronger shift of investment, both in terms of direct investment in green projects or companies, and through buying green stocks and bonds. There are a number of options grouped under two headings: using subsidies, guarantees, the tax regime and other tools; and requiring investment through green funds or institutions.

Using subsidies, guarantees, the tax regime and other tools

On the demand side, there are a number of ways governments can help to build the pipeline for investment and overcome the barrier of lack of suitable green investment opportunities for pension funds (Della Croce, Kaminker, and Stewart 2011). Here we are interested in ways policy can directly support or incentivise pension funds to make such investments, which include:

- **Reducing risks** - the government can use guarantees, and blended finance approaches – where public finance is used to incentivise private investment – to make green investments more attractive to pension funds (Gordon 2023). These can also be used to improve the sustainability of other investments, where the public payment ensures higher standards than the private investment would have targeted.
- **Enhancing returns** - the use of direct financing mechanisms such as subsidies, loans and bridge financing could incentivise help pension funds to make investments.
- **Using the tax regime** - changing investment allowances might also incentivise green investment by pension funds (Gordon 2023).
- **Varying charge caps** – the government rightly imposes caps on what pension funds can charge beneficiaries in DC schemes. The “charge cap” is currently set at 0.75% of funds under management, although it has recently been changed to exclude performance fees. Recognising that prioritising some higher-risk, higher-reward green investments could cost pension funds more, to incentivise them to do so higher charge caps could be allowed for certain types of green investment (Phoenix Group and Make My Money Matter 2023).

Investment vehicles, targets, or hard mandates

Government and regulatory policy might also be designed in such a way to more actively crowd in pension fund investment, or to ultimately mandate some level of fund investment in climate and nature positive assets. For instance:
• **Building vehicles for pension fund investment** - governments can also provide vehicles for pension funds to invest through, and they can incentivise the funds to do so. Vehicles could include new entities such as a UK (green) Growth Fund (Gordon 2023), or expanding the capacities of an existing institutions such as the UK Infrastructure Bank (which has a climate mandate but a limited funding base).

• **Setting targets for low-carbon investment** – rather than mandating a change, the government could work with the industry to set targets for expansion of green investment (similar targets have been suggested by both the government and the opposition with regard to UK unlisted equities, discussed in Section 4).

• **Mandating investment into green assets** – it has been proposed that smaller, unconsolidated pension funds could be mandated to invest 15% of their total assets in the UK in order to retain favourable tax treatment (Kakkad, Madsen, and Tory 2023). This approach could be adapted to mandate that a broader range of pension funds’ investments power the green transition. Directing some degree of pension fund investment is a policy that has been successfully used as part of industrial strategies in other countries.68 This could be particularly suited to the fact that closed DB pension funds are currently heavily invested in bonds – as the green bond market expands, requirements to invest a proportion of total assets in green bonds could be instituted and gradually increased.

• **Higher standards for publicly owned funds or for consolidated funds** – publicly owned funds such as NEST could be subject to higher standards in terms of green investment, or used to trial new standards. New climate-related requirements could also be set for new ‘superfunds’ that may be established as the industry consolidates: see Section 4 for more details.

**Assessment of these proposals**

There is clearly a need for governments to support and require greater investments by pension funds if the large investments in the green transition that are needed in the UK and globally are to be realised.

The first approach of incentivisation via subsidies, blended finance mechanisms and related tools could certainly be attractive to funds looking for low-risk ways to improve their green credentials. However, all such initiatives entail expense and risk for the public purse, unless offset by tax changes elsewhere, which may also limit their scope – particularly if governments feel fiscally constrained. Nevertheless, one proposal for their expansion would see £46 billion in investment delivered over ten years – important but relatively small compared to the scale required (Gordon 2023). There is also the risk that these policies would not in fact incentivise additional investment, but would simply

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68 For instance, South Korea has previously directed pension fund investments toward industrial policy ends (primarily in the infrastructure space) (Lee and Grimes 2023)
provide pension funds with better terms for investments they may have made anyway. Accordingly, they are best considered as a component of a plan for green investment rather than the whole approach.

Requirements to make green investments could unlock additional capital at the required scale. Particularly if phased in, this could also be done without affecting the vast majority of pension funds' existing investments given the small scale of investment required in the UK compared to the very substantial overall size of UK pension fund assets (£50 billion per year by 2030 compared with overall pension assets of around £3 trillion). A lack of clear vehicles to deliver this could be a problem given that dedicated institutions are small, and the full implementation of the green taxonomy is likely to take several more years (though the climate aspects will arrive earlier).

Using the process of consolidation as a tool for setting high standards is a mechanism that could help drive improvements at scale but would require significant buy-in across the pensions landscape and a high level of government ambition to shape the consolidation agenda. Using voluntary targets is a limited and lower-ambition approach, explored further in Section 4, although it does maintain greater pension fund agency.

5.2.3 Ending climate-damaging investments

Beyond helping to channel capital toward the green transition, policy could be used to actively dissuade or prevent the pensions industry from further fuelling climate damage. Ideas include:

- **Banning investment in new fossil fuels** – some pension funds exclude fossil fuel investments. For example, the Norwegian government excludes investments in coal and other assets based on climate concern from the Government Pension Fund Global. The French publicly owned pension fund FRR also has restrictions on investment in coal.\(^{69}\) Given that there is international expert consensus that we cannot afford to invest in the expansion of fossil fuel production and extraction, one step towards this would be for governments to adopt these kinds of exclusions, by banning pension funds (and ideally other financial actors) from investment in any company that is actively expanding or planning to expand fossil fuel production. The most ambitious option would include prohibitions on both direct investments and involvement in new equity raising, as well as prohibitions on holding bonds and equities in such companies. There is a clear logic for pension funds to become first movers on this critical issue, given the long-term time horizons of their beneficiaries.

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\(^{69}\) There are a large number of firms on the Norwegian fund’s exclusion list on the basis of climate. See: https://www.nbim.no/en/responsible-investment/ethical-exclusions/exclusion-of-companies/. For coverage of the FRR's approach see: https://www.ipe.com/french-pension-reserve-fund-turns-its-back-on-tobacco-coal/-10016717.article
• **Internalising externalities** – proposals could be developed for how the true long-term costs of pension fund investments could be reflected in their financial positions. This could include examining how to make less use of mark-to-market accounting, which encourages short-termism, and to examining how the triennial actuarial valuation that DB funds undergo could include specific provisions for dirty investments.

• **Adjusting capital requirements** – as for banks and insurers, DB pension schemes are required to put capital aside to protect consumers and the system against the risks they bear. Proposals that banks and insurers should be required to hold 100% capital against certain kinds of climate-damaging assets, known as ‘one-for-one’ rules (Philipponnat et al. 2020) which could be adapted for pension funds (McAteer and Jarvis 2023).

• **Treating climate harm as seriously as financial crime.** The UK has a set of rules aimed at preventing all financial institutions from committing fraud, money laundering, financing terrorism and other crimes. Though they are not perfect, they do represent major interventions in the market to prevent financial institutions from causing harm to the broader economic and social system. Adapting some of these approaches for climate harm could include creating an independent, rigorous Climate Harm register examining the climate impacts of companies, with an Environmental Sanctions List for the worst performers, and penalties for investing in companies on the list (McAteer and Jarvis 2023).

• **Extending due diligence requirements on illegal nature destruction** – the Global Resource Initiative recommended introducing a legal duty for financial institutions that would prohibit investment in illegally produced forest commodities (Gorman 2022). This would require them to prove that companies they were investing in were complying with relevant laws. A related proposal is for boards and senior managers in pension funds to be held accountable for failure to properly take environmental considerations into account, by extending the remit of the Senior Managers Certification Regime that is intended to hold such individuals to account for wrongdoing (McAteer and Jarvis 2023).

**Assessment of these proposals**

In so far as investments in climate-damaging industries affects risks to beneficiaries, as noted above, fiduciary duty allows pension funds to divest from and exclude further investment in, for example, fossil fuels (Thurley 2021). Thanks to effective campaigning from a variety of groups, this has already allowed some funds to do this. However, in

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70 In 2023 the House of Lords passed an amendment the 2023 Financial Services Bill to this effect, but were over-ruled by the government majority in the Commons, so this did not make it into the final Act, though the government did commit to a review.

71 For example, Waltham Forest has fully divested its local authority pension fund from fossil fuels in response to advocacy from groups such as Friends of the Earth. As of November 2022, four other UK local authority pension funds have followed Waltham Forest’s example in committing to full divestment. See:
the short-term, investments in fossil fuel companies, for example, can provide good financial returns for pension funds, and most still hold such investments. Therefore, given that the International Energy Agency’s Net Zero by 2050 roadmap requires no new fossil fuel expansion (IEA 2023), there is a good case for moving much faster and simply excluding certain investments in companies that are still expanding fossil fuel production, or who have plans to do so. This would bring pension fund regulation in line with climate science. Given market mechanisms and civil society pressure have so far failed to change funds’ investment practices wholesale, there is a growing case for strong government intervention.

The impact of this would not represent a significant hit to viability of such fossil fuel projects or companies, but it could impact the cost of capital for projects and companies who would have to turn elsewhere for investment (today UK pensions have £88bn invested in fossil fuel companies (Make My Money Matter 2023)). Relevant firms might also see their share prices affected by strong regulatory signal that fossil fuel expansion is no longer acceptable. This would also prevent pension funds being hit by a substantial loss of value due to fossil fuel assets becoming “stranded”. A 2036 net zero transition could render half of the world’s fossil fuel assets worthless via significant portions of illiquid fossil fuel assets suffering due to exposure to the impacts of climate change (Mercure et al. 2021). Perhaps most importantly such a bold policy would also be a powerful statement about the untenability of climate damaging investments, and the willingness of governments to act, significantly increasing the transition risks of any investment in fossil fuels.

One advantage of focussing on excluding climate damaging assets from pension funds’ portfolios is that it could be rapidly implemented. Unlike requirements to invest in green assets, no pipeline of alternatives needs to be built; pension funds simply need to replace proscribed assets with any other asset of their choosing. The only caveat is that seeking returns to replace those derived from oil and gas might require some level of increased investment overseas if UK opportunities are not forthcoming, which may be a justification for phasing in measures.

As discussed in Section 4, any restrictions or mandates on what pension investment pension funds make would have to be well designed and limited given the risk that they similar measures could be misused by governments.

5.2.4 Embedding longer term time horizons

https://groups.friendsoftheearth.uk/climate-action/how-waltham-forest-has-divested-pensions-out-fossil-fuels

72 In a climate context, stranded assets are assets that have undergone significant devaluations as a result of climate change, with major impacts for the value of portfolios containing said assets.
Ensuring pension funds are invested with longer time horizons could, by virtue of the risks inherent in climate change, help shift the nature of their investments toward a more sustainable footing. This could be achieved by:

- **Switching to pension scheme models with longer-term horizons** - because of the need to provide a set level of benefit for the rest of beneficiaries’ lives, and the fact that they have a beneficiaries at all stages of their pensions journey, open DB and CDC funds have a longer-term investment horizon and less volatility than DC funds (Millard, Pitt-Watson, and Antonelli 2021). While an expansion of open DB schemes is unlikely given the substantial industry shift away from them in recent years, the establishment of more CDC schemes might be encouraged in the place of pure DC plans.

- **Consolidation** - some argue that larger funds are more able to invest in less liquid, longer term assets such as infrastructure because their greater size and professionalism allows them to have a broader portfolio and balance risks better (Kakkad, Madsen, and Tory 2023).

### Assessment of these proposals

Open DB and CDC funds should have a longer-term investment horizon than the current predominant DC model. But the full extent to which this would favour sustainable investment depends on a range of other factors, reinforcing the need for the other proposals in this chapter to be implemented alongside any such shift to CDC as the norm that replaces the current DC norm. The benefits of consolidation are less certain, but consolidation does offer an opportunity to make a shift to longer-term or less liquid investments that could be harnessed for the green transition, if other proposals in this section were put in place.

### 5.2.5 Other actors and the wider ecosystem

Pension funds are far from the only actors in the financial system, so better policy and regulation targeting other individuals and institutions they interact with - including asset managers, advisors, stock exchanges and other actors - are also important.

Indeed, as alluded to above, pension funds’ abilities to make the necessary shifts in investment will be helped or hindered by the quality of other reforms affecting the financial system, including transition plans and the green taxonomy. The impact of ending pension fund investment in fossil fuels will also be affected by the approach of other actors to the issue – ideally government would take a whole-economy approach to such issues.

Obviously, the wider policy environment is also critical if pension funds and other asset owners are to help us make the major shift in investments required to meet global climate goals. Fiscal policies, government investment and industrial policies, and
sectoral policy in key areas including energy, the built environment, transport and agriculture are centrally important. The right policy environment and certainty will help provide the stability, incentives and opportunities for pension funds to make those necessary investments.

Regulators will be key in this respect too. Given that the impacts of climate change could be dramatic and unpredictable, a risk-based approach to regulation is unlikely to be sufficient. Some have argued that instead a precautionary approach should be adopted which would force regulators to shape markets and take preventive action and provide an underpinning rationale for other actions in this report (Kedward et al. 2022). Government could also strengthen the climate mandates of key regulators, including The Pensions Regulator, by making climate and nature part of their statutory objectives. This would ensure regulators give climate and nature issues proper consideration in their regulatory work in a way they are currently not empowered to. This is a step that recognises the urgency of the problem.

However, there remains a strong argument that pension policy can play a leading role in pushing forward this agenda, given the clear need for their beneficiaries to be protected from the severe future risks that breaching climate limits bring.

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73 WWF and other environmental groups have already led on calls for financial services regulators (namely the FCA and the PRA) to be given statutory objectives related to climate and nature. See: https://www.wwf.org.uk/sites/default/files/2023-01/FSMB-Committee-Stage-Briefing-25Jan.pdf
6. CONCLUSION: AN AGENDA FOR PENSIONS REFORM

This section summarises key conclusions about how the government could reform the UK pensions system so that it works: (i) for pensioners and pension savers; (ii) the wider UK economy; and (iii) the environment. It is intended to set out an ambitious but achievable agenda for reform to show that the interlocking problems facing the pension system can be resolved, and that focusing on these three key goals together is helpful as well as necessary. It also recognises that the scale of the problems we face call for systemic reform.

It is not intended as a blueprint with detailed recommendations, though we recognise that getting the details right matters a lot. The process of agreeing reform will also be crucial. Working with representatives of pensioners, pension savers and other key stakeholders, particularly trade unions, will be crucial if a programme of reform is to be agreed, especially if it is to be long lasting. This effort will also require close work with the industry and regulators in order to create and maintain buy-in for the long haul.

Fostering long term consensus, including between political parties, will also help to ensure the desirability and durability of reform. Ultimately, however, what matters most is that reform fixes the major problems facing pension savers, and helps to drive our economy towards environmental sustainability while also making it more inclusive and productive.

For this to happen, the country is in need of an agenda of raised ambition for change: this paper aims to contribute to that agenda.

Improving the state pension

The main function of any pension system will always be to ensure security and decent income levels for all in retirement: on this metric the UK’s system is failing. If we accept the basic structure of the UK system – with a state pension providing a baseline minimum income, topped up by private pensions – it is clear further improvement is needed for the state pension to play this baseline role. The UK state pension remains below comparator European countries and below what the public regard as minimum income standards. The rise in number of people who will be renting in old age means many will face significant hardship if they have to rely on this pension for much or all of their income. At the same time changes to eligibility could help ensure that more people who have gaps in their National Insurance contribution record, most of whom are women, could benefit.

Key recommendations:
Maintain the triple lock, or another automatic uprating mechanism, to ensure that, over time, the level of the state pension rises in real terms. In the medium term, one key question will be what the ultimate level the state pension should reach should be.

Set an adequate target for the state pension. It would be sensible for a state pension target to be set by a benchmark that is tied to what the public would regard as an acceptable minimum level of income, such as a percentage of the full-time living wage.

Include those with low contribution records. Finally, ways of guaranteeing the state pension to people with work histories that mean they have not built up sufficient National Insurance credit should be examined, such as adopting a residency-based qualification system, as used in other European countries.

Increasing private pension pots, particularly for those on low incomes

The main developments that are needed to meet the goals identified in this paper are to the occupation-linked private pension system, the private pension which tops up state provision. It is clear that savings in peoples’ occupation-linked pension pots need to increase: far too many people are facing a retirement with a pot far too small to provide a decent income in retirement or to last until they die.

The obvious place to start is with increases to the employer contribution, which is far lower under the current DC-dominant system than it was under the previous DB-dominant system. At the same time, any model that sets a percentage of gross pay as the minimum contribution rate for employers will be regressive as higher earners will receive substantially more in their pension pots than lower earners. It is also likely to mean low paid people do not save enough for their retirement, particularly if they are encouraged to opt out by higher levels of individual contribution.

Key recommendations:

Set a target of 12-15% pension contributions, with the increase largely funded by employers - the Pensions Commission’s target of 15% of income as the target minimum contribution, or other suggestions of a 12% target would be a significant improvement on the current 8% minimum. Again, it will be important to set these targets with reference to what the public thinks are acceptable levels of retirement income for all in old age.

Introduce a progressive contributions model to ensure the low paid can save enough - this would play a key role in fairer outcomes, with employers required to make relatively higher levels of contributions for low earners up to a certain absolute amount. The exact amount of this should again be agreed with reference to publicly acceptable expectations for retirement income, but a starting point is the proposal by the Living Wage Foundation for a Living Pension set at 12% of the full-time living wage salary, which would mean a pension contribution of £2,800 per year. The costs to employers could be offset by having lower minimum contribution requirements for higher earners.
Include those who are currently excluded - by reviewing options to make auto-enrolment or a similar default option work for the self-employed, and considering how the state can support contributions for those unable to work due to caring responsibilities, illness, unemployment or other issues.

Embedding long-term investment horizons and sharing longevity and investment risks

The current pensions system is largely comprised of closed DB schemes with short-term investment horizons and DC schemes that also tend to have shorter-term investment horizons than some alternatives. This is not ideal for supporting long-term investment in the economy and in the just, green transition.

While reform to the default DC schemes could help promote longer-term investment horizons, this would be more comprehensively achieved if they were, over time, replaced by Collective Defined Contribution (CDC) schemes that aim to embed longer-term time horizons, thanks to collective longevity risk-sharing, investment risk sharing, and the requirement to achieve returns to provide targeted levels of benefit to savers.

Furthermore, a pensions system based on DC pensions as the norm is unlikely to deliver adequate savings for large numbers of people, even with increased contributions. Saving in a DC scheme leaves low earners facing substantial risks in retirement. The first of these – the small size of pots they may have built up – could be overcome by the progressive reforms mentioned above. However, individualisation of risk is inherent in the design, so many are therefore likely to face the risk of not having – or not knowing if they have – adequate savings to guarantee a decent income throughout their entire retirement. Greater collectivisation of longevity risk would make retirement incomes better protected for those who earn and save the least. The impact would be more positive still when combined with higher employer contributions and a progressive model for such contributions as suggested above.

Key recommendations

⇒ Over time, replace DC with CDC pensions as the default retirement saving choice - CDC schemes offer a promising alternative that collectivises longevity and investment risks and embeds longer-term investment horizons. CDC schemes have the inbuilt advantage of offering greater security as they collectively offer all members some level of income until death.
⇒ Protect DB schemes - the benefits of DB schemes – the gold standard for reducing risks for pension savers – should be acknowledged and so shifts in the system should protect these where they do exist and expand them where possible.
⇒ *Ensure CDC designs are progressive* – as noted above, any system where minimum contributions are linked to a flat percentage of pay are regressive by design, but could be made much more progressive if absolute minimum employer contributions were implemented, offset by higher minimum employer contributions for low earners as suggested above. Examination could also be given to how to make sure that CDCs are designed to pay out targeted lifelong incomes, with a minimum income floor for a given number of years’ contributions. Again, as above, ways of ensuring that those unable to contribute sufficient years can also benefit from this income floor should be examined.

**Proactively green the pensions system**

The above reforms would significantly grow the private pension system in the UK, already one of the world’s biggest. It would be unacceptable to do this without also greening the pensions industry by ensuring that pension funds are environmentally sustainable by default. Without this, the growth in pension assets could simply lead to increasing currently high levels of climate and environmental damage. This is particularly important given the high risks to pension savers if dangerous climate change is not averted. As noted above, moving to a CDC default with longer-term time horizons should also provide more opportunity to align pension fund incentives with climate and environmental goals. However, given that we are all facing highly uncertain futures and the world remains way off track to hit safe climate targets, there is a clear and urgent need to do more.

**Key recommendations**

⇒ *Set targets for green investment* – setting targets for pension funds to make a proportion of their investments through green funds or institutions, such as the UK Infrastructure Bank, or a new green national investment fund, or into green assets such as green bonds, would be a reasonable step to ramp-up ambition. Targets could be set and increased over time, or could start as voluntary agreements before becoming mandatory if progress were not sufficient. This would provide benefits to the UK economy, which in turn would also benefit the economic prospects of pension savers.

⇒ *Begin excluding fossil fuel investment* – given the international scientific consensus that we should not be expanding fossil fuel production, it would be reasonable and in the best interests of pension savers to begin to exclude investments linked to firms that have plans to expand fossil fuel production. This could start with those investments where the link to the production is most obvious, such as lending to projects or companies that are expanding fossil fuel production. A timetable could lead towards complete divestment from companies that are expanding fossil fuels, and be expanded beyond the pensions industry.

⇒ *Give the Pensions Regulator and other relevant regulators strong climate and nature mandates* – properly tasking the key regulator with a requirement to think about the climate and nature impacts of the rules they set would ensure that
meeting climate and environmental goals would be embedded throughout regulation. This is warranted given the huge risks and considerable uncertainties climate change pose for our future.

⇒ **Examine fiduciary duty reform and improve accountability** – the extent to which trustees can already take into account environmental factors in their fiduciary duty should be emphasised, and agents such as asset managers and advisors should also be held to account for acting in the interests of beneficiaries. Moving towards a redefinition of the “best interests” of beneficiaries that includes environmental outcomes should be examined, given that environmental outcomes will have a major impact on their lives in retirement. Steps to improve the transparency and accountability in how pension funds, advisors and agents such as asset management companies report to their beneficiaries on climate and nature outcomes with regard to fund investments should be taken.

⇒ **Drive improvements in risk assessment** – to ensure that pension funds, advisors and agents are properly considering the risks of climate change and nature damage, they should be integrating the latest climate science and embedding the very high levels of uncertainty that we face into their risk frameworks. The government could drive a process of meeting far higher standards, including in its own models and stress tests.

### Supporting an inclusive, sustainable and productive economy

The above programme of reforms could be expected to provide significant economic benefits to the UK. In particular, boosting the incomes of future pensioners, particularly those otherwise on low incomes, would provide a long-term, sustainable economic dividend. In the nearer future, the pool of capital available for investment would grow markedly. The focus should therefore be on ensuring that reforms to the system are proactively designed to promote these desired outcomes. At the same time, the government will need to focus on delivering the overall green policy approach – such as a green industrial strategy – that provides the framework and opportunities for such investment.

### Key recommendations

⇒ **Shift to not-for-profit CDC schemes including through appropriate consolidation** - The need to consolidate many of the smaller funds, and the fact that this is happening already, provides an opportunity to move to CDC as a default model for UK pensions, but it should not be the only mechanism used. As noted above, CDC schemes have greater potential to invest for the longer-term and tackle issues around pension inadequacy arising from factors such as individual longevity risk than the current DC norm. If structured as suggested above, they would also lead to a larger private pensions system, giving greater potential to drive inclusive UK economy growth. One mechanism of ensuring that these new major actors in the system are designed to put the interests of beneficiaries first,
and to prevent conflicts of interest would be to create them as not-for-profit institutions.

⇒ **Align green targets with UK economic aims** – Setting targets for green investment should be aligned with other UK economic objectives. This could be done, for example, by linking green targets to investment in the UK, or in certain regions as suggested above. This would also provide benefits for pension savers whose current and future financial wellbeing is closely linked to the wellbeing of the UK economy, and to our collective efforts to prevent damaging climate change.

Throughout all these reforms, the regulators must also maintain a focus on their objectives of ensuring stability and the prevention of economic crises, the protection of consumers and the safeguarding of the integrity of the system.

Pensions reform is top of the political agenda again, offering a route to fixing the serious problems in the system: problems that will only grow and become more apparent over time. This agenda for reform is offered as a way of building on the best existing proposals that together can help ensure the system provides decent, secure incomes in retirement, helps to power the green transition and supports a sustainable, inclusive and productive economy.
7. BIBLIOGRAPHY


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