Pensions, explained.

An introduction to the UK's private pensions system.

September 2024

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Why do pensions matter?

The word "pension" comes from the Latin pension, meaning "payment", according to The Collins English Dictionary. It says "pension" means "a regular sum of money from the state or from a former employer".

£3.7 trillion

of assets is held by Britain's private pensions

This is more than the value of the entire UK economy in 2023 (£2.2 trillion).

But that money has a purpose – it has to support everyone in Britain in their later life. For some of today's workers, that will mean paying pensions into the 22nd century.

The state, public and private pensions overview.

State pension

A benefit paid to everyone who qualifies, out of today's tax revenues. It currently costs £132 billion, around 5% of GDP – more than the budget for the NHS in England.

Public sector pensions (funded)

Pension schemes for public sector workers that are paid from a pot of assets that has been put aside to pay pensions. The biggest is the Local Government Pension Scheme, for council workers.

Public sector pensions (unfunded)

Pension schemes for public sector workers that are not backed by a pool of assets. Instead, pensions are paid from today's tax revenues. Examples include schemes for NHS workers and teachers.

Private pensions

Pension schemes and long-term savings that don't involve public money, where pensions are paid from pools of assets that are invested to pay for people in retirement. Many – but not all – of these involve employers providing schemes for workers.

The two types of private pensions.

Defined Benefit

Collective schemes, where money is put into a single pot that then pays out retirement incomes for all the members of the scheme. They are called Defined Benefit (DB) because the member knows their expected income, as all the risk is borne by the company supporting the scheme.

One example of this type of pension is the Parliamentary Pension scheme for MPs.

A DB pension is a regular sum of money you'll get in your later life.

Defined Contribution

Individual savings, where money is put into a pot (or multiple pots) which members use to support themselves in retirement. Defined Contribution (DC) schemes do not deliver a guaranteed income – how much you have in retirement depends on how much you have in your pot when you retire. You chose how to use the money in your pot(s).

A DC pension is not a regular sum of money you'll get in later life – it's really a pot of savings intended for use in later life to support your retirement.

Parliamentary, and other pensions.

As an MP you will be entitled to entry into the Parliamentary Contributory Pension Fund (PCPF).

It is a type of Defined Benefit pension – that means you will know what pension income you will receive at retirement. This is a guaranteed income. Even if the assets within the scheme don't perform and there is a shortfall, meaning there isn't enough money to pay for MPs' pensions, the Parliamentary authorities are obliged to ensure you get your pension in retirement.

Other types of private pension you might have heard of:

SIPPs - Self-invested personal pensions

These are DC savings pots set up by individuals who want to have more control over their pension savings and investments.

CDCs – Collective Defined Contribution schemes

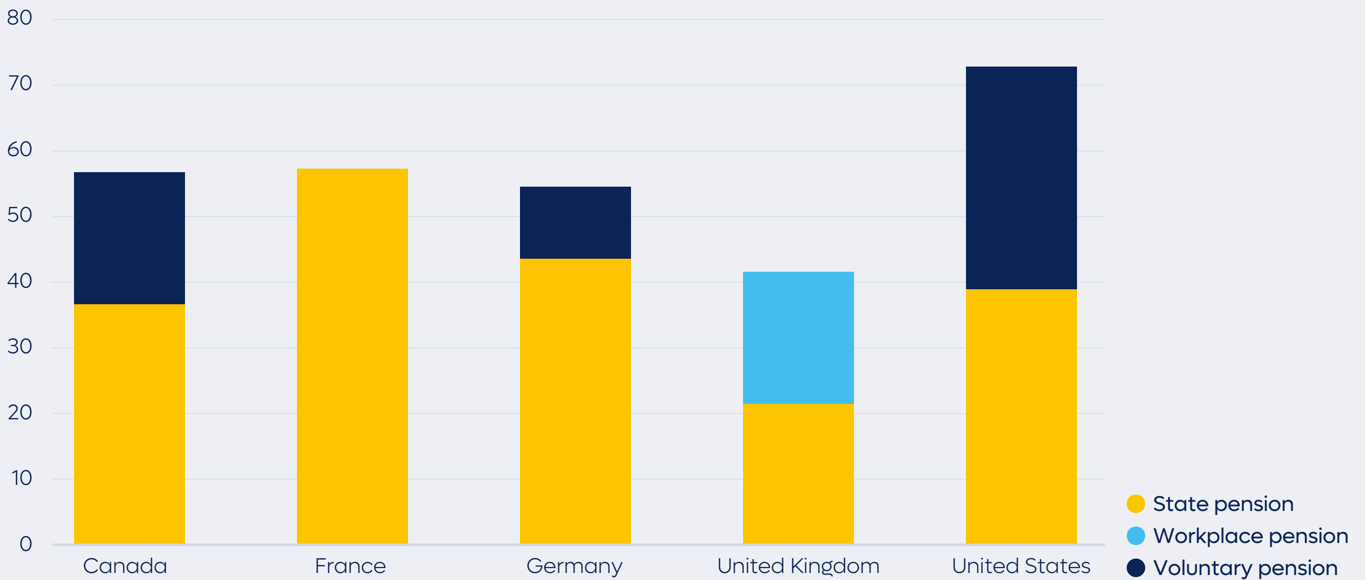
These are an experimental idea promoted by government in 2021, where workers and employees pay into a shared fund that provides pensions for all members on retirement. The aim is to pool risk and get better returns through bigger investments, but the final level of pensions paid out still isn't guaranteed. As at September 2024, only one employer has said it will set up a CDC scheme.

Why do private pensions matter to the UK?

The UK's private pensions are vital because the UK spends less on state pensions than other advanced economies.

That means private pensions (mostly linked to the workplace) are a crucial part of people's finances in later life.

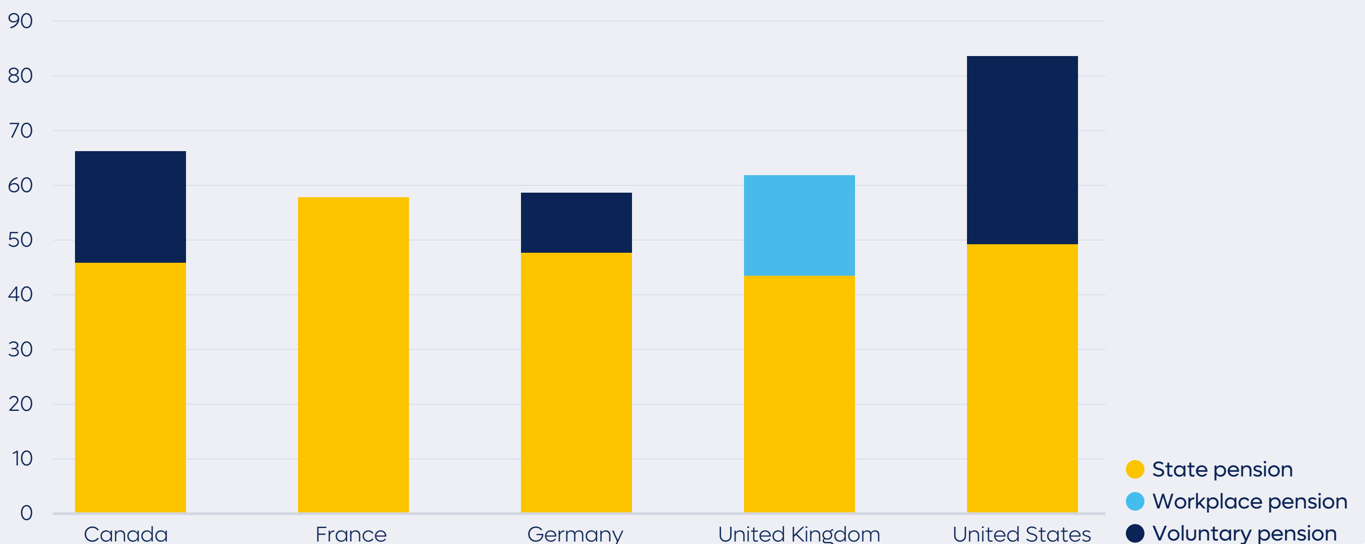
Pensioner income as % of working-life wages, for an average earner (OECD data 2023)



Private pensions are especially important for people on low incomes.

Thanks to private pensions, UK workers on below-average incomes have a higher retirement income (relative to their working-age earnings) than their equivalents in France and Germany.

Pension incomes: % of working-age wages for low-paid worker (OECD)

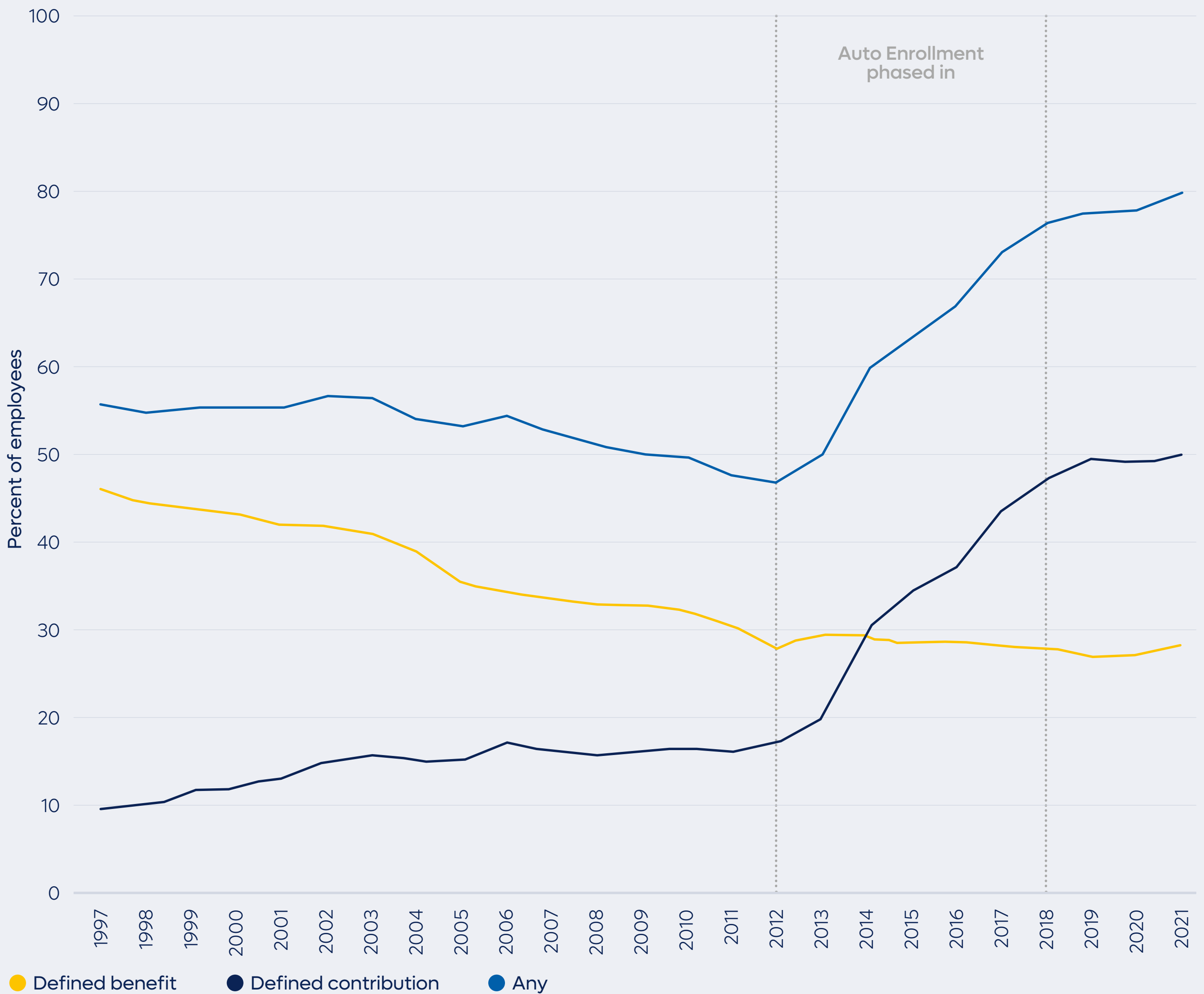


The state of the nation's pensions.

Over 70% of workers in the private sector have a pension. This figure will grow over time as new workers entering the labour market get pensions from the start of their careers.

But the type of pension arrangements people have is also changing, as Defined Benefit pensions become rarer, and Defined Contribution schemes become the norm.

Defined Benefit vs Defined Contribution pensions



Defined benefit pensions - the numbers.

DB pensions are also called "final salary" schemes. Some media outlets call them "gold-plated" pensions. They are becoming rarer, but remain hugely important.

There are

5,000

private sector DB pension schemes in the UK.

With

8.9 million

members.

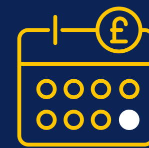
Just

9%

of private sector DB schemes are still open to new members.

700,000

members are still making contributions.



£1.4tn

of assets is held in UK DB pension schemes

The vast majority of people with DB pension entitlements are approaching retirement or already retired and drawing a pension. DB schemes invest in secure, easily saleable assets to ensure they can pay these pensions over the next 15 years or so.

Many schemes are choosing to wind up and move to management by a life insurance company, through a pension insurance buyout.

Defined contribution pensions - the numbers.

There are around 14 million active members in DC schemes (2023), compared to around 700,000 active members in private sector DB schemes.

In total DC schemes hold

£1.8tn

in assets

£545 billion

in workplace pensions.

This is the area that will grow in future as more and more workers are auto-enrolled into pensions.

(Workplace pensions are expected to have £1 trillion in assets by 2030.)

£790 billion

in personal pensions.

(Including SIPPs.)

£540 billion

already being drawn from pots by people in retirement.

(About £320 billion of this is invested in annuities providing a guaranteed income.)

Investments: risk, return and timescale.

Savers put money into pension schemes with the intention that their savings are invested and the value of their pot grows over time.

Investing involves risk, because there's always a chance that the value of your investment goes down, not up. Sometimes investments can even end up being worth nothing at all.

In principle, riskier investments offer higher returns: while you have a greater chance of losing money, you also have a chance of gaining more than you otherwise would.

Time therefore matters a lot to pension savers. Money that won't be needed for someone's retirement for 30 or 40 years can be invested in riskier assets, like shares, because there will be time to make up for any losses. In today's pension landscape this will usually be DC savers.

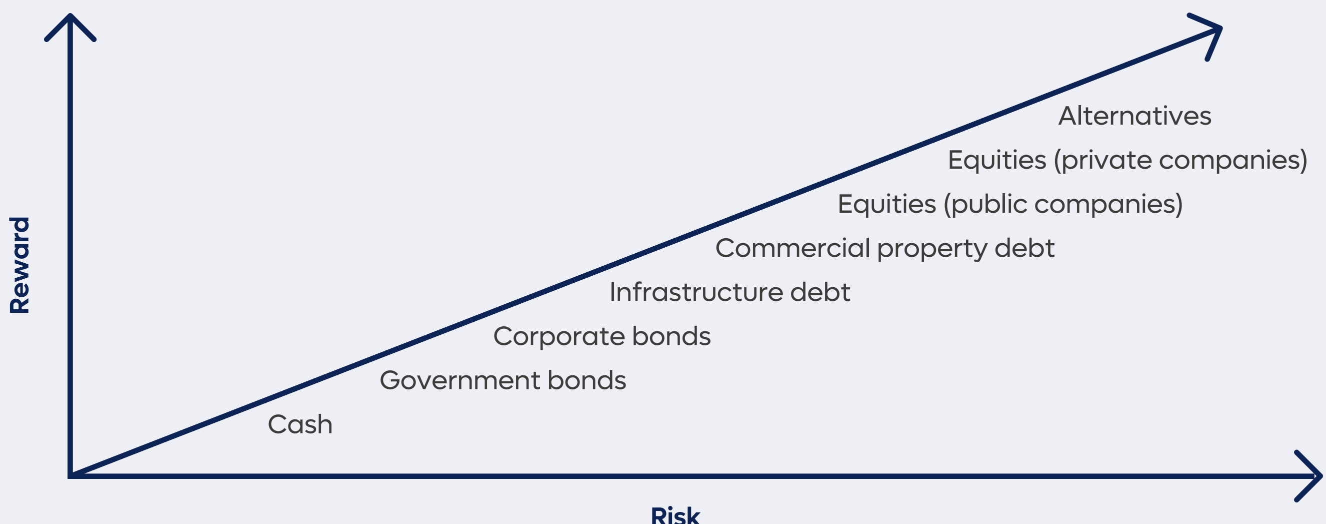
But money that's needed for someone's retirement now or in a few years will usually be invested in safer assets – for example, bonds – that will hold their value while generating a stable income and are easily sold to provide funds to pay pensions that are due. In today's pension landscape this will usually be DB members.

The ability to take higher levels of investment risk is therefore a function of the amount of time you have left before you need the funds to make good any potential losses.

Assets risks and returns.

The higher the risk, the higher the potential return – because the people asking for investment must promise investors more profit to persuade them to take the risk of investing.

The safest asset is cash, followed by bonds (loans, also known as "fixed income" because the payments on loans don't vary) issued by governments, companies, and owners of infrastructure and property, followed by shares either traded on stock exchanges or held privately (private equity). The riskiest assets include "alternatives" such as venture capital and hedge funds.



How purposeful investments create lasting social value.

Where risk, investor appetite and timescales are properly aligned, investments to support pensions can generate significant social value – benefits to people and places that go beyond traditional economic and financial measures.

CASE STUDY

Funding the UK's first reservoir for 30 years.

In 2023 PIC completed an investment with Portsmouth Water to finance the UK's first reservoir for over 30 years. This is a major infrastructure project which will play a critical role in ensuring adequate water supply to local communities across the South East of England.

CASE STUDY

Social value creation through regeneration.

During construction of PIC's £130 million Build-to-Rent development in Manchester more than 400 jobs were created, including the equivalent of 2,215 weeks of apprenticeship opportunities, 29 work placements, and 108 weeks of training. Forecast spend with small and medium businesses is set to be £65.2 million, with spend in Greater Manchester of £49 million since the development first broke ground in 2020. Our supply chain, in turn, creates jobs in their communities, supporting economic ripples throughout Greater Manchester and further afield.

CASE STUDY

Creating communities, revitalising town centres.

In September 2023, we welcomed the first residents into New Vic, our £130 million Build-to-Rent development in Manchester. Our starting point for managing our Build-to-Rent developments is the creation of communities. What we are starting to create is a vertical village. Initiatives include health and wellness events; a dog walking club; and fitness classes. Having 500 people living on the doorstep of local businesses – our residents are able to buy directly from them through the New Vic app – will support them over future years.

CASE STUDY

Funding emergency accommodation in Bromley.

After a number of years of moving from one temporary home to another, a mother and her two children moved into a beautifully refurbished three-bedroom house in Bromley in November 2021, thanks to PIC's £67 million investment in an innovative affordable housing deal with the London Borough of Bromley. The funds were used to purchase 300 affordable properties outright, significantly reducing the Council's cost of emergency nightly accommodation.

How pension saving is changing - the shift from DB to DC.

For people

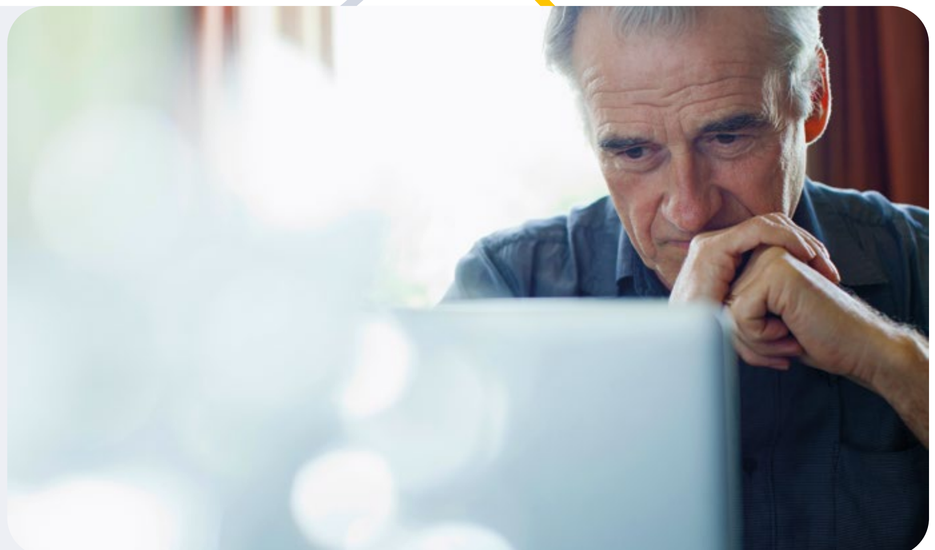
It transfers huge risks and uncertainty away from employers and on to individuals. DB schemes mean people have a guaranteed income in retirement. DC schemes don't offer that certainty.

For the economy

It changes the way pension assets are invested, because DB and DC schemes have different approaches.

For taxpayers

It increases the chances of needing to spend more money supporting pensioners in future, because DC schemes are less generous and less safe than DB schemes, raising the possibility that future retirees won't have enough money.



How defined benefit pensions work.

An employer who offers (or offered) workers a DB pension is known as a sponsor. The sponsor guarantees to provide the money that will pay the pensions of members for the rest of their lives.

The vast majority of occupational pension DB schemes are set up under trust.

This means the scheme is run by trustees who manage the assets of the pension scheme. They have a legal duty to act in scheme members' collective best interests.

The assets of the scheme belong to the trust – because they exist to provide pensions for members. Those assets don't belong to the sponsoring employer. The laws that govern these arrangements were written to stop unscrupulous employers – like Robert Maxwell – taking money from company pension schemes and using it for something else.

"Closed" schemes

Once a scheme closes to new members, it has two real choices:

- It can run on, paying out pensions until its last member dies, with the risks of pension liabilities being borne by the sponsoring company.
- Or it can make a risk transfer agreement with a life insurance company such as PIC. In exchange for the scheme's assets, PIC issues an insurance policy that guarantees the payment of pensions, and the sponsoring company is relieved of its responsibilities.

A buyout is widely considered to be the "gold standard" for DB schemes, because it removes all risk for members, who get a guarantee that their pensions will be paid.

Policy and regulation have hastened the closure of DB schemes, by pushing schemes to reduce risk, increasing sponsors' costs.

In March 2024, the Commons Work and Pensions Committee warned that:

Two decades of regulatory and policy caution from DWP and The Pensions Regulator have led to a low-risk approach to investment that threatens to inadvertently finish off the few remaining DB schemes still open to new members.

Rising longevity has also hastened the move away from DB schemes, since longer lives make it more expensive for employers to fund DB pensions. DC schemes are much cheaper for employers: they typically pay 5% of a workers' salary into a DC scheme, whereas funding a DB pension might cost them 22% of that worker's salary.

The benefits of "buyout".

DB schemes insuring their liabilities through buyout deals offer two major benefits to members and the wider economy:

1. Members get absolute confidence that their pensions will be paid.

2. Insurers taking on the assets of DB schemes can pool those assets and invest them more productively than individual pensions schemes can. This is because insurers insuring pensions have bigger pools of assets that they use to generate stable, long-term returns to pay pensions.

This means pension insurers are major investors in infrastructure and housing.

More than 20% of PIC's £50 billion portfolio is invested in UK infrastructure...

including housing, energy and a reservoir. Other pension insurers are also major infrastructure investors.

£200bn

of investments in UK infrastructure by the buyout sector by mid-2030s

In 2016 PIC invested £100 million to help finance the construction of the Thames Tideway project, a new 16 mile long tunnel under London to relieve the city's sewage system, reduce pollution in the river Thames, and improve environmental standards across the sewage network. Tunnelling was completed in 2023 and the project, which has an expected lifespan of more than 100 years, is set to go live in 2025.

The defined contribution “not a pension” problem.

DC pensions have largely replaced DB schemes as the norm for British workers.

A DC pension isn’t really a “pension” in the way that lots of people understand that word.

DC schemes don’t guarantee any particular income in retirement.

That’s because they’re a pot of money that belongs to a worker and is invested in the hope that it grows so it’s worth more when they retire.

Whereas DB schemes mean employers and schemes bear responsibility for managing financial risks, DC schemes put that burden on individuals.

Many workers don’t fully realise the way that responsibility has been shifted on to them. Surveys consistently show that public understanding of and engagement with pensions is very low.

What’s in a name?

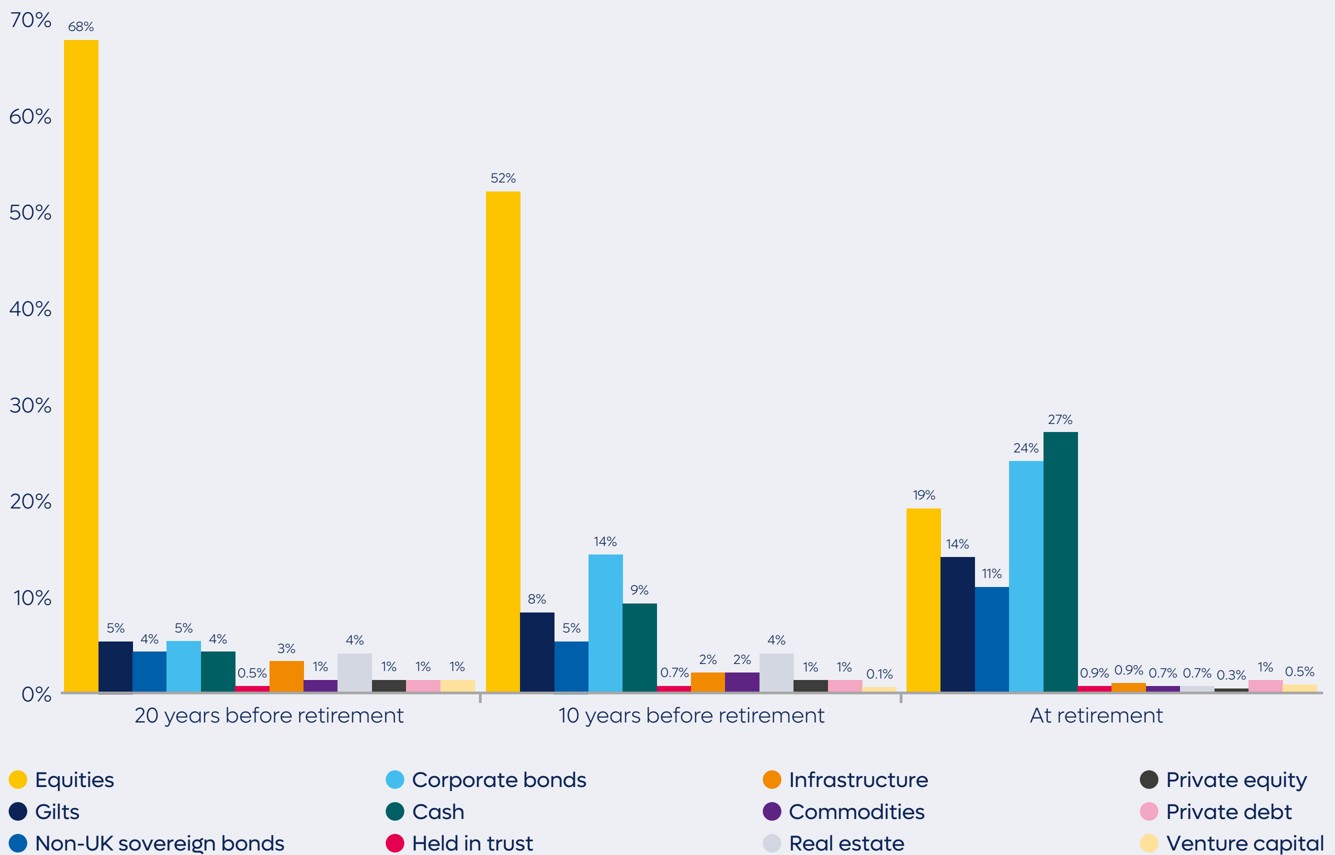
Some – including PIC – have argued that DC retirement schemes shouldn’t be called “pensions”, because using that word misleads people about their prospects for later life. We suggest DC schemes are more accurately described as “retirement funds”.

Defined contribution - investment strategies explained.

DC pension funds' investment choices are also determined by time. When their members are younger, they favour riskier investments like shares, that could produce higher returns.

While defined contribution investment remains heavily focused in equities and bonds, small allocations to alternative asset classes are increasing.

Average defined contribution asset allocation, 20 years before, 10 years before and at retirement, 2023.



Source: Pensions Policy Institute (PPI)

But as members get closer to retirement and want to secure their savings, funds switch towards bonds.

With encouragement from politicians, some DC funds are investing more in "alternative" assets. These include infrastructure but also private equity and venture capital - investing in start-up companies.

In July 2023, the Government announced the Mansion House Compact, signed by firms representing around two thirds of the UK's DC workplace pensions market. The voluntary compact commits the schemes to allocating at least 5% of their main funds to unlisted equities by 2030.

Automatic enrolment - is it enough?

Since 2012, around 10.9 million employees have been automatically enrolled into workplace pensions. This process is expected to increase workplace pension pots total value to £1 trillion by 2030.

AE currently covers workers aged 22 and over who earn at least £10,000 a year. Pension contributions are based on earnings over £6,240. In 2023, Parliament legislated to lower the starting age to 18 and base pension contributions on every pound earned, but these changes have not yet been put into effect.

Many experts are very worried about pensions adequacy.

Depending on what you consider to be a decent income in retirement, official projections show that around 38% of working-age people – 12.5 million individuals – aren't saving enough into their pensions.

Older workers, who haven't had as much time to build up years of savings via AE, may be at particular risk of retiring without enough savings to support their preferred lifestyle. The median DC pension pot among people 50-59 was £33,500 (in 2018-20).

Over the next 10 years, the average DC pension pot is expected to grow to £50,000.

Remember

The value of a DC pot isn't the pension it will pay out in retirement. It's the total amount of money someone has to spend over the whole of their retirement, a period that could last for 30 years or more, depending on their longevity.

A widespread call in response to this problem is for the law to be changed to increase the legal minimum contributions into workplace pensions. Currently, the combined minimum contribution is 8% of salary (5% from the worker, 3% from the employer). Many analysts say this should be at least 12% and perhaps 15% eventually.

The future of DC pensions – the coming questions.

"Decumulation"

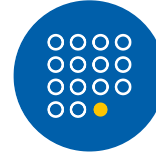
How can people retiring with DC pension pots spend and invest their money in the most effective way?

Since 2015, the law has allowed people aged 55 and over to take money from DC pots and use it however they wish. But the decisions involved in decumulation are extremely complicated – people have to estimate how long they will live – so there are calls for new rules to offer them more support with those decisions.

"Dashboards"

It can be hard for people to easily find out what their DC pots are invested in, and to make decisions about what they'd like to invest in.

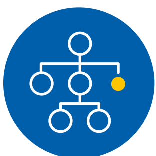
Technology could address this, and the Government has been working with the pensions industry for several years to create "pensions dashboards" that will allow people to see all of their pension pots and investments on a single, simple screen.



"Small pots"

Because people are living longer lives and changing jobs repeatedly over their careers, many will pick up several different DC pension pots over the decades.

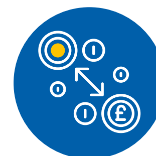
Some estimates suggest that today's workers will have on average 11 DC pots each by the time they retire. That creates administrative challenges, puts people off engaging with their pensions and runs the risk of pensions getting lost as workers lose or forget paperwork and access details. (In 2022, it was estimated that there are 2.8 million "lost" pots, worth more than £26 billion).



Too many schemes?

There are almost 27,000 occupational pension schemes in the UK. Over time, and with encouragement from the government, the number of DC schemes is falling.

Smaller schemes managing pension pots for workers from a single employer, are slowly giving way to Master Trusts, which are run by big finance companies and handle the pension pots of workers from multiple employers. There are now 36 Master Trusts, looking after 23 million pension pots holding more than £105 billion in assets.



Value for Money

There are concerns that DC pension pot owners end up paying too much in fees but don't get good value in the form of returns on their investments.

The LPGS – Britain's sovereign wealth fund?

Most public sector pensions aren't part of this pensions landscape because they are "unfunded". This means they don't have assets that are invested to pay pensions – instead, pensions are paid out of the Government's general tax revenue.

But some public sector pensions are "funded", meaning they hold assets that they invest to generate returns that they use to pay pensions. The most important of these funded schemes is the Local Government Pension Scheme.

The LGPS is one of the biggest pension funds in the world. It has 6.1 million members, who are entitled to or are receiving DB pensions. In 2022, it had assets worth £381 billion.

But the LGPS is fragmented. It is administered locally by 86 local pension funds in England and Wales. (LGPS Scotland is made up of 11 funds. At end March 2020, it had 606,312 members, and £46 billion.)

Because fragmentation can mean higher costs – from paying lots of different companies to manage money – there is a much better deal for the taxpayer by bringing all of the schemes into one big scheme.

Consolidating all LGPS funds into a single pool would create a global-level pension investor working to a mandate set directly by UK political leaders. Canadian public pension funds of similar size are some of the world's biggest investors in infrastructure and other productive assets. With the right policies, Britain could have a similar fund of its own.

1 Better investment

The LGPS currently puts relatively little of its assets into things like infrastructure and private investment in British companies. A consolidated LGPS could be mandated to invest a percentage of assets in a specific way.

2 £1 billion cheaper

Compared to Canada's public pension funds – which have a broadly similar role - the LGPS pays higher fees for investment management, gets lower returns on investments, and puts less money into things that benefit the national economy. A single management structure for the LGPS could save taxpayers £1 billion a year.

Lessons from around the world.

Canada

11 public sector pension funds have built up assets worth more than £1.2 trillion to pay the pensions of teachers and local council workers. Instead of paying asset management firms, they invest this money themselves and have become some of the world's biggest investors in infrastructure. Canadian pension funds own airports and utilities in the UK.

The UK equivalent of the Canadian pension schemes is the Local Government Pension Scheme, although the LGPS is much more fragmented than its Canadian counterpart.

Australia

Workplace DC schemes known as "supers" have amassed £2 trillion in assets – to pay the pensions of just 15 million workers. Australian has far fewer DC schemes than Britain and contributions into schemes are higher. This means fewer, bigger funds that are able to invest at scale, including in infrastructure.

Netherlands

DB schemes are being phased out by law. Proposed legislation will require all workplace schemes to operate on a DC basis from 2028. New workers will be automatically enrolled into those schemes.

About Pension Insurance Corporation plc ("PIC").

PIC generates long-term social value by fulfilling our purpose, which is to pay the pensions of our current and future policyholders. Our business covers the pension risk transfer ("PRT") and investment industry. Pension fund members of defined benefit ("DB") schemes transfer to insurers like PIC and become our policyholders following a buyout.

PIC's purposeful investment strategy leads to significant investment in UK social infrastructure, including social and affordable housing, urban regeneration, the UK's universities, and renewable energy. These investments provide stable cash-flows to support our projected pension payments over future decades.

We take care of our customers...

Total number of policyholders

339,900

Policyholder satisfaction

99.3%

Number of schemes insured

273

...and we invest in areas[1], such as:

Built environment[2]

c.£5.9bn

Student accommodation

c.£1.3bn

Social and affordable housing

c.£2.8bn

[1] Amount invested to date is estimated based on available historic data.
[2] Built environment is inclusive of student accommodation and social and affordable housing.

PIC's pension payments and investments.

PIC secures the benefits of hundreds of thousands of members and former members of UK defined benefit pension schemes.

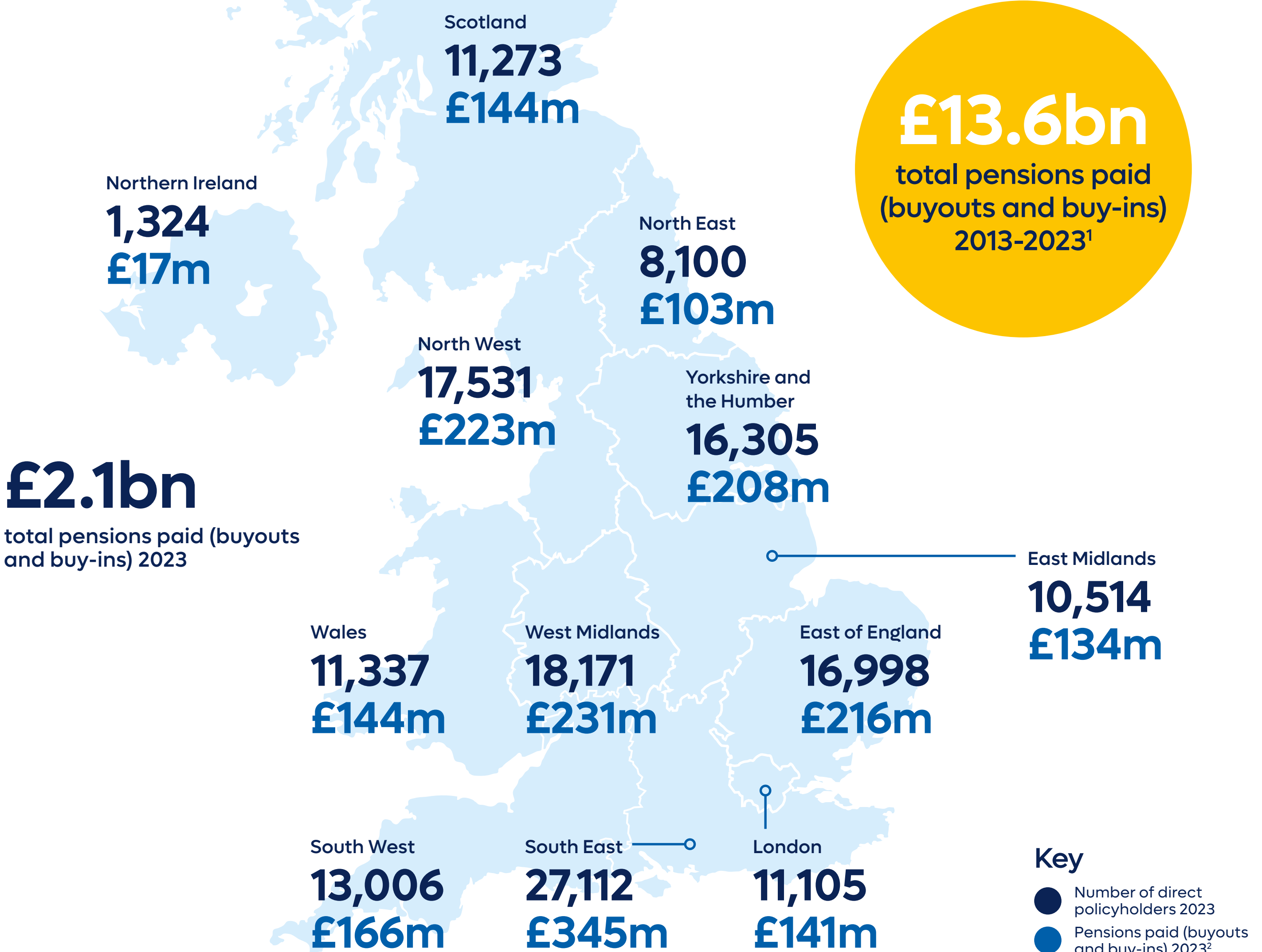
In order to do so, we channel investment into the economy, which supports jobs, growth and creates significant social value.

The map below shows the value of the pension payments we have made to our policyholders from the total pensions paid of £2.1 billion. These current payments are broken down by the countries of the UK and nine English regions.

PIC has insured more than 270 pension schemes, with a combined value of more than £58 billion, and the benefits of almost 450,000 of their members.

Pensions paid (buyouts and buy-ins) 2013–2023[1]

Region	Amount
East Midlands	£760m
East of England	£1,683m
London	£1,438m
North East	£470m
North West	£1,396m
Northern Ireland	£95m
Scotland	£812m
South East	£2,941m
South West	£1,267m
Wales	£575m
West Midlands	£1,318m
Yorkshire and the Humber	£865m
Total	**£13.6bn**



£13.6bn total pensions paid (buyouts and buy-ins) 2013-2023[1]

£2.1bn total pensions paid (buyouts and buy-ins) 2023

[1] Total paid to policyholders from 2013 onwards. Amounts paid before 2023 have been adjusted for inflation.

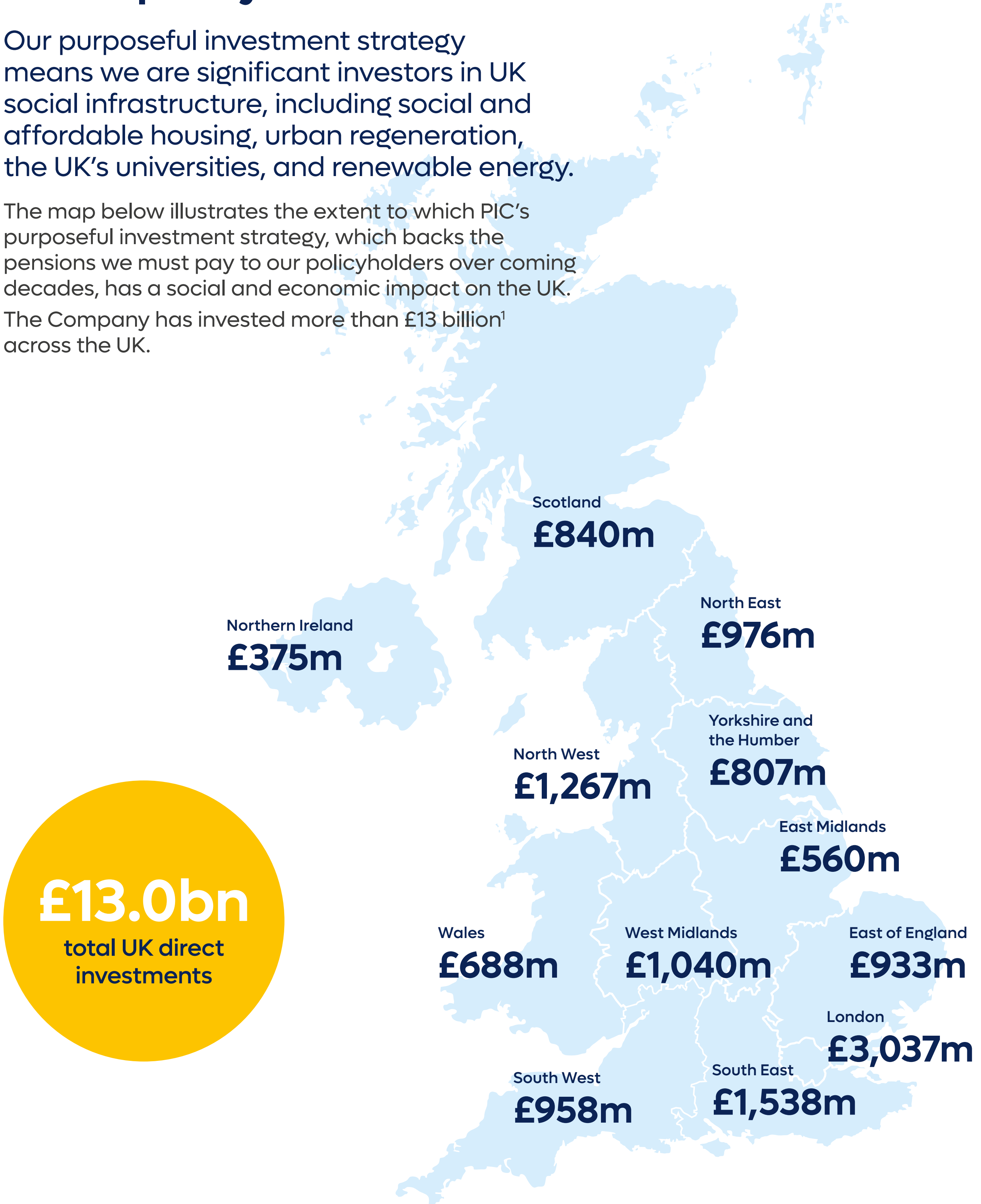
[2] Regional distribution of payments is estimated based on the split of policyholders across the country.

PIC's investments secure more than the pensions of our policyholders.

Our purposeful investment strategy means we are significant investors in UK social infrastructure, including social and affordable housing, urban regeneration, the UK's universities, and renewable energy.

The map below illustrates the extent to which PIC's purposeful investment strategy, which backs the pensions we must pay to our policyholders over coming decades, has a social and economic impact on the UK.

The Company has invested more than £13 billion[1] across the UK.



£13.0bn total UK direct investments

[1] Amount invested to date is estimated based on available historic data.

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