Pensions Policy Institute

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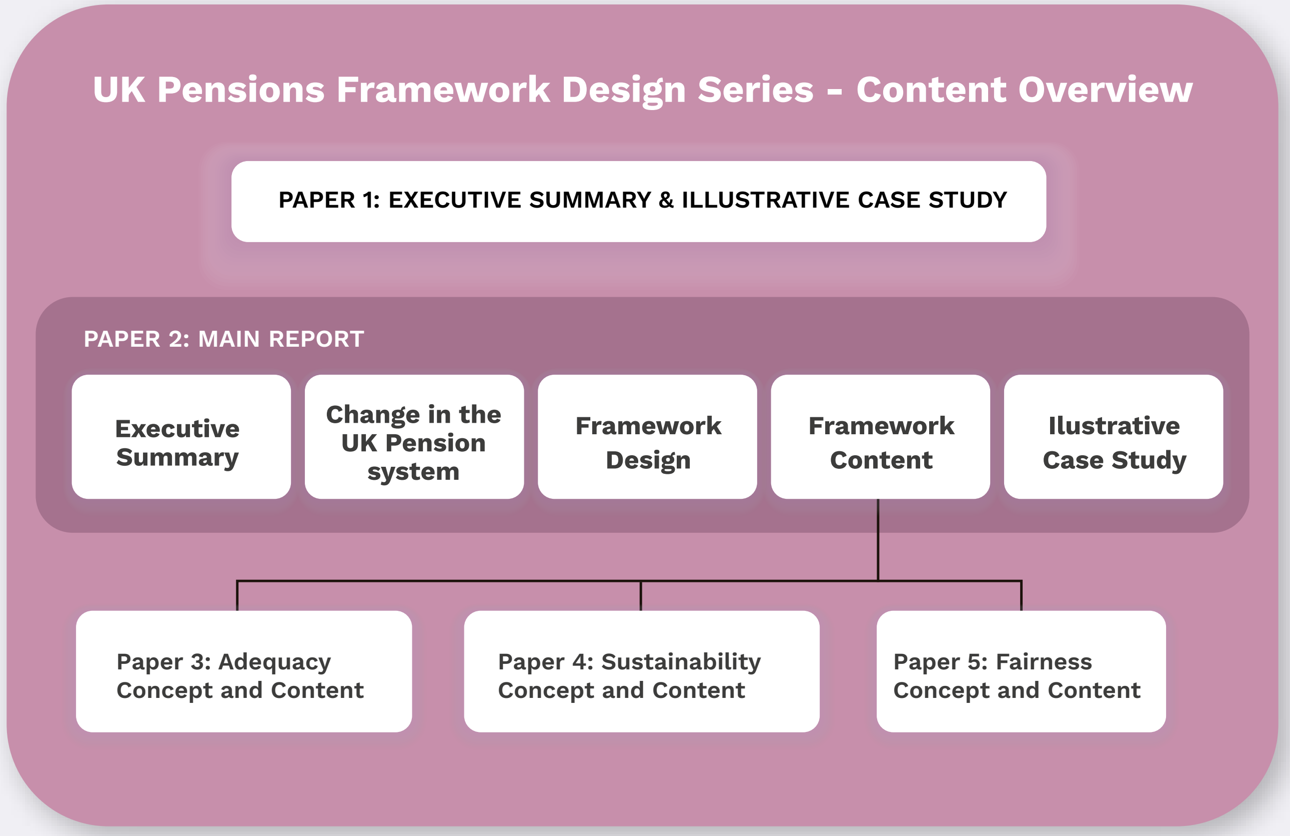
UK Pensions Framework Design Series

An examination of adequacy, sustainability and fairness in the UK Pension System

Paper 5: Concept and Content

UK Pensions Framework Design Series: Paper 5: Fairness – Concept and Content



The **UK Pensions Framework Design Series** comprises five papers which together document the process of developing the UK Pensions Framework, undertaken over the course of 2021.

The UK Pensions Framework is a long-term analytical instrument which seeks to build a clear picture of how strengths and weaknesses in the UK pension system are evolving over time. From its first release, due in Q4 2022 and annually thereafter, it aims to provide a consistent and systematic approach to examining and simulating changes in adequacy, sustainability and fairness in the UK State and private pension system, which overall determine the financial security that people have in later life.

This paper presents a more detailed discussion on what fairness means in the context of the UK pension system. It expands upon the introduction provided in the Main Report. The Main Report offers a detailed insight into the context, structure and content of the Framework, what the Framework is, why it is needed and how it has been designed. An abridged version is provided in the Executive Summary and Illustrative Case Study. Further examination of the concepts underpinning analysis of Adequacy, Sustainability and Fairness, along with their proposed content indicators, is provided in three supporting papers.

The Pensions Policy Institute is an independent not-for-profit educational research organisation, devoted to improving retirement outcomes by being part of the policy debate and driving industry conversations through facts and evidence. The UK Pensions Framework project has been kindly sponsored by Aviva. Sponsorship has been given to help fund the research, and does not necessarily imply agreement with, or support for, the analysis or findings from the project.

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The next step in the Framework project is to undertake detailed analysis of the UK pension to understand how it is changing year on year, the results of which will be made available annually from the end of 2022 onwards.

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The UK Pensions Framework

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FAIRNESS

Impartial and just treatment or behaviour without favouritism or discrimination

An inclusive system which engenders trust, provides fair benefits for all, protects people equally from risk in retirement and upholds the commitments that are made within and between generations.

Inclusion

Making access to pension incentives, products and services available to everyone, along with the support people need to understand them

Trust

A system wich gives people belief in its purpose, along with the confidence and motivation to work towards individual and common goals

Outcomes

Ensuring that people are protected equally from the risk that their standard of living might fall in retirement

Protection

Safeguarding people against risks inside and outside the pension system, whilst supporting them to make good choices from working life into retirement

Promises

Upholding commitments that underpin the integrity of the pension system within and between generations

Fairness

An inclusive system which engenders trust, provides fair benefits for all, protects people equally from risk in retirement and upholds the commitments that are made within and between generations.

1 Process Fairness

- Inclusion
- Engagement
- Choice & Defaults

2 Outcome Fairness

- Differences between population groups
- Differences between individuals

3 Protection Consumers

- Value for Money
- Pension Scams
- DB Transfers

Introduction

"What the public typically want from their Government are policies that are fair and treat citizens in an equitable manner. (Sen, 2009)".[1]

The need to plan for retirement affects nearly everyone in our society. For them to have a sense of ownership of their pensions, and to be encouraged to save for retirement, they need confidence that the pensions system is working for them and that their savings are protected.

This paper describes how fairness indicators have been derived from the concepts of equality of opportunity and equality of outcome. The indicator groups include process fairness, outcome fairness, and the need to protect consumers. An overview of the rationale, content and current themes for each indicator group is provided at the end of the paper. The paper addresses the following questions:

- What is fairness and why does it matter?
- What does fairness mean in the Framework?
- What are the Framework's indicators?

What is fairness and why does it matter?

Fairness matters because people who are treated fairly will have confidence in a system that they contribute to throughout their whole life, in order to have better outcomes in later life.

Balancing the competing objectives of adequacy, which relates primarily to benefits, and sustainability, which relates primarily to resources and costs, necessarily requires that decisions are made over how the costs and benefits of pensions are distributed. As with all areas of public policy however, outcomes are not always distributed evenly over time or group. The challenge for policy, and for society, is therefore to establish the extent to which they are distributed fairly. Establishing what fairness means, however, is widely contested, and the difficulties involved in doing so are arguably the reason that pension reform is known as the "third rail" of politics.[2]

The Framework's definition of fairness is derived from the principles of equality of opportunity and equality of outcome. It also incorporates the considerations for inclusion, trust, protection, commitments and fair benefits for all.

Although everyone expects fairness from pension systems and policy, defining what fairness means is a subjective concept that means different things to different people. Fairness is particularly difficult to objectively define and develop in the Framework. However, its importance to the way in which the pension system is delivering on its objectives is sufficiently high to warrant an attempt to do so. It will also be a measure of the extent to which the pension system is contributing the wider public policy priority of tackling inequalities. The chosen interpretations and indicators of fairness are the product of extensive discussions and research. However, whilst they are derived from a theoretical underpinning, they are also intended to reflect the shape of the UK pension system in order that findings can be practically related to policy design and outcomes.

Fairness has been chosen as a Framework objective to reflect the notion that every individual is a valued member of the collective.[3]

It also reflects the importance that people see in being treated fairly, and in treating others fairly.[4] Furthermore, if people believe that a system, authority or entity is fair, they are more likely to trust its motives and work towards individual and common goals.[5]

Trust and fairness are prominent issues for policymakers, pension providers and managers, employers and, most importantly, the public.

Trust plays a crucial role in the perception people have of pensions, and the extent to which they believe the system can deliver positive outcomes for themselves and the world they live in. It provides authorities with legitimacy and underlies voluntary cooperation with the system and its laws.[6] It also has demonstrable economic as well as political significance, and has been shown to motivate the moral rules by which people judge entities and individuals, as well as Governments, on what they may or may not do.[7] For people to trust the system, they need to know they can take part on the same terms as everyone else and expect an outcome that allows them to live with dignity and security in retirement.[8]

What does fairness mean in the Framework?

In the Framework, "fair" means that people have an equal opportunity to participate in and benefit from the pension system, and that they can achieve outcomes which meet their needs and preferences equally.[9]

Much of the debate around equality in pensions, as well as other policy areas, centres around the question of "equality of what?". The Framework's interpretation of fairness, and the indicators chosen to assess it, are broadly based upon the principles of equality of opportunity, and equality of outcome.

Equality of outcome means equalising where people end up. Equality of opportunity means equalising where they begin. (Phillips, 2004)

Equality of opportunity refers to the extent to which people are treated equally in the pension system in order that its benefits are available to everyone, regardless of other factors such as gender, race, class or capability.[10]

Equality of opportunity is considered a primary criterion in the pursuit of justice and fairness in public policy.[11] Its purpose is to counterbalance factors that might otherwise contribute to unequal outcomes such as access, awareness and understanding in order that everyone who wishes is able and supported to achieve a good outcome. It implies that:

1. Each person has choices that are equivalent to everyone else, in terms of the opportunity to satisfy need and preferences through choices that are on offer
2. People should be able to "negotiate" these options equally through comparable levels of awareness of the options, ability to choose among them, and willingness to do so
3. Where people are not able to negotiate equally, their options should differ in structure or content to the extent that they counterbalance some of these inequalities[12]

In order to examine equality of opportunity, the Framework will focus largely on factors relating to process fairness. These include initiatives or interventions which can help to make levels of inclusion, engagement, awareness, capability and motivation more comparable. It will also consider how the use of policy levers such as default options and pathways can help make the benefits of pensions more widely accessible.

Equality of outcome reflects differences in the benefits that individuals, or groups of individuals, are able to achieve from the pension system.

The benefits of the pension system relate directly to is overarching objective, which is to provide financial security in later life in such a way that people are protected from poverty, and able to maintain their living standards in later life. Equality of outcome is covered in the Outcome Fairness group of indicators, and overall refers to the under or overrepresentation of certain groups or individuals among those at risk of not being able to meet their basic needs (poverty) or preferences (living standards) in retirement.

[1] Peters, B. (2015) p.156
[2] Borssh-Supan, A. (2014)
[3] Niesiobedzka, S. & Kokodziej, S. (2017)
[4] Kahneman, D., Knetsch, J. & Thaler, R. H. (1986); Sen, A. (2009)
[5] Feld, L.P. & Frey, B. S. (2007); Niesiobedzka, S. & Kokodziej, S. (2017)
[6] Slemrod, J. (2007); Feld, L.P. & Frey, B. S. (2007)
[7] Kahneman, D. (2013)
[8] Holzmann, R., Hinz, R. P., & Dorfman, M. (World Bank) (2008); Hutton, J. (2006); European Commission (2018)
[9] BRawls, J. (2001)
[10] Fleurbaey, M. (1995); Rawls, J. (2001)
[11] Rawls, J. (2001)
[12] Arneson, R. (1989)

In this way, equality refers to the equal distribution of outcomes among individuals, not the equal distribution of resources. A key factor to achieving this, however, is the redistribution of resources in such a way that differences across society are minimised.[13] Many of these differences are reproduced from inequalities which originate in and widen throughout working life, particularly among women and ethnic minorities who suffer both from gender and ethnicity pay gaps, and overrepresentation in low-income groups.

By looking at both equality of opportunity and equality of outcome in the pension system, or at process fairness and outcome fairness, the Framework aims to identify where and how pension inequalities originate, and where efforts to correct them can be most productive.

Helping savers to make informed decisions about their pensions and avoid falling victim to scams, poor decisions or detrimental outcomes is a focus for policies that aim to improve fairness across the pension system.

Pensions are different to other forms of saving because people generally have a lower risk tolerance, relatively low understanding of what is needed to achieve good outcomes, a higher proportion of their average wealth invested than in other vehicles, and somewhat constrained choice of products and services.

Although responsibility for pension outcomes has moved towards individuals and households, Governments still have a commitment to adequacy and to protecting people from harm. This can include measures to ensure savers achieve value for money, provide protection or compensation against scheme failures or defaults on commitments, and mitigate the asymmetries in information between providers and savers through engagement or use of defaults. Three of the most widespread risks to savers are examined in the third indicator which relates to protecting consumers: value for money, Defined Benefit (DB) transfers and pension scams.

The next section of this paper outlines the sub-objectives and indicators which will be used to examine fairness in the pension system.

[13] Peters, B. (2015); Rawls, J. (2001)

F1: Process Fairness

Differences in the opportunity that people have to access the benefits of the pension system and the way in which they are treated within it.[14]

Process fairness is a key element of the overall fairness objective because it is a driver of fair outcomes. When processes are deemed to be fair, people are more likely to interact positively with the system and changes which are brought about within it. It can also build and maintain confidence and legitimacy,[15] as well as secure commitment to rules and objectives.[16]

Process fairness indicators examines inclusion, engagement, default architecture and policy commitments in the context of equal opportunity, individual autonomy and freedom of choice. The extent to which processes are equal within the pension system is complex. Active decision makers generally prefer less process fairness over having their actions constrained.[17] In contrast, low process fairness can leave some individuals vulnerable to unfair or harmful outcomes and inequalities. In reality, the extent to which processes are equal is highly dependent on the policy area and process in question. Choice architecture, or the use of defaults such as automatic enrolment, are becoming more widely used to moderate many of these processes.

Issues around inclusion frequently arise when considering process fairness. Inclusion is essential to tackling savings and investment gaps,[18] and refers to differences in the extent to which individuals can benefit from certain outcomes on account of eligibility and other criteria. A good example of this is the difference in the treatment of tax relief in net pay and relief at source arrangements, or some automatic enrolment qualifying rules. Engagement is also another consideration, given its power to influence positive long-term change and tackle the asymmetry of information that exists between savers and financial services organisations.

F1.1 Inclusion

Variation in the extent to which individuals have awareness of and access to pension incentives, products and services that meet their needs, and the support to understand them

F1.2 Engagement

Changes in the provision and use of guidance and advice services, as well as information provided by State, DB and Defined Contribution (DC) providers

F1.3 Choice and Defaults

Where choices are available, the proportion of people opting for default options and the difference in outcome compared to active decision making

F1.4 Policy Commitments and Implementation

Differences in how rules are announced or enforced between groups or over time

F2: Outcome Fairness

This group of indicators examines how differences in the way in which retirement outcomes are distributed among individuals and population groups can put some people at greater financial risk in later life than others

Outcome fairness refers to the under or overrepresentation of groups or individuals when examining overall levels of poverty, and the extent to which people are able to generate a level of savings sufficient to maintain their standard of living through from working life into retirement. These indicators bring together a range of information from across the Framework in order to build a picture of the drivers and outcomes of later life experiences among at-risk groups, with a particular emphasis on women, BAME people, carers and those with disabilities, as well as those in non-traditional or self-employment.

Analysis will also consider where inequalities that originate in working life are replicated in retirement, and where risks exist that could be mitigated or exacerbated by pension policy and system design. For example, policies such as increased pay gap reporting and the widespread provision of National Insurance credits are designed to narrow pension savings gaps, and reduce the likelihood that inequalities are compounded over time. However, others such as automatic enrolment eligibility criteria may be exacerbating inequalities because those most likely to be ineligible for workplace pension saving on account of working patterns are also those at greatest risk of poor outcomes in retirement. Closing these gaps is an important consideration for fairness in the pension system.

The Framework will also consider how pension outcomes differ among individuals when major life events occur such as divorce, illness and death.

The way in which pension benefits are shared when couples separate, transferred and taxed when the saver passes away, and vary in the event that an individual has to stop work due to ill health can differ on account of factors such as the type of pension people have or the age at which event occurs. These differences can impact on financial security in later life either for the saver or for their family, sometimes putting people already vulnerable to inequality at even greater risk. For example, married women accumulate up to five times less total pension wealth than married men, but around 70% of couples do not discuss pensions at all when they divorce. Of those who do, only one in seven will actually result in pension sharing. Single women are already at greater risk of poverty in later life than men or couples, and these risks are likely to be compounded by these differences, particularly as one in seven women over 60 is divorced.[19]

F2.1 Differences between population groups

Pension wealth gaps by age, gender, ethnicity, employment status including self-employed, carers and those with disabilities, marital status, poverty gaps, and differences in the proportion of people expected to maintain living standards in retirement

F2.2 Differences between individuals

Pension sharing on divorce, treatment of pensions at the onset of ill health or after the death of a member

[14] Brockner, J., Wiesenfeld, B. & Diekmann, K. (2009)
[15] Rawls, J. (1972)
[16] Kirchler, E. (2007)
[17] Brockner, J. Wiesenfeld, B. & Diekmann, K. (2009)
[18] The Wisdom Council (2019)
[19] Buckley, J. & Price, D. (2021)

F3: Protecting Consumers

This group of indicators will examine trends across three risks that savers face to their retirement savings and actions taken by schemes and regulatory bodies to manage them: DB transfers, pension scams and value for money.

These risks reflect the notion that policy has an important role to play in fairness. It can help to moderate the relationship between pension outcomes and financial markets, and secure an appropriate degree of protection for consumers from detrimental outcomes or from others who "deliberately exploit their weaknesses".[20] Among the institutions responsible for maintaining and enforcing complex rules to protect people are Government, regulators, and trustees.

Two of the risks, DB transfers and pension scams, relate to circumstances whereby people either opt to transfer DB rights into DC arrangements, or are fraudulently persuaded to part with their savings. In both cases, activity has evolved and increased since the introduction of pension freedoms in 2016. Poor decisions can threaten the financial wellbeing of individuals, as well as the wider integrity of the pension system and are becoming a growing source of concern. Since 2016, over 210,000 people have transferred a combined £80bn in DB pension rights into DC arrangements. Although transfers can offer benefits in some cases, without the right guidance and support in others, people risk making decisions that could be detrimental to later life outcomes by giving up guaranteed income. In the case of pension scams, activity is likely to be significantly underreported.[21] 43% of people aged over 65 believe they have been targeted (but not necessarily the victim of) scammers, and an estimated £10bn has been lost to pension scams over time with average losses per person of around £91,000 in 2017.[22]

The third risk relates to the concept of value for money, a priority issue for Government and regulators. Value for money looks beyond the costs and charges that might erode the value of savings over time, and asks what people are getting for the money they pay. Where higher charges result in better investment returns for example, it might be worth paying more. Some of the main drivers of good value for money include suitable investment strategies, reasonable costs and charges, and efficient services and administration. As well as value for money, this indicator will also examine trends in DC scheme consolidation in order to track the extent to which scale could contribute to efficiency of costs

F3.1 Value for Money

Policy initiatives, investment returns, charges and charge caps, scheme consolidation

F3.2 Pension Scams

Reported and estimated number and cost of pension scams, prevention initiatives and policies which improve provision for victims of scams including tax amnesty

F3.3 DB Transfers

Number and value of DB transfers; affordability and availability of advice, process regulation

[20] FCA (2013); Kahneman, 2013, p. 413
[21] House of Commons Work and Pensions Committee (2021); PSIG (2021)
[22] Wilkinson, L. (2020)

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