

PENSIONS POLICY INSTITUTE

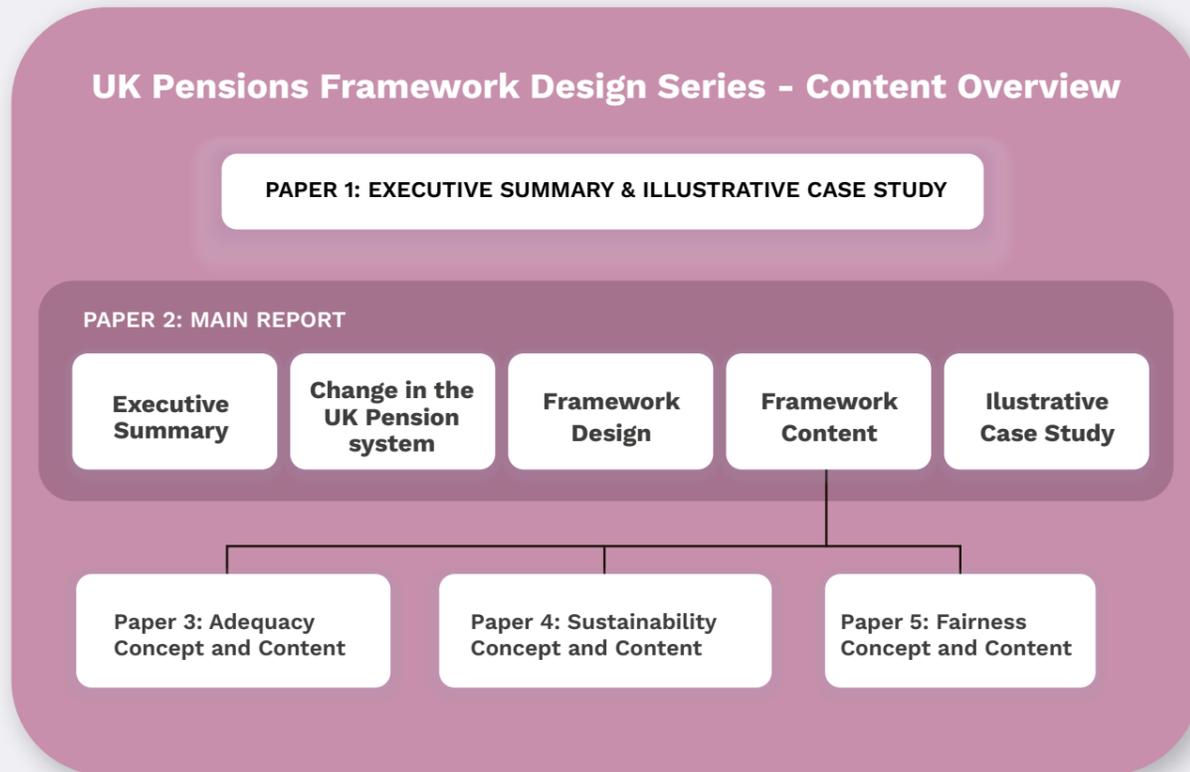
PPI

UK Pensions Framework Design Series

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

Paper 4: Sustainability -
Concept and Content

UK Pensions Framework Design Series: Paper 4: Sustainability – 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 sustainability 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.

The UK Pensions Framework Design Series has been authored by Anna Brain, Research Associate at the PPI. The PPI would like to thank experts from across government, regulators, academia and industry around the world who have so generously given their time to provide insight and guidance into the development of this work. Their contribution is gratefully acknowledged in the [Main Report](#). 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.

Published by the Pensions Policy Institute

© December 2021

ISBN 978-1-914468-06-3

www.pensionspolicyinstitute.org.uk

PENSIONS POLICY INSTITUTE
PPI

The UK Pensions Framework

In association with...

SUSTAINABILITY

1. The ability to be sustained, supported, upheld, or confirmed.

A stable, secure and affordable system which allows the needs of the present to be met without compromising the ability of others to meet their own needs

Stable



A reliable system which keeps pace with changes and risks inside and outside the pension system

Secure



Protection for retirement savings and income against a range of demographic, economic, market, political and ESG risks over time



Affordable



A system which operates within the constraints of its finances and at a “credible and serviceable” position over the long-term

Compromise



A system which balances the need to provide adequacy and sustainability over populations and over time, according to the needs and preferences of society



SUSTAINABILITY

A stable, secure and affordable system which allows the needs of the present to be met without compromising the ability of others to meet their own needs

1

Population & Ageing

- Population & Ageing
- Family Arrangements
- Health & Social Care

2

Financial Sustainability

- Macroeconomic Indicators
- Pension Age & Access
- Employer Sustainability
- Scheme Sustainability
- Fiscal Sustainability
- ESG

3

System Design

- Regulation
- Political Sustainability
- Complexity
- Innovation & Reforms
- Data Adequacy

Introduction

This paper describes what sustainability means in the UK Pensions Framework by adapting a well-known conceptual definition to the practical needs of the UK pension system and its savers

It discusses how a series of indicators have been developed to examine sustainability from the perspective of risks, challenges, resources, costs, benefits and system design.

The paper addresses the following questions:

- What is sustainability and why does it matter?
- What does sustainability mean in the Framework?
- What are the sustainability indicators?

An overview of the rationale, content and themes for each group of sustainability indicators relating is provided at the end of the paper.

What is sustainability and why does it matter?

“Pension promises are some of the most long-lasting we can make”.¹

The performance of pension systems is sensitive to a series of wide-ranging risks, many of which are continually evolving and any of which can compromise sustainability. They include:

- **Demographic risks:** Longevity and dependency ratios that affect the proportion of people claiming retirement benefits and the length of retirement periods
- **Macroeconomic risks:** Including growth, interest rates, inflation, earnings, public spending and debt, which affect the cost of funding pensions, the levels of pension income received, and competing demands for limited resources
- **Investment risks:** Exposure to downturns in financial markets and potential for permanent loss of capital which affect the growth of savings over time

- **Political risks:** Changes to values and institutions within the political system which can affect the long-term stability of pension systems
- **Environmental, social and governance (ESG), and climate change risks:** financially material risks arising from the impact of ESG factors and climate change

Some of the policy levers used to address sustainability risks include:

- Adjusting risk sharing and dependency on public, private and individual resources
- Increasing eligibility criteria to reduce the proportion or duration of pension claims
- Adjusting indexation or valuation measures to make payments less generous
- Growing contributions through measures to increase employment, wages or productivity
- Increasing contribution rates or taxes to grow the savings needed to fund payments
- Developing solutions that generate economic value by improving efficiency or reducing complexity through technology, processes and investments
- Ensuring that the companies which schemes invest in are taking account of ESG and climate change related financial risks

Sustainability means meeting the needs of the present without compromising the ability of future generations to meet their own needs²

The concept of sustainability is one that is increasingly important to us all. It is embedded and applied in a wide range of familiar contexts but is generally understood to encompass human, social, economic and environmental sustainability.³ Like fairness and adequacy, however, sustainability can be understood in many ways and has no single definition in literature.

From a qualitative perspective, the concept of sustainability is relatively straightforward. Resources are limited, so using them disproportionately could either deprive fellow individuals or institutions of an equitable share or could deprive future generations of people or institutions from a living standard comparable to that of the present.⁴ The principle behind sustainability, therefore, is to restrain the use of resources, in order that others can fulfil their own ambitions of living standards.⁵

The 1987 United Nations Brundtland Commission derived its definition of sustainability from a similar principle: “meeting the needs of the present without compromising the ability of future generations to meet their own needs”. Whilst this definition underpins UN Sustainable Development Goals, its principles are also relevant to the pension system and can help to explain how sustainability will be defined in context of resources in the Framework. Resources in the pension system, can be understood in two ways:

- **Costs:** Firstly, pension systems require resources and revenues to finance the growing costs of providing retirement income, as well as the operational and regulatory costs associated with delivering it. Financial resources are typically provided through taxation in the State system; along with individual and employer contributions, supported by tax relief, in the private system. In this context, sustainability relates to the ability of Governments and providers to maintain the cost of providing pensions within the constraints of public or scheme finances, and at a “credible and serviceable” position over the long term - and to distribute them across populations or across generations in a sustainable way.⁶
- **Benefits:** Secondly, pension systems provide resources in the form of expenditure on benefits to savers and citizens, as well as to the economy and wider society. To savers and citizens, they aim to provide resources that enable financial security, or a means of insurance, in retirement. To the wider economy and society, pension assets are a crucial part of capital markets, investment and corporate governance, whilst their design may also create positive or adverse labour market incentives.⁷

Financial sustainability relates to the balance between costs and benefits, and is the primary reason that countries have been reforming their pension systems since the 1990s.

In 2019, the World Bank said that “most public pension schemes are not viable financially and cannot therefore keep their promises to younger cohorts that will retire in the future”.⁸ In short, they are only sustainable as long as the resources going into them continue to increase at the same pace as the benefits being paid out. Population ageing, rising dependency ratios and high levels of public debt have produced significant challenges for the financial sustainability of pension systems in recent years. Together, they underlie extensive reforms that have effectively transferred longevity, investment and adequacy risks away from the State and employers, and towards individuals.

Whilst financial sustainability has been the focus of many reforms over recent years, the notion of sustainability has implications beyond affordability, including for the stability and security of the system, as well as how it can contribute to society.

¹ Willetts, D. (2019) p. 277

² UN (1987)

³ Sen, A. (2009)

⁴ Sikdar, S. (2003)

⁵ Hawken et al (1999)

⁶ OECD (2013)

⁷ Barr, N. & Diamond, P. (2006)

⁸ World Bank (2019)

What does sustainability mean in the Framework?

The sustainability objective includes measures related to the cost of financing and resourcing pensions, and measures related to the benefits provided by pensions.

It also considers the various risks that could compromise affordability, stability, efficiency and integrity, which overall determine the sustainability of the pension system. At this point in time, however, the Framework does not incorporate measures relating to sustainability in the wider economy and society for reasons that are briefly detailed here.

Pensions are playing a growing role in the pursuit of wider sustainability goals.

In many respects, the value of pensions extends beyond the primary goal of providing financial security in retirement. Pensions can also make a positive impact on the world at large by providing a resource to support sustainable development and the improvement of living standards both now and in the future. This can be made possible through economic development, which refers to the creation of wealth, from which economic, social, environmental and political benefits are realised; and through strengthening the role of institutional investors, who can influence efficiency and sustainability goals in companies or markets by directly improving stewardship and governance through their role as large shareholders.⁹

Considered in this sense, the concept of sustainability in the pension system is becoming synonymous with responsible investing, as pension providers and investment managers increasingly integrate wider sustainability goals into their business models and values. Responsible investing refers to investment strategies, including investment decisions and active ownership, which place value on the positive influence that investments can generate for society, as well as the financial returns they can yield. The goals of impact investing are similar, and generally include the requirement for demonstrative positive impact.

The principle underlying responsible investing is for pensions to better serve the ultimate purpose of improving security and quality of life for members in old age, by harnessing the power of pensions to generate positive value for society.¹⁰

Integrating ESG considerations into portfolio selection and governance strategies is a core aspect of responsible investing. The purpose of ESG investing is to enhance traditional financial analysis by identifying financially material ESG risks that extend beyond technical valuations. However, the tendency to overlay social values to ESG is leading to an overlap with the notion of responsible investing, despite ESG objectives being related to financial performance. Beyond regulatory requirements, the rationale for responsible investing, including ESG investing, is threefold:

1. Taking the financially-material risks of ESG and climate change factors into account can help mitigate their potentially negative effects on future returns.
2. Responsible investing can help investors to realise potential for growth and value, through investing in companies which are leading transitional and net-zero operations.
3. Responsible investing can provide a way to invest in the future shape of society by tackling environmental and social challenges, with the aim of giving people access to a better quality of life and greater security, particularly in later life.

Furthermore, the benefits of responsible investing and ESG are widely recognised as a channel through which to improve engagement with savers, particularly younger savers, among whom sustainability values are of increasing importance.

However, the impacts and evolution of responsible investing in the context of wider sustainability and economic development are very difficult to substantiate.¹¹

This challenge, coupled with the vast scope of the early-stage UK Pensions Framework design, present a significant challenge for defining substantive measures against which the broader concept of sustainability in the UK pension system can be examined. At this point in time, the Framework will therefore specifically examine measures which relate to the integration of the consideration of

financially material ESG and climate change factors in investment processes, in order to understand the contribution that strategies make to the first rationale for responsible investing: mitigating against economic risk.

In the future, it is the intention of the Framework to consider ways in which to develop analysis of responsible investing by incorporating indicators that relate to wider goals of contributing to economic development and generating positive value for society. To do this however, it will be necessary to gain a cross-industry perspective by examining outcomes in respect of policies and requirements set out by regulators, recognising that best practise among some providers will go beyond these measures. Developments in policy, regulation and practises will therefore be monitored over time and the decision of how best to include the societal value of pension resources will be taken in consultation with market participants and system stakeholders in the future.

The next section of this paper outlines the three sub-objective groups of indicators, along with the rationale for analysing them in the context of the UK pension system, and some of the key changes that have taken place in recent years.

⁹ Lanishok et al (1992), Thomas & Spataro (2016), Bijlsman M. et al (2018)

¹⁰ Share Action (2021)

¹¹ Bijlsma et al (2018)

S1: Population and Ageing

This group of indicators covers factors which impact the size of the older population, the length of time people spent in retirement, and the implications of population ageing for the cost and provision of health and social care services.

Population ageing, which is brought about by rising life expectancy and falling birth rates, means that more people are spending longer in retirement than ever before. As a result, it has contributed to almost a twofold increase in the relative amount of age-related spending on health, social care and pensioner welfare in recent decades. Age-related spending is set to rise to 14.2% of the UK's Gross Domestic Product (GDP) in 2024-25, up from 7.3% in 1966-67, of which pensioner welfare accounts for 3.4% and 5.8% of GDP respectively.¹² Over the same period, the proportion of the population aged 65 and over has risen from 12.7% in 1966-7, to a projected 19.9% in 2024-25.¹³ Health and care are expected to represent 8.4% of GDP in 2024-25, up from 3.9% in 1978-79, and over 44% of all day-to-day public spending compared to 27% in 1999/2000.¹⁴ Although population ageing has been occurring for several decades, it is accelerating as the Baby Boomer generation enters retirement and has been the biggest driver of pension reform around the world.

These indicators will consider how population ageing, including measures of life expectancy and dependency ratios, are contributing to changes in pensions and the security that people are able to achieve in later life. They will, where possible however, look beyond traditional measures of dependency to examine economic activity in order to reflect the notion that not everyone over State Pension age (SPa), or 65, is necessarily "dependent", and not everyone under SPa is necessarily active. Indicators will also look beyond average measures of longevity to consider how different cohorts, or socioeconomic groups within the same cohort, can have different life expectancy and therefore different pension durations. Measures will further consider the notion of healthy life expectancy, or the age to which people can expect to live in good health. Healthy life expectancy is a key source of inequality and will impact the extent that people are to have longer working lives, as well as the growing costs of health and social care. Whilst the cost of social care

to the State is further included in these indicators, the cost of social care to individuals is covered under adequacy indicator A5.4. Finally, changes in family and household arrangements will be examined including the proportion of people living alone in later life, a known risk factor for poverty.

S1.1 Population Ageing

Longevity and healthy life expectancy by population groups, dependency ratios

S1.2 Family Arrangements

Household composition, proportion of older people living alone, as couples or with family

S1.3 Health and Social Care

Costs of health and social care to the state as a proportion of GDP and public spending

S2: Financial Sustainability

This group of indicators will consider a range of risks that can impact financial sustainability in the UK pension system for the State, pensions industry and employers, as well as the effects of policy and industry reforms to address them.

Ongoing changes in population ageing, macroeconomic shocks or trends, labour market shifts, ESG and climate risks are all factors that can raise concerns over financial sustainability for stakeholders in the pension system, even if the system itself is fiscally balanced.

For policy makers, ensuring long-term fiscal sustainability requires continual forecasting of future revenues and liabilities, socioeconomic trends and environmental factors in order that planning can be adapted accordingly. Current and future growth in the ever-evolving UK welfare system is being driven by cost of pensions, including tax relief, and pensioner benefits, which can no longer be offset by reducing spending in other areas.¹⁵ Some of the reforms designed to tackle these issues include

increasing SPa, the flat rate new State Pension (nSP), and replacing final salary public sector pensions with career average alternatives.

For funded Defined Benefit (DB) pensions and annuity providers, the scarcity of options to hedge or diversify longevity risk, along with lower-than-expected investment returns, changing economic and labour market conditions, and legislative requirements have led to scheme closures and consolidation as providers look for ways to continue to maintain member benefits, whilst minimising the costs and risks to the sponsor. Over 400,000 people have seen their schemes fail and are now receiving or set to receive compensation from the Pension Protection Fund (PPF). In both the Defined Contribution (DC) and DB system, financial sustainability is also linked to scale, as well as charges, or in some cases the cross-subsidisation of charges, and regulatory constraints. For employers, the cost and complexities of providing and administering pensions needs to be balanced with investment in jobs and growth, and also requires consideration of the value placed in pensions by the employer and employee as a long-term reward for performance.

S2.1 Macroeconomic Indicators

Interest rates, GDP, economic growth, inflation, public debt

S2.2 Pension Age and Access

SPa, normal minimum pension age (NMPA), access age exceptions

S2.3 Sustainability for Employers

Contribution rates including employers paying above default minimum, administration costs

S2.4 Sustainability for Pensions and Financial Services providers

Scheme size and Assets Under Management (AUM), rates of consolidation, PPF and protection for members if schemes fail

S2.5 Sustainability for the State

Revenues and liabilities including cost of State Pensions, pensions welfare and tax relief

S1.5 ESG

Pension fund and corporate disclosure requirements, stewardship codes

S3: System Design

This group of indicators cover factors that relate to efficiency, innovation, stability and transparency, necessary for the delivery of long-term pension goals and commitments.

The design of the UK pension system and welfare state is based in a traditional social order of the past, which featured stable families and stable long-term jobs, both of which are being replaced by non-traditional arrangements, as well as high levels of employment. The Framework will consider how policy and industry responses to changes to these areas, as well as other types of socioeconomic and demographic change, are affecting sustainability in the pension system through innovation and reform. This could incorporate factors such as new products, policies and developments designed to target adequacy, sustainability or fairness, or new technologies designed to cut costs, generate economic value or improve awareness.

Maintaining sustainability in the pension system also depends upon more than increasing funding or reducing benefits. Complexity can, for example, add to layers of administration and costs for employers and providers. It can also lead to too much choice for people, which can increase the risk of poor decisions or the need for mechanisms to regulate options. Greater sustainability can be achieved by reducing complexity to lower costs and improve outcomes.

Sustainability can also be further supported by regulation and supervision, designed to ensure that parties are performing required functions and

¹² OBR (2021)

¹³ OBR (2021), ONS (2019b)

¹⁴ Zaranko, B. (2021)

¹⁵ Gardiner, L. (2019)

protecting the interests of stakeholders equally. Regulation addresses market imperfections; stimulates competition and efficiency; promotes long-term outlooks; compensates for asymmetries in information between providers and savers; and controls the potential for moral hazard.¹⁶ It can also promote the collection of information and monitoring of systems to support review, analysis and innovation. At the same time, a fragmented regulatory framework or excessive regulation which is complex or costly to implement or enforce can undermine compliance and, in turn, sustainability. Poor data is also a significant barrier to improving pension design and outcomes. Lack of data is a key problem for employers and providers too, who typically have little of the information they need about people's wider saving or employment patterns to support an appropriate selection of investment products or retirement pathways.

S3.1 Regulation

Alignment of interests, market competition, asymmetry of information, fragmentation

S3.2 Political Sustainability

Stewardship of the pension system, long-term decision making

S3.3 Complexity

Market and regulatory fragmentation, choice, administrative burdens

S3.4 Innovation and Reform

Evolution of products, technologies, processes and reforms in response to system needs

S3.5 Data Adequacy

Gaps, comparability, quality of data across schemes and savers

¹⁶ Hinz, R. & Stewart, F. (World Bank) (2019)



List of References

Barr, N. & Diamond, P. (2006) *The economics of pensions*. *Oxford Review of Economic Policy*, 22 (1). pp. 15-39. DOI: 10.1093/oxrep/grj002

Bijlsma, M., Bonekamp, J., van Ewijk, C. et al. (2018). *Funded Pensions and Economic Growth*. *De Economist* 166, 337–362. <https://doi.org/10.1007/s10645-018-9325-z>

Gardiner, L. (The Resolution Foundation) (2019) *The shifting shape of social security: Charting the changing size and shape of the British welfare system*. Available at: <https://www.resolutionfoundation.org/> (Accessed 5 September 2021).

Hawken, P., A. Lovins, and L. H. Lovins, (1999). *Sustainable Development Progress Metrics*. Available at www.icheme.org/sustainability/metrics.pdf (Accessed 2 September 2021)

Hinz, R. & Stewart, F. (World Bank) (2019) *Pension Regulation and Supervision*. Available at: <https://thedocs.worldbank.org/> (Accessed 2 November 2021)

Lakonishok, J., Shleifer, A., & Vishny, R. W. (1992). *The impact of institutional trading on stock prices*. *Journal of Financial Economics*, 32(1), 23–43.

OBR (2021) *Economic and Fiscal Outlook – October 2021*. Available at: <https://obr.uk/> (Accessed 1 November 2021).

OECD (2013) *Strategic Governance: Fiscal Sustainability*. Available at: <https://www.oecd-ilibrary.org/>. (Accessed 4 August 2021).

ONS (2019) *Principal projection – UK population in age groups*. Available at: <https://www.ons.gov.uk/> (Accessed 12 October 2021).

Sen, A. K. (2009). *The Idea of Justice*. Cambridge, MA: Harvard University Press

Share Action (2021). *Achieving Impact: The next chapter in the story of responsible investment*.

Sikdar, S. (2003). *Sustainability Metrics*. IN: *AICHE Journal* 49:8. Available at: <https://academia.edu>

United Nations (1987). *Report of the World Commission on Environment and Development: Our Common Future*. Available at: <https://sustainabledevelopment.un.org/> (Accessed 16 October 2021).

Willetts, D. (2019) *The Pinch*. London: Atlantic Books

World Bank (2019) *Pensions Overview*. Available at: <https://www.worldbank.org/> (Accessed 6 October 2021)

Contact Details

Editing decisions remained with the author who takes responsibility for any remaining errors or omissions.

© Pensions Policy Institute, 2021

Contact: Chris Curry, Director

Telephone: 020 7848 3744

Email: info@pensionspolicyinstitute.org.uk

Pensions Policy Institute

King's College London

Virginia Woolf Building

1st Floor, 22 Kingsway

London WC2B 6LE