Gambling with your pension

Millions were advised to opt out of the state pension into a personal pension; two thirds stand to lose out

Our unique research shows that two thirds of people who contracted out of the state second pension into a personal pension look likely to end up with less than they would have received had they stayed in the state scheme. We've calculated that this affects 4.5 million people. The whole exercise has been a colossal waste of money – unless, of course, you're in the pensions industry, in which case it's been a nice little earner.

People thought they'd get a better retirement income by contracting out. And since 1988, £35 billion in taxpayers' money has been handed over to the pensions industry to invest on behalf of people who were advised to opt out of the state second pension scheme into a personal pension.

Of that £35 billion, around £3 billion has been paid to pension providers and financial advisers in charges for the advice you received, and for investing your money. But a combination of high charges, poor investment performance and a huge abdication of responsibility from both government and the pensions industry has combined to produce yet another pensions scandal in which ordinary consumers end up the losers. We've taken our results to the Pensions Minister, Stephen Timms, and to the Financial Services Authority (FSA). The FSA was so concerned that it's commissioned its own research that confirms our shocking findings.

Of course, no one can accurately predict what the position will be at an individual's retirement date. However, based on current assumptions for future investment growth, we think it's unlikely anyone whose contracted-out personal pension is showing a loss now will see this turn into gains of any substance. At best, some may end up with benefits similar to those they would have received from the state. Yet the incentives given to encourage contracting out in the late 1980s made it look likely that you'd get a bigger pension by leaving the state scheme. On the following pages, we explain what the situation is now, and what you can do if you're contracted out into a personal pension.

The whole exercise has been a colossal waste of money

ALL ABOUT CONTRACTING OUT

Most people are entitled to the basic state pension but, if you are an employee (so not self-employed), you are entitled to an additional state pension currently known as the state second pension (S2P). This replaced the state earnings related pension scheme (Serps) in 2002. The amount you receive at retirement is based on how much you earn over your working life.

Employer's occupational pension schemes have always been able to opt their members out of the state second pension, as long as the scheme provided an equivalent pension. This was known as contracting out. Then, in 1988, this option was extended to employees who either didn't have access to an employer's scheme or whose employer's scheme was contracted in to the state scheme. These people contracted out using a type of personal pension known as an appropriate personal pension (APP). Around 7.5 million people have contracted out through one of these personal pensions.

Our research study looked at people contracted out into an APP. If you're contracted out through your employer's occupational pensions scheme, the rules are different.

Contracting out through an APP

When you contract out through an APP, you and your employer pay the same National Insurance

OUR RESEARCH

We looked at the cases of 108 Which? staff and readers who contracted out of the state second pension into a personal pension. We noted their age and salary and asked their pension providers for details of their past payments and current fund values. We asked actuaries Pensions & Actuarial Services to calculate the potential gains and losses based on assumptions approved by the Financial Services Authority. Our results are based on 90 completed cases.

What our research shows

The majority of people in our study are worse off as a result of contracting out

Percentage of people losing from contracting out

Percentage of people gaining from contracting-out

Contracting-out lottery

The government's saved money, and pension companies have earned billions – the only losers are consumers who did as they were advised

Ten ways to plan for a comfortable retirement

How to maximise your retirement income, whether you're opted out or not.

1 If you work for someone else No matter whether you are 25 or 55, if your employer offers a pension scheme, it's likely to be worth joining it. If you don't, it's like turning down extra income.

2 If your employer offers access to a stakeholder or group personal pension scheme and pays into it on your behalf Remember that you're unlikely to get a better deal elsewhere – so join it. If your employer doesn't pay in, shop around to see whether you can find a scheme with lower charges.

3 If your employer has an occupational pension scheme Take an interest: ask trustees how solvent the scheme is and get copies of the scheme's annual report and accounts. You could even stand as a trustee (occupational schemes can have a certain number of trustees nominated by the membership).

If your employer offers a pension scheme, join it

4 If you have just started work or are on a low income Start saving if you can. If committing your money into a pension plan for 30 or 40 years is impractical, you can start saving with as little as £1 in a tax-free cash Isa.

5 If you are self-employed You won't be building up any additional state pension scheme, so all you're entitled to is the basic state pension. Pay something into a private pension if you can – pick one that charges no more than 1 per cent a year.

6 Join a collective scheme if you have the option If you don't have access to an employer's pension, you may be able to join a collective scheme. These are run by non-profit organisations such as unions and have low running costs.

7 Plan ahead Work out how much you should be saving to buy the income you need in retirement at www.pensioncalculator.org.uk

8 Check whether you're on track – assume you are due to retire next week What costs will you still have (food, bills and so on), what won't you have (mortgage, kids)? How much money will you need? Check what you'll get from the state (see point 9) and private pensions (look at annual statements). If you're not on track, think about how to fund the difference.

9 Get a pension forecast The Department for Work and Pensions (www.thepensionservice.gov.uk, tel 0845 3000 168) can tell you what you're likely to get from the state when you retire.

10 Take advice For help with pension planning, see an independent financial adviser who specialises in pensions. See 'Contacts', p56, for useful numbers.

One of the losers

On the advice of his bank, Stephen Brown, 35, contracted out into his HSBC personal pension in 1988. In 2002, he contracted back in. Just over £7,000 in National Insurance rebates has been paid into his pension, which has grown to £11,000.

Taking account of future charges, and assuming investment growth of 7 per cent a year, this gives him an expected pension of around £1,104 a year – £109 a year less than he would have built up with the state.

Have you lost out?

To find out whether your contracted-out pension is a winner or a loser, contact your pension provider and ask for a personalised statement. This should compare the projected income from your contracted-out personal pension with the amount you would have got had you stayed contracted in. Your pension provider may refuse to do this or tell you it can't. If it does, let us know – see 'Your views', p15. We can't force it to do this, but we're lobbying the Financial Services Authority (FSA) to do so.

You can't buy back the years you've been contracted out

Maximising growth

Even if you decide to contract back into the state scheme, you can't buy back the years you have been contracted out. So it makes sense to make the most of your contracted-out personal pension. The more this money grows, the better the pension you'll get in retirement. You may be able to get better growth or lower charges by transferring to another pension provider – our research shows that the provider you are with can have quite an effect on how your pension plan performs. You may also be able to transfer to different investment funds with your existing provider.

But be careful – there may be transfer penalties. Consult an independent financial adviser who has qualifications in pensions, but find out how much they'll charge you first. See 'Contacts', p56.

Were you mis-sold?

Financial advisers had rules to follow when they advised people to contract out. One of these rules was to make sure that their customers understood that there was a risk their contracted-out pension might end up less than their state pension. If your adviser didn't make this clear, you may have grounds to complain.

WARNING

If you wish to make a complaint about a financial product, you must do so within three years of the date you first became aware you might have been mis-sold. If you do manage to get a personalised statement and it shows that your contracted-out pension is falling behind your state benefits, this might trigger the start of the three-year period. We're trying to get the FSA to confirm this, and to say what kind of compensation people might expect if their complaint is successful. In the meantime, if you do receive a personalised statement and you want to complain, make sure you do so within three years.

contributions as before, but some of the contributions are directed to your own pension plan instead of to the state scheme. This payment is known as your National Insurance (NI) rebate. Tax relief is added to the rebate and the total amount is invested for you in the same way as any other payments you might make to a personal or stakeholder pension. As an added incentive, until 1993, the government paid an extra 2 per cent of your earnings into your APP if you were contracting out for the first time. At retirement, the amount that has built up in your APP is used to buy an income. The idea was that, by investing in the stock market, the pension you receive would exceed what you would have got from the state scheme. But, as our research shows, there is no guarantee that it will.

If you don't have a clue whether you are in or out, call the HM Revenue & Customs contracting-out helpline on 084591 50150. You'll need your National Insurance number to hand. It will tell you for how long you've been contracted in or out.

What went wrong?

Despite substantial amounts of your money being invested over the years, APPs have failed to live up to early optimistic predictions. Since 1997, when the rules changed again, the amount paid into APPs hasn't been enough to match what you would have got from the state. Added to this is the double whammy of high charges and poor investment performance. Contracted-out personal pensions will have to work very hard just to maintain their current value, and even harder to actually beat the benefits currently available from the state.

Results of our study

Our research suggests that, overall, most individuals have lost out as a result of contracting out through a personal pension: 71 per cent of the people in our study look likely to receive a lower pension from their contracted-out personal pension than they would have got from the additional state pension scheme (Serps/S2P).

- Our losers, on average, look set to get just 80 per cent of the pension they would have received if they'd stayed in the state scheme.
- Those over 50 in our study are the most likely to have lost out. Only one person out of 22 aged over 50 is on target to get a better pension by contracting out.
- The really big losers are those who stayed contracted out after 1997. The minority who are better off are those who were contracted out, but contracted back in again before 1997. This year is important because it's when NI rebates became age-related – the younger you are, the less rebate you now get.

PHOTOGRAPHY ALAMY, MALCOLM CASE-GREEN, PAUL FRANCIS PHOTOGRAPHY

What the pension providers say

After falling over themselves to contract you out back in the 1980s, some of the big pension companies are now taking the opposite view. Earlier this year, Norwich Union announced that it was automatically contracting 40,000 of its policyholders back into the state scheme unless an individual specifically tells it not to. HSBC also did this in 2003, and Standard Life, Prudential and Axa have all come out publicly against contracting out.

Whether or not you should contract out of the state pension scheme still depends upon your personal and financial circumstances. So providers such as Norwich Union are taking a bold step by

Many pension providers are refusing to help their customers

making this decision on your behalf without going through the pros and cons with you. However, Tony Martin, Head of Product Management at Norwich Union, told us: 'We believe the current level of rebate is insufficient to provide a match for the state second pension, given expected levels of investment growth in the future.'

Financial advice?

Many pension providers and financial advisers are refusing to help their customers at all. The Pensions Advisory Service is an independent non-profit organisation that provides free information and guidance to members of the public on pensions. It says it is experiencing an increase in the number of callers to its helpline asking whether they should contract in or out of the state system. Most of the calls have arisen as a result of pension providers urging those who are contracted out to review their decision, but the people concerned haven't been able to find anyone who is willing to

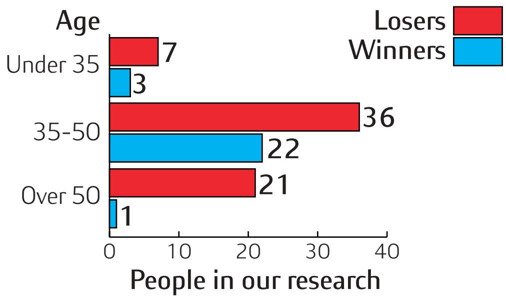
Our campaign

We've put together an information pack on contracting out that gives you more of the facts than we can fit here. So if you want to know how contracting out works and how to get some advice, go to **www.which.co.uk/campaigns** or phone 0845 307 4000 for a pack to be sent to you (ask for code CONTRA).

Which? has long campaigned for fairer, decent, sustainable pensions. We've recently joined forces with the TUC, Age Concern and Help The Aged to form the People's Pension Coalition to work together to achieve a fair deal for pensioners of the future. Read the full statement from the People's Pension Coalition on **www.which.co.uk/campaigns/personalfinance** where you can also access all the Which? campaign and policy papers, including *Blueprint for a national pension policy*, June 2003, and *Which Choice?*, *Pensions*, June 2005.

Winners and losers

The graph shows that 21 out of 22 people over 50 have lost out as a result of contracting out



FURTHER INFORMATION

www.which.co.uk/campaigns

Department for Work and Pensions
www.dwp.gov.uk

Pensions Advisory Service
www.opas.org.uk

Financial Services Authority
www.fsa.gov.uk

One of the winners

Jane Grogan, 40, contracted out through Legal & General in 1987. She's one of the few winners in our survey. Just over £13,000 has been paid into her contracted-out personal pension, which has grown to £23,350.

Taking account of future charges, and assuming investment growth of 7 per cent a year, she can expect an income of £2,408 a year when she retires. She's given up a state pension of £2,024 a year for the period in which she's been contracted out, so she's better off by £385 a year.

The future: should you be out or in?

You may be better off staying in (or moving back to) the state scheme if:

- you're unhappy that your personal pension is likely to pay less than your state pension
- you'll mostly depend on state benefits for your retirement income
- you trust the government more than the financial services industry to provide you with a pension.

You may want to contract out (or stay contracted out) if:

- you're comfortable with the risk that you may end up with less than the state pension
- the bulk of your retirement income will come from investments and savings or other private pensions
- you expect to be a taxpayer when you retire and like the idea of taking a quarter of your contracted-out pension as a tax-free lump sum (available from next April)
- you want access to your private pension before retirement age
- you think investment returns will improve dramatically in the future
- you don't need to provide a pension for a dependant at retirement. The state pension includes a pension paid to a spouse after you die. If you're contracted out and don't need to provide for a partner or spouse, you might get a higher income by buying a single-life pension, which doesn't contain any allowance for a spouse.

THE WIDER PENSIONS CRISIS

Unless you've been living on Mars, you'll have heard about the pensions crisis. Although the contracting-out fiasco isn't wholly to blame, it hasn't helped. The pensions crisis is about the bigger issue that, as a nation, we're not saving enough to see us through our retirement.

In 2002 the government set up the Pensions Commission, an independent body that reviewed the state of UK pensions and recommend solutions. It published its first report in October 2004 – here are some of its key findings.

We're not paying enough into our pensions

Many of us don't save enough during our working life to see us through an increasingly long period of retirement (especially as investment returns have been lower lately). And the problem is going to get steadily worse over the next 20 to 30 years.

We're living longer

State pensions for retired people (mainly the over 65s) are funded by those in work (mostly 20- to 64-year-olds). This is known as the dependency ratio. Today, there are four people aged 20 to 64 for every person over 65. By 2050, there's set to be just two people working for every retired person. Also, life expectancy is increasing, so we have a longer retirement to fund. In 1950, a man aged 65 was expected to live a further 12 years, compared with 19 years now. By 2030, this will be 21 years.

We're not saving enough

11.3 million people in work aren't contributing to any private pension and 8.8 million of those don't have a partner contributing, so are relying solely on state benefits. This includes about 1.7 million self-employed people who don't have access even to the second tier of the state scheme, so are just relying on the basic state pension. Even topped up by a means-tested minimum credit, this comes to just under £110 a week (for 2005-2006).

The real value of state pensions is reducing

The number of pensioners is rising and, if the government doesn't increase the amount spent on state pension benefits over the next 30 years, spending per pensioner will fall by 26 per cent.

Employers are paying less

Employers are closing final-salary schemes and instead are turning to schemes where the pension you receive relies on investment performance. With these new schemes, many employers are reducing the amount they pay in on your behalf.

Consumers aren't saving elsewhere

Consumers aren't plugging the gap left by a retreating state scheme and employers. One reason is that, according to Which? research, less than one third of consumers trust the pensions industry to provide their pension needs.

Successive UK governments

What they did wrong:

- UK governments have failed to provide an adequate state pension. The UK state pension system, unlike many overseas systems, is designed to prevent poverty rather than replace income. The Pensions Commission described it as 'among the least generous in the developed world'.
- They've created a monstrously complicated system that no one understands. It's virtually impossible to work out what you might expect to receive from the state when you retire.
- They have relied too heavily on privately funded pensions to solve the problem. The fact that we have such a poor state system has been masked by one of the most generous employers' pension systems in the world, but this is changing.

Employers

What they did wrong:

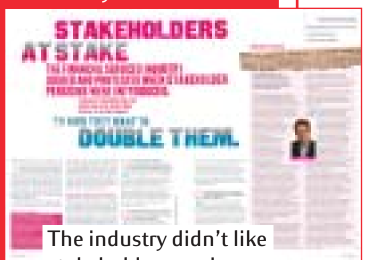
- By the end of 2004, the number of occupational pension schemes in the UK had fallen to 95,900, down from 151,000 in 1995.
- Where a company pension was offered, employers often took 'payment holidays' in the good years and failed to plan for the bad years.
- They closed final- salary schemes and turned to money-purchase schemes, including group personal pensions, which carry much less risk to the employer because there is no pension 'promise' or guarantee.
- Many employers are paying less into the new money-purchase schemes: 4 to 7 per cent compared with 12 to 15 per cent for final-salary schemes.

Employers are replacing final-salary schemes with money-purchase schemes

Pension providers

What they did wrong:

- Pension companies imposed excessive charges and penalties on personal pension schemes, which ate away at our savings.
- When the government introduced stakeholder pensions, which capped charges, many in the industry refused to sell them as they weren't profitable.
- Pension mis-selling during the 1980s and 1990s resulted in disciplinary action against 345 companies, fines of £9.5 million and compensation payments of £4.4 billion. This damaged consumer confidence in the industry.



STAKEHOLDERS AT STAKE

DOUBLE THEM.

The industry didn't like stakeholder pensions advise them on what to do. Chief Executive of the Pensions Advisory Service, Malcolm McLean, told us: 'We are particularly disappointed that, where the original decision to act was recommended by a financial adviser, there's an unwillingness to accept responsibility for ongoing advice.'

What the government says

The government isn't offering much help, either. In answer to a recent question in the House of Commons on the subject of contracting out, Stephen Timms MP, the Minister for Pensions, said: 'It is for individuals to decide and keep under review whether it is in their best interest to contract out, taking into account their attitude to risk and their personal circumstances.' He added that the government was committed to ensuring that people were properly informed of the issues involved so that they can make a decision that best suits their needs.

LOOKING TO THE FUTURE

Whether contracting out into a personal pension proves to be good value in the future depends on many things: how well investments perform, the charges that your pension provider deducts, annuity rates when you retire and, not least, how much gets paid into your contracted-out personal pension. Future investment growth and annuity rates are clearly unknown, so you have to be prepared to take a risk if you contract out or stay contracted out.

However, what the government intends to do with the state second pension also affects whether you should be in or out of it. It may be abolished altogether, or the benefits from the scheme may reduce further in the future. If the government wants to stop a massive stampede back into the state scheme, it may decide to reintroduce incentives to persuade you to stay out.

It's clear there are too many variables for consumers to make an informed decision on their own. Even the pensions industry can't make up its collective mind, and many are refusing to give advice, despite still getting paid handsomely in charges and commission. And yet for millions of people, this decision will directly affect the money they have to live on in retirement.

Given the government's stated concern over the so-called pensions saving gap, we think it's time it got off the fence and gave some clear direction before millions more lose out.

YOUR VIEWS

We want to hear from you if you are contracted out into a personal pension

Are you contracted out into a personal pension? How do you feel about this issue? What do you think the government or the industry should be doing? What do you want us to do? Do you think you may have been mis-sold? How do you think you should be compensated? If you've got a view on any of this, go to **www.which.co.uk/campaigns**

PENSIONS GLOSSARY

Type of pension	How it works
Basic state pension	A state pension not related to earnings, based on an individual's National Insurance contributions record. Currently pays up to £82.05 a week.
State second pension (S2P)	The current additional state pension scheme (it replaced Serps, below) paid to employees on top of the basic state pension. Carers and some disabled people also qualify. The amount you receive depends on earnings but is more generous for low earners.
State earnings-related pension scheme (Serps)	The earlier state second pension, replaced by S2P in 2002. Also earnings related.
Pensions credit	The main means-tested benefit for pensioners, which provides a guarantee of a minimum pension. It currently guarantees a minimum of £109 a week for a single person, and £167 for couples.
Employer's occupational scheme (defined benefit or final-salary)	A scheme that your employer, and usually you, pay into. The amount of pension depends on your final salary and length of time you are in the scheme.
Employer's occupational scheme (defined contribution or money-purchase)	A scheme that you and your employer pay into; the money is invested to build up a pot with which you buy a retirement income. The amount of income depends on investment performance and annuity rates.
Personal pension	A contract between an individual and a pension provider – you pay in, and the money buys an income when you retire. A personal pension can be provided through an employer, as a group personal pension, or purchased individually. The pension paid depends on investment performance and annuity rates.
Stakeholder pension	A personal pension with capped charges and no penalties for stopping premiums or transferring. As with personal pensions, it can be provided through an employer or purchased individually. The pension paid depends on investment performance and annuity rates.
Appropriate personal or stakeholder pension	The scheme used to contract out of the state scheme for employees who are not members of an employer's occupational scheme, or whose scheme is contracted-in to the state scheme. Also used for people who are members of a group personal or stakeholder scheme if they wish to contract out. Part of the National Insurance contributions you and your employer pay are invested directly into your pension plan.