

# Extending Living Pension to Defined Benefit Overview of Approach & Methodology



## Introduction

The Living Pension standard builds on the work of the real Living Wage with the aim of providing stability and security for workers now and in the future. It is a voluntary savings target for employers who want to help their employees build up a pension pot that is expected to provide enough income to meet basic every day needs in retirement. It was initially set up for Defined Contribution (DC) pensions in order to set a stretching standard that went beyond the minimums required under auto enrolment.

Following the launch of Living Pension (DC) the Living Wage Foundation (LWF) received numerous enquiries from employers offering Defined Benefit (DB) pensions, which were not covered by the Living Pension accreditation. This demonstrated an appetite for the accreditation to cover DB schemes.

LWF appointed [Isio](#) to complete a feasibility study for DB pensions and then worked with the [Living Pension Steering Group \(LPSG\)](#) to develop the best approach to extending Living Pension to DB pensions.

*Thanks go to Paul Moffatt, Daniel Chadwick and Fatima Patel from Isio, as well as the LPSG and associated sub-committees for their expertise and guidance in shaping the approach to extending the Living Pension standard to DB pensions.*

This document summarises the **objectives and approach** to this work and the **assumptions and testing** that went into creating the Living Pension (DB) standard, which is outlined in the Living Pension Standards and Guidance & FAQs.

**isio.**

## Objectives & Approach

When creating this standard, there were four key objectives in approach:

- To build on the Living Pension (DC) standard and align wherever possible
- To define simple, consistent criteria for a DB Living Pension standard
- Enable as many employers as possible to be able to meet a Living Pension for all workers, with those on lower incomes prioritised
- To balance the affordability of a pension scheme today with the retirement benefits it will provide in the future

The main considerations under review were the affordability of contributions and whether benefits meet the Minimum Income Standards (MIS) as set by the Resolution Foundation in their DC Living Pension research. This specifically focused on three key areas:

1. **Eligibility** - employers need to be Living Wage accredited
2. **Benefits** – schemes must achieve, on average, a minimum benefit level in retirement to bridge the gap between the State Pension and the MIS
3. **Affordability** – contributions must be deemed affordable as outlined in the Living Pension (DC) standard (earnings do not fall below 95% of the real Living Wage after pension contributions are taken into account); **and/or** alternative scheme options are available that are deemed affordable; **and/or** opt out rates are low ( $\leq 10\%$ )

### Breakdown in approach

#### 1. Eligibility

All Living Pension employers must be Living Wage accredited. And, under the Living Pension (DC) standard, all direct employees over the age of 18 must be given access to a Living Pension contribution regardless of earnings and regardless of whether they are auto enrolled, contractually enrolled or they opt in. This is outlined in full in the Living Pension standards.

In addition, there is a longer term requirement for all Living Pension employers to extend a Living Pension benefit to their third party contracted workers.

Therefore, for an employer to be accredited, they must meet the Living Pension criteria across all their core pension offers. Where this differs for different groups of employees and/or contractors, this may mean meeting different (DB or DC) standards for different schemes, concurrently.

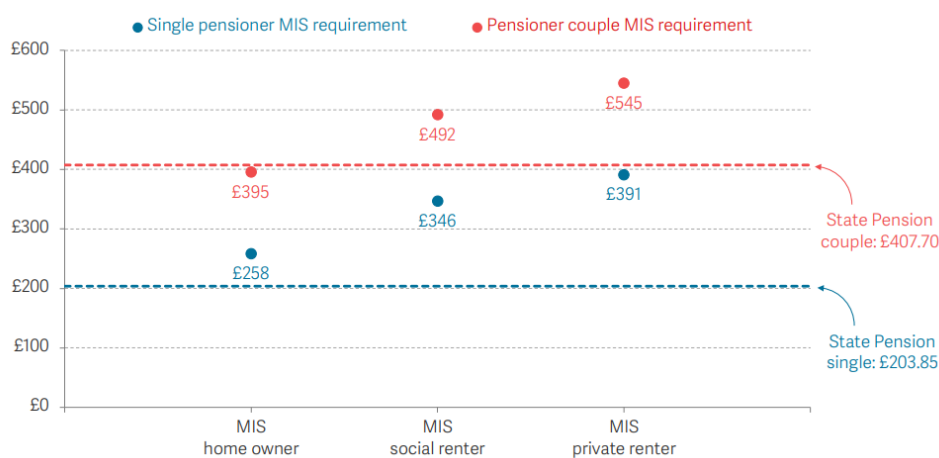
#### 2. Benefits

For the Living Pension (DC), the Resolution Foundation calculates a Minimum Income Standard (MIS) for pensioners. Where the State Pension (net of tax) does not meet this MIS, the shortfall is to be made up by the Living Pension. With DC, this is converted into a target pension pot at retirement and the contribution rate is set so this amount can be saved over the course of a career.

A consistent approach has been taken when extending Living Pension to DB, where a scheme’s benefit should bridge the gap between the State Pension and MIS at State Pension Age (all net of tax). Because benefits are “defined” in advance in DB schemes (and there is no “pot”), their expected output directly targets the shortfall (after tax is deducted).

### Living Pension MIS for DC

When calculating the DC Living Pension MIS, the Resolution Foundation looked at a range of ages, relationship statuses and housing tenures (including private and social renting). For simplicity, the final DC standard requirements target an “average” savings rate across all these categories, based on the population as a whole. The MIS targets (net of tax), per the Resolution Foundation’s research for the DC accreditation is summarised below.



NOTES: Minimum income standard benchmarks are based on 2021 figures uprated in line with prices.  
 SOURCE: A Davis et al., A Minimum Income Standard for the United Kingdom in 2021; ONS, CPIH index; ONS, Private rental market statistics October 2022 to September 2023; and DWP, Benefit and pension rates 2024 to 2025.

Source: M Broome, *Calculating a Living Pension: the 2024 update*, Resolution Foundation, September 2024

The approach with DB Living Pension is the same and uses consistent underlying population statistics to develop a target pension to bridge between the MIS and the State Pension. This has been adjusted to account for the difference in tax allowances between drawing down DC pots, and the payment of a DB pension (more details below).

This results in a gross income shortage of around £2,200 per person from State Pension Age to be made up by the Living Pension. When added to the State Pension, this is expected to meet the Living Pension MIS after tax. This is consistent with the DC standard when allowing for differences in the tax treatment of benefits, as described below.

### Living Pension MIS for Defined Benefit

For the Living Pension (DB), a DB scheme’s benefits accrued over the course of a career should meet the MIS, and the pension should broadly be expected to keep pace with the MIS until retirement.

With the Living Pension (DC) accreditation, the core or default pension scheme is assessed against the relevant criteria. The same principle was applied as a starting point to Living Pension (DB).

As the minimum benefit an employer can offer is an Automatic Enrolment ('AE') minimum (or equivalent) scheme, the AE 'test scheme' standard was assessed against the MIS. As an AE compliant scheme must be certified by an actuary, and benefits must be at least as good ("equivalent") as the 'test scheme', it was concluded that the 'test scheme' could be used as a baseline case to see if it meets the MIS (over a career, after tax, in conjunction with the State Pension).

It then follows that **if** the AE test scheme is expected to meet the MIS, it would be possible to say that **all** AE compliant DB schemes would be expected to do so, and so AE certification could be used as part of the accreditation test.

### Assessing the AE 'test scheme'

To assess the AE 'test scheme' against the MIS the following assumptions were used. Where relevant, the items below are in line with those used for the DC Living Pension:

- **Benefits** – scheme certified as meeting the AE 'test scheme' standard which covers various defined benefit structures and uses a build-up rate of (at least) 1/120ths for each year of pensionable service.
- **Service** – the 2024 Living Pension (DC) calculation aligns with an average service/career length of 33 years (accounting for periods of absences, opt-outs, career breaks, part-time periods etc.). This was used in the calculations but some sensitivities were considered (see section on "service length").
- **Pensionable salary** – assumed to be a proportion of the UK real Living Wage (currently £23,400, as the minimum salary offered by employers eligible to accredit) between the Lower Earnings Limit (LEL) and the Upper Earnings Limit (UEL) for AE purposes (i.e. Qualifying Earnings). The amount of this between the LEL and UEL is currently £17,160 i.e. £23,400 less £6,240). It is assumed the individual maintains the UK real Living Wage throughout their career (in line with the 2024/25 DC calculation) as a minimum benefit benchmark.
- **Maintaining "real" benefit value** – while in service, it is assumed that the real Living Wage, Qualifying Earnings and MIS will increase in line with each other (and so the effect of inflation is neutral).

Finally, it is important to note that the structure of benefits from the Living Pension (DC) gives rise to tax benefits, such as individuals being able to take 25% of their DC pension income tax free when using a "drawdown" approach.<sup>1</sup>

Whilst we recognise that DB pensions sometimes can have automatic lump sums available with the same treatment, this benefit has been ignored for the purpose of our baseline analysis. However, this type of core benefit structure would be permissible for accreditation, subject to meeting the criteria in this document.

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<sup>1</sup> Note: as part of this analysis consideration was also given to how benefits would change if a) members left service prior to retirement and b) how benefits change in payment, relative to inflation. The impact of these items will depend on individual scheme rules but broadly, it is expected that the relative generosity of DB pensions and inflationary increases (even if at statutory levels), would be sufficient to meet the MIS.

## Results

Based on the above, it is expected that the AE minimum test scheme would build up the following (gross) benefits over a career (in today's terms):

Service Length in years (A)	Build-up (accrual) rate (B)	Qualifying Earnings (C)	AE Test Scheme Pension (A) x (B) x (C)
33	1/120	£17,160	£4,720

**This is above the (gross) amount needed, on average, to bridge the gap between the MIS and the State Pension.**

This assessment demonstrates that it is reasonable to use an AE certification as a gateway test for the Living Pension (DB) as all schemes meeting it would be expected to be sufficient to meet the MIS for someone on the real Living Wage.

It is, however, important to note that this is an average and that there are certain underlying categories of members where the MIS (in conjunction with the State Pension) would not be met. This is consistent with the Living Pension (DC) standard and will be kept under periodic review.

### 3. Affordability

One of the key considerations for Living Pension (DB) is the affordability of contributions for members. Contributions need to be affordable, especially for those on the real Living Wage, so employees can remain part of the scheme and receive benefits.

#### Real Living Wage and pension contributions

The real Living Wage is calculated with an employee 5% pension contribution included (this takes account of DC AE Minimum contributions of 3% employer, 5% employee making 8% total. The Living Pension (DC) standard is set at 5% for employees in line with this, to ensure that contributions under Living Pension do not take a worker's pay below 95% of the real Living Wage.

A consistent approach is desirable for the DB accreditation. So, if employee contributions are less than or equal to 5% of the real Living Wage, and an employer's scheme is an AE certified scheme, they will be eligible to become Living Pension accredited.

However, given that many DB schemes have employee contributions greater than 5%, and because employee contribution rates are not always set by employers (e.g. in the public sector), and because DB schemes can often provide benefits significantly higher than the MIS, the approach to DB has been developed to allow for other options to account for affordability. These alternatives are set out below.

#### a) Scheme Flexibility

Some DB schemes have alternative scheme options for members which require lower employee contributions resulting in lower benefits. This is becoming increasingly common when the "core" scheme benefits are high, and as a result, so are contributions for members. Where scheme

flexibility is an option, as long as these benefits still meet the MIS criteria, it has been decided that these options can be used to mitigate against unaffordability of the core offer.

For example, the Local Government Pension Scheme (“LGPS”) 50/50 option allows members to choose to pay half the contributions for half the benefits. Nevertheless, the benefits from this scheme are still expected to be above the MIS and so as contributions are below 5% with this option, it would meet this alternative affordability criteria.

Using this flexibility will be considered on a case-by-case basis.

#### **b) Opt Out Rates**

Opt out rates for schemes are another way to assess an employer's eligibility for meeting the affordability criteria. Should opt out rates be deemed ‘low’ it was decided this was a good indication of affordability. The maximum opt out rate has been set at 10%. This aligns with the average opt out rates for DC schemes and feedback from employers was supportive of this rate.

## **Employer & Scheme Consultation & Testing**

As part of the DB assessment Isio and LWF tested this approach with several public sector DB pension schemes in the UK to assess the feasibility of this accreditation, and how it can be applied consistently and easily.

The test was based on public information and the benefits in each scheme at the time of assessment. On the whole, the tests were conducted against “core” (normally AE certified benefits) for an individual earning the real Living Wage and were based on the same assumptions in section 1 of this report. An outline of the findings are as follows:

<b>Scheme and/or section</b>	<b>AE certified scheme?</b>	<b>Member contributions less than or equal to 5% (for an individual on the Real Living Wage)?</b>	<b>Benefits at State Pension Age expected to be greater than MIS shortfall?</b>
<b>NHS Pension Scheme (“NHSPS”) - 2015 Scheme</b>	Yes	No – 5.2%	Yes – over 6x shortfall
<b>Principal Civil Service Pension Scheme (“PCSPS”) - Alpha</b>	Yes	Yes – 4.6%	Yes – over 8x shortfall
<b>Teachers’ Pension Scheme</b>	Yes	No – 7.4%	Yes – over 6x shortfall
<b>Universities’ Superannuation Scheme</b>	Yes	No – 6.1%	Yes – over 4x shortfall
<b>Local Government Pension Scheme (“LGPS”) – Core Benefit</b>	Yes	No – 5.8%	Yes – over 7x shortfall
<b>Local Government Pension Scheme (“LGPS”) – 50/50 Option</b>	No – option for members in LGPS	Yes – 2.9%	Yes – over 3x shortfall

The key points of the analysis above are:

- On average, all the schemes tested would be expected to meet the gross income requirements to cover the MIS shortfall.
- In all of the AE schemes, except the PCSPS, the member contribution rate is higher than the 5% required by the current Living Pension accreditation. Therefore, members on lower salaries could therefore potentially be paid less than 95% of the real Living Wage, after pension contributions.

The above illustrates that these schemes are therefore generous relative to the MIS but have a higher cost for members.

This test demonstrated that from a benefits perspective, the proposed approach to accrediting DB pensions was sound.

From an affordability point of view, it would come down to the individual employer and not the scheme itself in most cases and alternative approaches to assessing affordability was necessary.

### **Employer Testing**

LWF consulted with ten Living Wage employers with DB pensions and one DB pension provider on the proposed accreditation approach via focus groups and individual calls. Overall, the response was very positive. Key themes were as follows:

- **Ensuring 95% of the real Living Wage** – some employers felt this was feasible for them and that it would be the right thing to do as an employer. Others expressed concerns about an employer's ability to sustain this should contribution levels (set by schemes) increase significantly in the future.
- **Alternative scheme options** – this option is only available with a small number of schemes with flexible benefit options with an aim to improve access. Some employers also offered a DC alternative with a lower employee contribution requirement for affordability reasons. This was deemed appropriate as long as it meets the Living Pension (DC) Standard.
- **Opt out rates** – these ranged from 1% to 15% across the employers consulted. Some employers highlighted specific demographics of organisations and sectors which could influence the level of opt out rates e.g. older workforce who are already drawing a pension or students working to finance their studies. It was felt these nuances should be considered, so this will be looked at on a case-by-case basis.

### **Ongoing Monitoring & Review**

This summary was designed to provide an outline of the key factors and decisions that went into the design of the DB Living Pension standard. This work was supported by advice received from Isio who undertook a feasibility study, as well as by the Living Pension Steering Group with experts across the pensions industry, unions and employers in the Living Wage network. It will continue to be reviewed as part of wider ongoing governance of the standard and the impact it is making to low- and middle-income earners.

## **Appendix – Additional Considerations**

*As part of this work, LWF, Isio and LPSG considered a number of key aspects of DB pensions, how these would interact with the MIS and how they could be accounted for in the extended Living Pension accreditation. In all cases, there has been a balance struck between the need for simplicity in the accreditation, alongside technical detail and the need for ongoing monitoring. Some of these considerations as listed below and will be kept under review.*

### **London real Living Wage**

*Isio performed their analysis on the “national average” real Living Wage, and the national average MIS calculated by the Resolution Foundation (adjusted as required for the difference in tax treatments between certain DC and DB benefits).*

*It was expected that variations in the London real Living Wage and the MIS would lead to proportionate outcomes in pension, so would not change the analysis.*

### **Member options**

*Like the DC accreditation, it was assumed that the baseline benefits of a pension scheme are accredited and that core benefits are at least as valuable as the AE test scheme standard.*

*However, within DB pension schemes members often have options such as retiring early, late or exchanging pension for cash. As they are not core options, they were not included in the accreditation.*

### **Ancillary benefits**

*Many DB schemes offer benefits such as spouse/dependant pensions, pensions for children, life assurance and ill health benefits.*

*As these are not core benefits to be assessed against the individual’s MIS at retirement, they were not considered in the accreditation.*

### **Member security**

*In the DC accreditation, the investment return generated by contributions to fund pensions was assumed to have a reasonable probability of being realised. Hence, it was assumed that members would receive their benefits.*

*But, because DB pensions are known in advance and generally, the money set aside needs to pay for them, the chances of the funds being sufficient and the sponsor being there to make good any shortfall are the most important determinants of whether members will receive their benefits.*

*In the UK, most DB Schemes are subject to regulation and detailed scheme funding requirements set out by the Pensions Regulator.*

*This means that those who run schemes (generally trustees) must meet certain requirements to give members the best possible chance of receiving their benefits, in full.*

*Given the stringency of DB scheme funding regulations, it is believed reasonable to assume the benefits on offer, in most cases, will be provided. This includes assuming that all relevant risks affecting the provision of benefits are properly managed and addressed by the parties involved in the provision of DB scheme benefits.*

*For those where the sponsor ceases to exist and the funding level is insufficient to cover benefits, they may be brought within the scope of the Pension Protection Fund, the UK's DB pensions "lifeboat".*

*In this scenario, members typically receive at least 90% of their benefits and so this adds another layer of security for DB members.*

*Members of unfunded public service schemes (such as NHSPS, TPS, PCSPS, Fire and Police schemes) are backed by Government and so it is reasonable to consider their benefits are secure.*

### **Running and administration costs**

*The impact of running / administration costs were not considered for the DB assessment.*

*This is because there is no recourse to the member for these costs and they are picked up by the employer.*

### **Other types of pension schemes**

*Schemes where members build up both DB and DC benefits on an ongoing basis (e.g. "hybrid" schemes), or newer types of schemes such as Collective Defined Contribution ("CDC") schemes, were not considered and these schemes would be considered on a case-by-case basis.*