ASSOCIATION OF ACA CONSULTING ACTUARIES

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State Pensions Reform Consultation team
Pensions Analysis and Incomes Division
Department for Work and Pensions
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Dear Sirs

Consultation document – A State Pension for the 21st century

I am writing on behalf of the Association of Consulting Actuaries in response to your consultation on the above, which concerns the future provision of state pensions.

Members of the ACA provide advice to thousands of pension schemes, including most of the country's largest schemes. Members of the Association are all qualified actuaries and all actuarial advice is subject to the Actuaries' Code. Advice given to clients is independent and impartial. ACA members include the scheme actuaries to schemes covering the majority of members of defined benefit pension schemes.

The ACA is the representative body of consulting actuaries, whilst the Institute and Faculty of Actuaries is the professional body.

We have the following general comments:

- Occupational pensions from the private sector have significantly diminished over recent years and a scaling back of public sector arrangements seems inevitable. Against this background individuals will become more reliant on state support, whether through state pensions or other benefits that society has to provide to the retired. The Association, therefore, welcomes the steps being taken to clarify the existing system.

- Our strong view is that any changes made should be decisive and lead to a robust position that will not be subject to further review in the short to medium term. They should complement auto-enrolment and Government's other initiatives to encourage personal responsibility and saving.

- The revised arrangements should be as simple as possible to aid individual understanding. They should be accompanied by a comprehensive communication and education exercise that will enable individuals to make well informed decisions about their overall retirement provision.
- In our view moving to a single-tier approach with the removal of contracting-out and the Savings Credit would best achieve these aims.
- Government should consider the proposed 30 year qualifying period to receive the full benefit specified under the single-tier approach. Although not providing any additional benefit, extending this period would mitigate the perceived impact on individuals who will be paying National Insurance contributions without earning further state benefits.
- In considering future increases in State Pension age we believe that Government first needs to consider its objectives in this area before considering what mechanism should be used to determine increases. However we would favour an approach that gives individuals sufficient time to prepare for any changes.

Some responses to individual questions are set out in the Appendix.

We hope that you find our comments of assistance, and would be happy to discuss this potentially very significant issue. You can contact me on 020 7082 6228 (charles.young@hymans.co.uk) or my colleague Chris Fletcher on 0113 284 8066 (chris.fletcher@xafinityconsulting.com).

Yours faithfully

Charles Young
Chairman, Pension Schemes Committee

ACA Views on Consultation document – A State Pension for the 21st century

Question 1: Would the current state pension if left unchanged, meet the Government's principles for reform and provide an effective foundation for saving?

Our view is that the current state pension does not meet the Government's principles for reform. In particular:

- *Personal responsibility* – The current system of credits and guarantees are complex and make it difficult to understand the benefits of making individual provision, particular for the lower paid.

- *Fairness* - Certain groups such as those on Jobseeker's allowance and the self-employed are unable to pay towards the state second pension.

- *Simplicity* – There is significant complexity in the current system particularly in relation to pension increases, the second state pension and means-testing arrangements.

- *Affordability and sustainability* – The cost of providing state pensions is not expected to be reduced. However decisive change is needed in order to create a model that meets the above principles over the long-term.

In light of the above, particularly the principles of personal responsibility and simplicity the current state pension does not provide an effective foundation for saving.

Question 2: To what extent would faster flat rating meet the principles for reform and improve savings incentives?

To a limited extent, faster flat rating would simplify the current system but significant complexity will still remain. Any changes will also still take time to work through the system.

The retention of the savings credit in particular is a significant barrier to members taking personal responsibility over their retirement provision.

Our preference would be for a more decisive and radical change, which would enable existing entitlements to be consolidated at a point in time

Option 1 has the benefit of rewarding individuals for making additional years of National Insurance contributions (in excess of 30), which can be argued to better satisfy the principle of fairness.

Question 3: What further reforms might be required to the State Second Pension, such as crediting arrangements and uprating of pensions in payment, to better meet the Government's principles, recognising that there is a trade-off between coverage and the potential level of any combined, two-tier flat-rate pension?

Crediting arrangements will enable the principle of fairness to be better met. Applying the same level of indexation across all state pensions will make benefits easier to understand.

In order to achieve the principle of simplicity and encourage individuals to take personal responsibility for retirement saving a review of the current savings credit would be required.

However the above changes are likely to come at a cost that will impact on the affordability of the changes and may lead to a review in the level of benefits that can be provided. This could have the result of increasing complexity.

Question 4: To what extent would a single-tier pension meet the Government's principles for reform and improve savings incentives?

Moving to a single-tier approach better meets the principle of simplicity, particularly under the suggested, straightforward mechanism. The removal of contracting-out provides further simplification and would also remove one barrier to any subsequent review of the tax system. (On the other hand, it would be wrong to underestimate the very considerable complexities that would flow from a cessation of contracting-out for those schemes which still operate on this basis – see Question 8).

The single-tier approach better meets the principle of fairness by being available to all. One issue is that individuals will receive no reward for making National Insurance contributions for more than 30 years. This is likely to attract adverse publicity as it will affect individuals on average income levels.

The removal of the savings credit provides a far stronger incentive for individuals to save for their retirement provided it is backed up by a system of financial education.

A single-tier approach will work most effectively if existing state benefits from all sources are quantified and communicated in a straightforward way at the point of transition. In our view the benefits of simplifying future provision will be eroded significantly if past complexity is allowed to persist.

Question 5: Which of these two options would act as the best complement for automatic enrolment?

A single-tier arrangement provides the best incentive due to its simplicity and the removal of the savings credit. Removing the issue of interaction with means-tested benefits will make auto-enrolment significantly easier to administer.

However, individual understanding of the benefits of saving will be a key component in promoting individual responsibility. This will require thorough communication of the expected income from state benefits from all sources, including a quantification of those benefits built up under the current system.

Question 6: Government would be interested in hearing any other options that would meet the Government's principles for reform.

In our view moving to a single-tier approach as implied by Option 2 is the most appropriate option.

We would suggest that Government reviews the 30-year qualifying period required to receive the full state pension specified under Option 2. Although not providing any additional benefit this will nonetheless mitigate the perceived impact on those individuals who already have a

30-year history of National Insurance contributions and who would otherwise see no return for the contributions made in later life. The impact of this is considered further in the response to Question 7.

Question 7: What would be the impact of ending contracting-out as implied by any single-tier model?

This will lead to a review of those schemes still providing final salary benefits on a contracted-out basis. It will almost certainly lead to the closure of a proportion of these schemes (or equivalently a switch to defined contribution provision for the future). However, should employers decide to take this step the ending of contracting-out will only be one factor amongst many.

One concern is that where employers are reviewing their provision at the same time as making provisions for auto-enrolment they are much more likely to opt for a defined contribution arrangement. This trend is exacerbated by the current legislation surrounding any non-defined contribution pension provision in the UK where the regulatory burdens and the economic risks fall almost exclusively on the sponsor.

Individuals who are currently members of contracted-out schemes are likely to perceive themselves as worse off as they may well have to pay increased National Insurance contributions at a time when employer pension provision is scaled back or member contributions increased. Careful communication will be needed to highlight any additional benefits being earned from the state (not least around the possibility of these being amended in future; for example, as state pension ages have to be increased).

However those members who already have a 30-year history of National Insurance contributions will see an increase in contributions at the same time as a review of employer provision and will not receive any additional state pension to mitigate this.

The impact of the above situation could be managed by extending the qualifying period for a full pension from the current 30 years. This would not seem unreasonable in an environment in which individual working lives are likely to become longer rather than shorter.

Question 8: If the decision is taken to end contracting-out how could the process be best managed so as to minimise any adverse impacts on employers and individuals?

There are practical issues associated with the cessation of contracting-out in occupational schemes, which employers and trustees will need to address. These centre principally around the need for schemes to be re-designed to mitigate the increased National Insurance contributions associated with contracting back in to the state arrangements. We also note that there are a number of schemes whose benefits are designed to specifically reflect aspects of the current state system.

We believe it will be necessary to introduce overriding legislation to enable the necessary consequential changes to individual scheme rules to be made (as some scheme rules have very prohibitive amendment powers).

Other measures that will help would include:

- communication to enable individuals to understand the benefit they are receiving in return for additional National Insurance contributions;
- reviewing the period over which individuals will need to pay National Insurance contributions compared to the qualifying period for a full state pension;
- simplifying the taxation system through the complete removal of National Insurance would mitigate the perceived impact for individuals although we recognise that is unlikely to be an option in the short-term; and
- greater freedom in the types of arrangement that employers can provide within a balance regulatory framework would reduce the tendency to opt for defined contribution schemes when reviewing their arrangements.

Question 9: In conjunction with the reforms outlined in Chapter 2 are there ways we can change the means-testing system for future pensioners to make it more simple, reduce disincentives and encourage personal responsibility while continuing to help pensioners avoid poverty?

The retention of the Savings Credit under Option 1 is a disincentive for members to save and its interaction with auto-enrolment presents a challenge. We would suggest that if Option 1 is chosen Government should review the future viability of the Savings Credit.

The removal of the Savings Credit under a single-tier approach is a big step in making the advantages of additional saving clear. However individuals will only make provision if they fully understand the impact on their expected income at retirement. A co-ordinated system of communication and financial education will be needed to enable individuals to amalgamate information from existing sources.

Under either approach the Pension Credit standard minimum income guarantee will need to remain to ensure that a minimum retirement income is provided. However, under Option 2 a significantly lower proportion of individuals will qualify for this guarantee. This may enable the interaction with auto-enrolment to be made simpler.

Question 10: What mechanism should be used to determine future increases in State Pension age?

Increases to state pension age ("SPA") will need to be made in order to manage the cost of future state pension provision. However, before considering the mechanism for increasing SPA government first needs to set its objectives in this area. For example, is the intention to maintain costs at the current level or is it desirable to reduce costs to previous levels to negate some of the effects of past increases in life expectancy for which no adjustment has been made?

We note that there is no unique answer when considering the longevity of pensioners beyond SPA. There is considerable variation between individuals even within the same region and occupation as a result of many factors, which it will not be possible to reflect when setting SPA. The important consideration is to reflect general improvements in longevity so as to create a sustainable system for the future.

If government wishes to specifically measure increases in life expectancy we would consider it more appropriate to compare time spent in retirement with time spent in employment and contributing towards the cost of providing state pensions.

Once government's objectives have been considered it will be possible to set a current target for SPA. Based on current projected increases in life expectancy it will also be possible to set a series of future increases in SPA that will be required in order to maintain expected costs at the target level.

There are a range of possible improvement methods, which will lead to different results. Furthermore actual experience will be different from any prediction made. There will also be short-term fluctuation; for example, as a result of significant medical advancements.

Government therefore needs to balance two conflicting requirements:

- communicating increases in SPA well in advance to enable individuals to make appropriate arrangements; and

- calculating increases to SPA based on the most up-to-date available projections of future life expectancy (this being the most technically accurate approach but one which will reduce the time that individuals have to prepare for any changes).

In practice there is a minimum period of notice, which individuals will need to be given in advance of any changes being made. We would suggest that this could be around ten years but recognise that there are a number of factors to take into account when considering what constitutes appropriate notice including:

- the need for a sustainable system that does not fall behind actual experience as has been the case in previous years;

- the extent of the changes required and the period since any previous changes were made;

- the degree of individual reliance on state benefits for a reasonable level of retirement income; and

- promoting fairness across generations whilst allowing individuals sufficient time to prepare for any changes.

A key issue in any case is not just the period of notice given but ensuring that any changes made are communicated to and understood by the affected parties so that use can be made of the notice period given. In particular, we note the statistics indicating that a substantial proportion of women are still unaware that they will be unable to take their state pension from age 60.

The consultation document suggests two possible approaches to increasing SPA:

A formula linked to life expectancy.

This has the advantage of putting in place a pre-determined approach. However, the difficulty with any such approach is that where the results are not known in advance they are likely to become subject to debate as they emerge. As the consultation highlights it is questionable whether this approach would provide the necessary level of oversight.

There is also the question of communication. Any formula is unlikely to be understood by the vast majority of the population. Individuals will need to see the expected outcome in order to plan ahead. This will again create issues if the actual results vary from predictions, although it may be possible to mitigate this by issuing regular updates on trends in life expectancy as figures become available.

A review mechanism

This has the advantage of basing any increase on the most up-to-date information. It also enables other factors to be taken into account in setting any change. A disadvantage is that using up-to-date information will mean that any changes to life expectancy will be communicated at a late stage.

A review process by its nature defers decisions on the issue until a future date. The fact that significant increases in SPA are likely to be required should be communicated to individuals, along with the appropriate supporting information, as soon as possible.

We would advocate a hybrid approach as set out in the paper where a core set of increases are determined in advance with reference to expected improvements as well as any other relevant factors. A regular review can then determine whether these increases, or indeed any further ones, are required.

Question11: How should the Government respond to the frequent revisions in life expectancy projections whilst giving individuals sufficient time to prepare?

An approach where the anticipated level of increases is communicated in advance would allow individuals to better respond to the changes.

Recent mortality improvements suggest that a significant increase in SPA will be needed even to maintain the current level of costs. Government will therefore need to consider the reaction of individuals. For example, increasing SPA to age 70 and beyond is likely to present a significant challenge. Illustrating the underlying data that has lead to this position will help mitigate this.

In our view the best approach would be a combined communication exercise in relation to both future state pensions and future retirement ages, as well as occupational provision, auto-enrolment and private savings. This will enable individuals to properly plan their retirement provision taking into account all relevant factors.