ASSOCIATION OF CONSULTING ACTUARIES

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Sofia Stayte
Head of the Independent State Pension Age Review
Department for Work and Pensions
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Tothill Street
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Dear Sofia

Independent Review of State Pension Age

I am writing on behalf of the Association of Consulting Actuaries to set out our views on some of the factors to be considered when determining the future State Pension Age. We welcome the opportunity to contribute to the Independent Review at this stage in the process. Our initial submission is focused on high-level principles rather than technical detail. We look forward to responding more fully when the Independent Review has published its interim report and formal consultation later this year.

On the assumption that, in aggregate, longevity continues to improve, whilst significant differences in life expectancy continue to exist between different sectors of society, we believe that the retention of a universal but rising State Pension Age will become increasingly difficult. However, we think that there are practical difficulties in identifying specific groups for differential State Pension Ages. We therefore believe that further thought should be given to alternative measures that would allow individuals with shorter life expectancies to access their State Pension or equivalent income before the official State Pension Age. Our views on such approaches are set out in the Appendix.

We hope that you will find our submission of assistance and would be happy to discuss further if that is helpful.

Yours sincerely

Jane Beverley
Deputy Chairman, Pension Schemes Committee
On behalf of the Association of Consulting Actuaries Limited

Sent by e-mail to: SOFIA.STAYTE@DWP.GSI.GOV.UK

APPENDIX

Independent Review of State Pensions Age

1. Background

Under section 27 of the Pensions Act 2014, the Secretary of State is required to 'review whether the rules about pensionable age are appropriate, having regard to life expectancy and other factors that the Secretary of State considers relevant'. In addition to the Secretary of State's own report (which must be published before 7 May 2017), the Secretary of State is also required to obtain two reports:

(a) from the Government Actuary on whether a person can, on average, be expected to spend a specified proportion of his or her adult life in retirement (and on any adjustments needed to achieve that effect); and
(b) from an appointed person on 'other specified factors relevant to the review'.

The Independent Review of State Pension Age will be producing the second of these two reports. The Terms of Reference for the Independent Review set out that it will need to consider:

(a) What a suitable State Pension Age is, in the immediate future and over the longer term;
(b) Whether the current system of a universal State Pension Age rising in line with life expectancy best supports affordability, fairness and fuller working lives objectives;
(c) And, if not, how State Pension Age arrangements might better support these objectives.

We have structured our submission around these points.

2. What a suitable State Pension Age is, in the immediate future and over the longer term

2.1 The purpose of the State Pension

The determination of the future State Pension Age opens up fundamental questions about what we understand by the terms 'retirement', 'pension' and 'State Pension[1]'.

Over the last century, there has been a perceived change from a pension being a vehicle to provide for those people that society has judged no longer able to work to being a vehicle to 'reward' people for their hard work during their working lives and to enable them to enjoy activities for which they did not have time whilst working. During that time, average life expectancy in retirement has increased considerably, meaning that people now have more time in which to enjoy their retirement. The introduction of the new pension freedoms in April 2015 was also a reflection of the changing view of what retirement and retirement income is for, enabling individuals to use their pensions to pay for expenses as and when they want rather than to provide a fixed income.

This then raises the question of what the State Pension itself is intended to achieve. Is it intended solely to provide a minimum income to keep retired people out of poverty or should it also include some of the 'reward' element that is increasingly part of individuals' expectations of retirement? Plainly the State Pension should as a minimum aim to provide a decent level of support (coupled with other state benefits) for those who are no longer able to work, but how far should it go in supporting individuals' aspirations for retirement?

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[1] When we refer to State Pension in this submission, we mean the new single-tier State Pension introduced with effect from April 2016.

This is a question that needs to be debated by all generations – a longer period spent in retirement will represent a higher cost for those currently in work, but this may be a cost that individuals are prepared to pay if they expect to have a similar period of retirement themselves in the future. The problem for the working age population is that they cannot be sure that future Governments will provide benefits on the same terms as at present and therefore may be reluctant to pay for pensions which are perceived to be generous.

Whilst it is true that a universal State Pension will provide higher total income to those who live longer (and who may be more likely to be better off), we believe that it is still appropriate for the state to provide some benefits and services which are universal[2]. A universal State Pension will ensure that everyone has a more or less guaranteed and stable income throughout retirement (irrespective of the length of that retirement). The alternative would be to have a system based solely on private sector savings and means-tested state benefits, which would mean that disadvantaged groups with little or no private saving would have to go through the hoops of applying for a means-tested benefit which under the State Pension they would get automatically. We therefore support the retention of the principle of a universal State Pension.

2.2 The significance of the State Pension Age

The State Pension Age is (obviously) the date at which individuals can first access their State Pension. However, the choice of State Pension Age also sends an important signal about what is thought to be an appropriate age (on average) to cease active participation in the labour market. Given the increasing old age dependency ratio[3] in the UK as in other developed countries, the Government's focus should be to encourage citizens to work for longer where they are able to do so in order to contribute to economic activity and ultimately GDP. Whilst a higher State Pension Age on its own is unlikely to encourage all individuals to work longer, it will be a powerful push in that direction.

2.3 Implications of the State Pension Age for employment opportunities

Concerns are sometimes raised that encouraging people to stay longer in the working population will take jobs away from the younger generation, thereby creating intergenerational unfairness. However, economic theory suggests that employment opportunities are not finite (the so-called 'lump of labour fallacy'). In practice, there appears to be little evidence that increased employment at older ages is correlated with increased unemployment at younger ages. Instead, the number of jobs in the economy is expected to change in line with demands for new products and services (partly through technological improvements), leading to an increased demand for labour[4].

It is therefore not necessarily the case that a higher State Pension Age would lead to increased numbers of people chasing the same number of jobs, resulting in increased spending on other state benefits such as unemployment benefits in place of spending on the State Pension. Instead, a higher

[2] Discussion of the concept of a Universal Basic Income is beyond the scope of the review of State Pension Age (and therefore of this submission).

[3] R. Hammond et al, *Considerations on State Pension Age in the UK* (Institute and Faculty of Actuaries Sessional Paper, March 2015) Figure 4.2 (https://www.actuaries.org.uk/documents/sessional-paper-considerations-state-pensions-age-uk)

[4] See, for example, Buttonwood, "*Keep on trucking: Why the old should not make way for the young*", *The Economist* (11 February 2012) *(*http://www.economist.com/node/21547263) and International Longevity Centre, *The Age Audit: Delivering a business response to ageing* (October 2014) section 6 (http://www.ilcuk.org.uk/images/uploads/publication-pdfs/A_business_response_to_ageing_1.pdf).

State Pension Age and a larger working population may act to reduce the old age dependency ratio and increase overall growth in the economy.

2.4 Implications of the State Pension Age for non-state pensions

It is worth noting the implications for non-state pension schemes of changes to the State Pension Age. Some public sector defined benefit schemes (such as the Local Government, NHS, Civil Service and Teachers' Pension Schemes) peg their normal retirement age to the State Pension and will therefore be directly affected, with a higher State Pension Age leading to lower costs (all other things being equal). Other defined benefit schemes may pay bridging pensions between normal retirement age and State Pension Age, and may therefore find themselves facing additional costs as the gap to be bridged increases or needing to amend the terms of their bridging pension. Over time, as the gap between the 'typical' normal retirement age of 65 in defined benefit occupational pension schemes and State Pension Age increases further, this may give rise to new calls for occupational schemes to be able to amend their normal retirement age for accrued benefits in the same way that the Government has already done with the State Pension Age.

There are also implications for members of defined contribution schemes. Given the point made under 2.2 that the State Pension Age is likely to act as a signal for many people that retirement has started, it is likely that it may also act as a trigger for individuals to start accessing their defined contribution pot under pension freedoms. An earlier State Pension Age may therefore make it more likely that individuals exhaust their own defined contribution funds before they die. It should also be noted that the earlier members retire, the fewer years they are likely to be contributing to their pensions, thereby reducing their overall retirement pot.

Whilst the implications for non-state pensions cannot be at the centre of the decision to change State Pension Age, it is important that the range of possible impacts is recognised and understood.

2.5 Proportion of life spent in retirement

Sections 2.1-2.4 have looked at some of the wider background to setting the State Pension Age. We now turn to look at some of the assumptions that will be used in the calculations performed by the Government Actuary.

The proposed process for setting the State Pension Age involves setting out as a principle that individuals should on average expect to spend a 'specified proportion' of their life in retirement. The 'specified proportion' to be included in the Government Actuary's report has not been set out in legislation, but we understand from a DWP background note published in December 2013[5] that the intention is to preserve the position that applied at that date that approximately one third of an individual's adult life should be spent in retirement.

It is worth questioning whether one third is the correct proportion, given that it is only in recent years that the proportion of adult life spent in retirement has reached one third[6]. Arguably the only reason that the proportion has reached a figure as high as one third is because the State Pension Age has remained static for too long. There is a risk of 'baking in' a historically high proportion for all years in the future, increasing state pension costs and reducing the proportion of workers in the

[5] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/263660/spa-background-note-051213_tpf_final.pdf

[6] See Chart 6.5 in the DWP's January 2013 White Paper 'The Single-tier pension: a simple foundation for saving' (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/181229/single-tier-pension.pdf)

population. Alternatively, if it becomes clear over time that one third is not sustainable and the proportion has to be reduced for future generations, this will give rise to intergenerational unfairness.

We would hope therefore that the Secretary of State will have regard to whether one third remains an appropriate proportion to specify. In particular, we would suggest that possible outcomes under different proportions of adult life (such as 25%, 30% or 35%) are considered.

2.6 Limitations of projections

It is also important that the Secretary of State is aware that any projections of future life expectancy are based on assumptions and may not be borne out in practice. There is a risk that a projected increase in life expectancy does not come to pass and so individuals end up (on average) living less than the specified proportion in retirement, which could therefore create intergenerational unfairness for particular cohorts of individuals. On the other hand, once someone has passed the State Pension Age, no further adjustments can be made in respect of that person. So if longevity improves markedly in excess of the projections, those already over State Pension Age will benefit from a longer period spent in retirement, with the costs passed on to those yet to retire.

Whilst this is always an issue with any set of assumptions, the Secretary of State should be particularly wary of making significant changes to the State Pension Age having regard merely to the most recent (e.g. one year's) set of data. In the occupational pension scheme context, for example, we have seen considerable discussion about whether the latest mortality data represents a new long-term trend or is simply a blip and therefore on how future mortality rates should be projected. In the context of an ongoing funded pension scheme, the assumptions are used to determine funding levels and contribution rates, and therefore any correction will come through at future valuations. With something as fundamental as the setting of State Pension Age, any correction will have real impacts on individuals' working lives and it is therefore important that the limitations of the projections being used are recognised.

3. Whether the current system of a universal State Pension Age rising in line with life expectancy best supports affordability, fairness and fuller working lives objectives

3.1 Life expectancy and healthy life expectancy for different sectors of the population

The basic principle that the State Pension Age should rise in line with rising life expectancy (and conversely fall in line with falling life expectancy) seems uncontroversial. However, the question of whether that age should be universal is harder, recognising the different average life expectancies of different sectors of the population, whether grouped by socio-economic class, geographical location, level of earnings or occupation.

Another factor to consider is the extent to which healthy life expectancy differs across different groups. As a minimum, it would seem reasonable to expect the State Pension Age to be set so that (on average) individuals should be able to draw their State Pension before they start to experience poor health and are therefore no longer able to support themselves by working. However, differences in average healthy life expectancy between different sectors of the population are likely to mean that some individuals may already be in poor health when they start to receive their State Pension, whilst others may have a longer period of healthy life expectancy during which they can actively enjoy their State Pension.

3.2 Fairness

Of the three objectives listed, the hardest to satisfy is fairness. Fairness means different things to different people, and so it is impossible to achieve an outcome that would be universally agreed to be fair.

It could be argued that a system in which every individual has a health assessment and is then allocated a State Pension Age based on a principle of having an expected 20 years (say) in retirement is 'fair'. However, even under such a system, individuals would still experience different lengths of retirement in practice – the person told she could not have her State Pension until age 72 might well complain (in her dying moments) when run over by a bus at 70 that she has not received any of her State Pension whilst someone of the same age in poorer health might already have received several years of State Pension. Equally it could be argued that a system under which everyone has the same State Pension Age is 'fair' since everyone is being treated in the same way.

It is not possible to run what is effectively a form of insurance so that all its outcomes are fair; all that can be done is to ensure that the principles on which the system is run take into account the likely range of life expectancies in practice and try to strike some balance between the extremes.

The question is made harder by the fact that some forms of discrimination are more likely to be challenged (by the courts or by society) than others – for example, a State Pension system that gave women a later State Pension Age than men would be unlikely to be seen as justifiable even though on average at present women live longer than men. However, other forms of discrimination reflecting different life expectancies (for example for those who have worked in heavy manual industries) might seem easier to justify (and less likely to fall foul of discrimination law).

3.3 Affordability

The affordability objective will tend to drive the State Pension later. Having a low State Pension Age for everyone in order to meet the needs of those with shorter life expectancies (accepting that this means an effective windfall for those with longer life expectancies) is likely to fail to meet the affordability objective, with a smaller working age population having to pay for the State Pension for longer.

3.4 Fuller working lives

As noted under 2.2, it would be counterproductive if the State Pension Age were to act so as to disincentivise people from working. It should, however, be noted that fuller working lives[7] do not necessarily mean people working full time until State Pension Age and then stopping work altogether. The State Pension Age should ideally operate as part of a system that encourages people to work in some capacity whilst they are willing and able to do so, allowing for people to move to part-time working towards the end of their working lives. A discussion of fuller working lives should also recognise that individuals may reasonably wish to take career breaks to learn new skills in order to enable them to extend their working lives in different, possibly less physically demanding, fields.

3.5 Simplicity

A final objective that we believe should be added to this list is simplicity of implementation. The theoretical system outlined above under which everyone is given an individual State Pension Age

[7] The term 'fuller working lives' is defined in the DWP's June 2014 paper, *Fuller Working Lives – A Framework for Action* (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/458861/fuller-working-lives.pdf) page 4 as 'working as long as is necessary to create the future you want'.

would be prohibitively expensive as well as practically impossible to operate, with money that could be allocated to pension payments being used instead to administer the system. It would also be very hard to communicate to individuals, who would find it difficult to plan for retirement until their health had been appropriately assessed. Clearly then some compromises need to be made to ensure that the ensuing system for setting State Pension Age is easy to understand and operate.

3.6 Retaining a universal State Pension Age

Given recent trends in life expectancy, it may well be that the outcome of the State Pension Review will conclude that the State Pension Age should rise. However, having a system in which there is a single State Pension Age (without any adjustment mechanisms) may be less and less viable the higher that age becomes, because of the likelihood that certain sectors of society will see very little of the State Pension.

But that having been said, there seems no straightforward way to identify groups of individuals for whom a lower State Pension Age is appropriate. Any approach based on occupation or postcodes is likely to give rise to different kinds of unfairness and may also leave it open to individuals to try to 'game' the system by moving or changing jobs in the run-up to retirement. Even without such deliberate gaming, it is likely that individual circumstances may change in some cases, making it very difficult to apply any non-universal system in practice. It is probable that large-scale infrastructure would need to be introduced to implement a system that would allocate individuals to different State Pension Ages.

Therefore, on balance, we believe that a universal State Pension Age should be retained, but with measures to allow members of disadvantaged groups access to income before their State Pension Age where they are unable to continue working (or have to reduce the amount of work they do). We cover some of the possible options under the next heading.

4. How State Pension Age arrangements might better support these objectives

It is accepted that there are groups within society for whom working until the current State Pension Age may already be impossible, and for whom a further increase in State Pension Age would only exacerbate the situation. For these groups, the State Pension system (and indeed the retirement system as a whole) needs to incorporate features that allow such individuals the option of accessing retirement funds earlier. The possible options could include:

4.1 Equivalent state-funded benefit before State Pension Age

Under this model, a state benefit would come into payment for those meeting certain ill-health criteria and would be paid between the date of assessment and the State Pension Age.

This could either be based on qualifying years accrued to date, or could allow for the future qualifying years that the individual would have expected to have, had they been able to continue to work. By way of analogy, in the defined benefit occupational pension scheme context, ill-health benefits are sometimes calculated on a basis that gives credit for the prospective service the member would have had up to retirement.

For reasons of affordability, such a benefit would probably need to be means-tested. It might be preferable to use some description of this benefit other than 'pension' to preserve the concept of a universal State Pension payable without any means-testing, but in practice it would have the effect of allowing someone to access a benefit equivalent to their State Pension ahead of their State Pension Age.

This option would involve additional costs to the Government in terms of both the costs of assessment (including any means-testing) and the payment of the benefit, which would have to be financed in some way, possibly by a higher universal State Pension Age. It should be noted that there are already working age benefits available to those under State Pension Age who meet certain ill-health criteria, so the additional costs could be restricted to the difference between existing benefits and the full State Pension if ill-health and means-testing criteria were aligned.

4.2 Using other pension benefits before State Pension Age

Following the introduction of the new pension freedoms in April 2015, individuals with relatively small defined contributions pots could use these funds to bridge the gap between their chosen retirement date and the State Pension Age (rather than spreading them across their lifetime), thereby using their non-state pension to provide an equivalent to the State Pension until the State Pension kicks in at State Pension Age. This approach could work particularly well for individuals who are moving to a part-time basis and who wish to use their non-state pension to smooth out the reduction in their earnings in preparation for the time when their State Pension kicks in.

It is not straightforward for members of defined benefit schemes to access their pensions in the same way. Some schemes (especially in the public sector) still provide enhanced benefits on ill-health early retirement. Whilst these do not provide a perfect bridge to State Pension Age (since they are payable for life rather than to a specific date), such enhanced pensions would act to support individuals in the period up to State Pension Age. However, such benefits are now rare in the private sector, and for most members the ways of accessing defined benefits before the scheme's retirement age would either be to take early retirement (usually reduced on actuarially neutral terms where allowed) or to transfer to a defined contribution scheme (which will probably require the member to pay for independent financial advice). In addition, in some cases, the occupational pension scheme may offer a bridging pension payable between normal retirement age and State Pension Age.

Whilst these options may help to bridge the gap before State Pension Age, there may be some resentment at individuals being required to use their own pension funds to provide a retirement benefit where the State Pension is not in payment. And of course some individuals may have no non-state pension at all, or too little to bridge the gap between their desired retirement age and State Pension Age.

4.3 Early access to the State Pension

Allowing individuals to access their State Pension before State Pension Age seems the most straightforward of the options discussed so far and could be available to all individuals, whether they have access to non-state pensions or not. It should be noted that individuals already have the option to defer access to their State Pension in order to get a higher initial pension, and so this would simply be extending the retirement window below State Pension Age as well as above it.

Under such a model, individuals would be able to opt to draw their State Pension at any time after a minimum retirement age (possibly five years before State Pension Age). The amount of the pension would be reduced for early payment just as it is increased for late payment. Deferred State Pension (for those who reached State Pension Age on or after 6 April 2016) is currently increased for late payment at the rate of 1% for every 9 weeks that it is taken late. Given that the State Pension would already have come into payment, it would not be possible for the individual to accrue any further qualifying years towards the State Pension after the date of early access.

However, there are difficulties with this option. If the State Pension is intended to provide a minimum acceptable level of income in retirement, then paying a reduced State Pension would, by definition, mean that individuals would receive less than a minimum acceptable level of income from the state and would therefore trigger a need for other, means-tested, benefits to fill the gap required for a socially acceptable level of income in retirement. If, on the other hand, early access to the State Pension were to be restricted to those who had sufficient private savings to take their total income to the level of State Pension, this would reduce the value of this option as a way of addressing inequalities in life expectancy.

Whilst the deferral percentage given above has been chosen with the intention of being 'broadly actuarially fair'[8], the use of an equivalent percentage for early payment may not be completely cost neutral for the Government in practice, in particular if the reduced State Pension results in the need for additional means-tested assistance in the future. (It should also be noted that the Government does not account for State Pensions on an actuarial basis.) There will also be administrative costs associated with early payment.

In theory, this approach could be extended to allow individuals to take only part of their State Pension early to fit with a move to part-time earnings, although in practice this might be difficult to administer (and would create further complexity if members were allowed to continue accruing qualifying years after accessing State Pension).

4.4 Flexible access to the State Pension

One possible approach is simply to give all individuals a State Pension pot (calculated based on average life expectancy) and allow individuals to draw from this (within a certain age range) as they wish, by analogy with the new defined contribution pension freedoms.

Such a model would leave the Government effectively running the largest drawdown scheme in the country and would be very unlikely to be practical. In addition, the risks of individuals exhausting their State Pension are too great to make this a viable alternative (unless they were constraints on how much could be withdrawn in each individual year). It would also seem inconsistent with a view that (at least) the State Pension is there to ensure a minimum level of income in retirement to keep individuals out of poverty. We do not think it should be taken forward.

4.5 Early access to State Pension based on length of working life

Under this option, whilst the State Pension Age itself would remain universal, individuals would be able to access their State Pension early (without reduction) once they had a minimum number of years of NI contributions (using the same criteria for qualifying years as the State Pension). So, for example, if the minimum number of years was set at 48, someone who entered the labour market at 16 would be able to access their State Pension at age 64, whilst someone who did not start working until 22 would have to wait for the earlier of 70 and State Pension Age before they could receive their State Pension.

Whilst this model would not be precisely targeted at specific groups in society, it could have the effect that some manual workers (who are likely to start working at a younger age) may be able to

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[8] See Explanatory Memorandum to the State Pension Regulations 2015 paragraph 7.27 (http://www.legislation.gov.uk/uksi/2015/173/pdfs/uksiem_20150173_en.pdf)

access their State Pension earlier. However, there will be some manual workers (possibly particularly the self-employed) with gaps in their NI records for whom this reform would make no difference.

Clearly the Government would have to meet the costs of early payment for these individuals, possibly by adjusting the State Pension Age later for the rest of the population.

Such a system might work to some extent in the short term, although, over time, changes in the age at which young people are permitted to leave education or training and the increase in students working (and therefore paying NI contributions) whilst they are at university might mean that the length of working lifetime becomes less correlated with reduced life expectancy.

4.6 Conclusions

With the exception of option 4.4, we think all of the options listed above merit further consideration as ways of maintaining a universal State Pension Age, whilst mitigating the impacts on those with the shortest life expectancies.

Some of the options could be no cost or low cost to the Government, particularly using non-state pensions (4.2) or allowing broadly actuarially neutral early retirement from the State Pension (4.3), although it is worth noting that there would still be costs associated with implementing the system and issues relating to means-testing under 4.3. Others (4.1 and 4.5) involve additional costs to meet payments of State Pension or an equivalent to certain individuals before State Pension Age, and would therefore need to be offset by a reduction in Government spending elsewhere, possibly by increasing the State Pension Age for the rest of the population.

We would be very happy to work with the Independent Review of State Pension Age in developing the thinking around any of these measures further.

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