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Shiona Charlery
Workplace Retirement Income Commission
c/o National Association of Pension Funds
6th Floor
138 Cheapside
London
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Dear Ms Charlery

Workplace Retirement Income Commission: Call for evidence

I am writing on behalf of the Association of Consulting Actuaries (ACA) in response to your call for evidence in relation to this Commission and my discussions at a recent dinner with Lord McFall. We would be very happy to meet to elaborate on our views if that would assist; otherwise we await the Commission's report with considerable interest.

Members of the Association are all qualified actuaries and are subject to the Actuaries' Code of the Institute and Faculty of Actuaries. 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. Our members also provide advice to sponsors and trustees of thousands of arrangements, both defined benefit and defined contribution schemes of all sizes.

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

Summary

We are supportive of the Commission's objectives but feel that a huge amount of work needs to be done to embed a culture of financial education necessary to underpin a culture of saving.

We agree that it is important to the success of the economy to encourage saving and develop a greater understanding of the need for saving.

Overall we feel this is best achieved through a combination of the following:

- building trust in long term savings;

- removing the complexity and uncertainty inherent in the current State pension system;
- improving financial education (e.g. through schools, colleges, public information channels and employers) to help individuals understand their need for long term saving and the savings options available;
- making it easier (and worthwhile) for employers to provide support in both saving itself and education; and
- encouraging the widest possible participation in some form of long term retirement saving.

We recognise that the government has and is taking a number of important steps in this direction (e.g. through auto-enrolment and the recently announced review of the State pension) but these are only two essential building blocks and on their own they will simply not produce an adequate retirement income to support the needs and aspirations of most future retirees. This inadequacy is likely to be exacerbated further by the decline of private sector occupational provision (see below), the scaling back of public sector provision, improving life expectancies and the rising costs of long term care, themselves driven by irreversible demographic factors.

Bolder moves required

We applaud these moves but would like to see bolder policies to support the objectives described above.

In particular, we believe it to be essential to increase financial education, beginning in schools and ultimately spreading throughout the entire population. Linked in with this is the need to change the culture of society from one of "living for today" and spending everything earned to a more balanced one in which saving and long term financial planning have greater prominence. With many commentators (including David Willetts) highlighting severe and widening inter-generational inequalities, we would suggest that government could usefully consider how inter-generational transfers might be facilitated, not as a means of IHT mitigation, but so as to broaden the genuine reach and appeal of long term saving.

Furthermore, we feel that the government should do more to encourage employers in providing pension provision in a number of the following areas:

- Specifically, we feel that there should be some form of tax incentive given to employers that provide schemes (either defined benefit or defined contribution) that meet a certain quality standard, which would be set at a much higher level than the minimum total 8% contribution.
- Whilst we have been making this point for some time now, we believe that legislation should be changed to allow scheme sponsors more flexibility in terms of benefit design – essentially in the space between pure defined contribution (DC) provision and the withering defined benefit (DB) régime which is now over-regulated and over-protected. We feel that risk-sharing schemes could be made an attractive option for many employers who are not prepared to take on the full risk attached to traditional defined benefit schemes. Conditional indexation (for which the ACA has campaigned hard in the past) is simply one example, but there are many others. In our view it is at best a moot point as to whether the lack of take-up is due to legislative restrictions (the ACA's view and the view of an increasing constituency) or due to sponsors now

being fundamentally opposed to any risk; but this is perhaps a sterile debate given the evidence of rapid DB decline in the private sector.

Research undertaken by the ACA over a number of years, echoed by other surveys, has shown that among larger employers there is the appetite for offering risk sharing arrangements, but legislative inaction in this area is preventing those employers from being able to offer the option (see below). Whilst the DWP has consistently resisted reform proposals, arguing there are sufficient risk sharing options available under current legislation, the absence of any significant take up of schemes indicates that this view patently is not supported by employers.

The ACA's 2009 Pension Trends Survey, covering 309 employers, found as follows:

- 77% of employers said existing legislation did not allow for simple 'middle way' pension designs so schemes can share risks
- 76% of employers said public policy should be more supportive of 'middle way' pension designs
- 51% of employers said they would consider a 'middle way' design if legislation was changed to make this easier.
- Employers should be encouraged to provide education to their employees on financial matters and indeed might be incentivised to provide them with access to independent financial advice by abolishing the £150 tax free limit on independent financial advice paid for by the employer.
- Encouraging employers to promote the benefits of savings through the range of vehicles which might be available (e.g. ISAs, SAYE schemes, share option plans and pension savings vehicles) and creating better opportunities for movement between the vehicles as savers' priorities change. Consideration might be given to bridging the gap between ISAs and pensions to strike the right balance between accessibility (which can be crucial for younger savers) and locked-away saving (more essential as retirement approaches). This may require a new type of product or changes to the tax treatment and inter-transferability between the two vehicles; at this stage our thinking is not developed.

A point about evidence

The ACA understands a general need for policymakers to obtain and consider evidence. However, this should be done in an even-handed way (i.e. all evidence considered, not just evidence supportive of, say, perpetuating the status quo). On the other hand, there have clearly been times when policy has been developed (e.g. on tuition fees and higher earner tax changes on pensions) because of political necessity, but in the absence of any material evidential support.

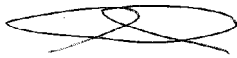
What is evidentially irrefutable is that in the private sector space voluntary DB provision is now in terminal and rapidly accelerating decline. Alternative DC provision is often very inadequate and even if this is added to an improved State pension the ACA believes that many private sector workers could face a relatively impoverished retirement. If this issue is left un-addressed (which the ACA considers would be at odds with the Coalition Agreement undertaking to “...simplify the rules and regulations to help reinvigorate occupational pensions....”) then the public/private sector pensions divide will become unsustainable,

even after the potential scaling back in the former. As Lord Hutton observed in his interim report, a “race to the bottom” has to be avoided and reinvigoration of adequate occupational pension provision in the private sector should, in our view, be considered a political necessity, not just a vague commitment.

Our answers to the specific questions in the consultation are set out in **Appendix A**.

As mentioned above we would be very happy to meet if that would be helpful to the Commission.

Yours sincerely

A handwritten signature in black ink, appearing to be 'Stuart Southall', written in a cursive style.

Stuart Southall
Chairman

Appendix A - Consultation questions

Q1: Is this the right assessment if the state of retirement savings provided through the workplace and elsewhere today – and likely future trends.

Subject to the following comments, we agree that this is the right assessment on the state of retirement saving in the UK.

The point on State pension reform has, of course, moved on with the government's recently published consultation on increasing the basic state pension to £140 per week, subject to conditions. Should these changes come to fruition they should encourage saving, particularly for people on lower income, since the State pension underpin would remove previous disincentives to save caused by concerns over the possible loss of means-tested benefits.

We believe that the likely abolition of contracting-out for defined benefit schemes will make their decline even quicker, with them being replaced by defined contribution arrangements with contributions that could be as low as the minimum 8% auto-enrolment standard.

It is a statement of fact that whereas a defined benefit scheme might typically now require total contributions of over 25% of earnings to meet its defined benefit target, total contributions into defined contribution schemes range between 8-11% of earnings (source: *ACA 2009 Pension Trends Survey* and *ACA 2010 Smaller Firms Pensions Survey*)

Q2: What are the barriers to getting people to save – and to save more – for their retirement? What further actions might overcome some of these barriers?

We agree with the barriers to saving that are summarised in the call for evidence.

We feel that affordability is a particularly important factor in the short to medium term. High price inflation, which is not being matched by wage inflation, is reducing the amount of income that is available for savings. Fear of job loss might encourage saving in a form that is readily accessible but is likely to discourage people from retirement savings that cannot be accessed early if necessary. An increase in mortgage rates, which we feel is more likely than not over the next few years, will further reduce the amount of income available for saving for many people. Such an increase could also make it more advantageous to direct surplus income to paying off or reducing the mortgage rather than to adding to retirement saving.

Financial education is fundamental to removing the barriers of lack of foresight / long term planning and inertia. It would also assist with the affordability barrier to the extent that it was able to adjust people's preferences as between current and deferred consumption in favour of the latter. Generally, the relative preference is far too skewed towards current consumption at present as you have identified.

The lack of basic financial knowledge in a significant part of the population is a cause for considerable concern and financially reckless behaviour can easily filter down through the generations. Many people do not appreciate the extent to which they need to save to provide appropriate income for their retirement. A better understanding of this key issue would begin to overcome the "lack of foresight" and "inertia" barriers and might increase the propensity to defer some current consumption. Aside from inadequate pension provision, many people would be better off using money held in banks / building societies to pay off

mortgages sooner and many people are paying higher interest rates on loans / credit cards than they need to.

Financial education should be provided at school as part of the national curriculum and should not be confined to the A-level (or equivalent) cohort. Urgent progress needs to be made in setting up a government sponsored organisation providing financial education to other sections of the population. This could take various possible forms, such as guides sent to all households, TV broadcasts and seminars in work places and community centres.

If it proves impossible to re-adjust the preference for deferred consumption away from current consumption quickly enough then some degree of compulsory saving may have to be considered. Arguably, this is coming already with NEST, but it also effectively existed in a pre-1988 world where very often membership of an occupational (and often contributory) pension scheme was a condition of employment. Protecting citizens from themselves may be unpopular in the 21st century but the consequences of not significantly increasing long term savings should be more worrying still.

Q3: How far will auto-enrolment address these barriers? How do you think employees and employers will respond to auto-enrolment?

The ACA supports auto-enrolment and believes that it will reduce significantly the number of people who are not making any retirement savings. Inertia is expected to prevent a lot of people from opting out.

Based on various ACA surveys, we are concerned however, that auto-enrolment could lead to a reduction in the level of retirement saving being made for some in the workforce. This might be because the NEST requirements become seen as the new (8%) benchmark, but there might also be a levelling down of pension provision by employers where they seek to contain their compulsory pension expenditure across an enlarged proportion of the workforce.

Whilst an 8% contribution may be a satisfactory level of retirement provision if paid throughout an individual's working life and from an early age, the ACA considers that it is unlikely to prove adequate if it starts part way through a working lifetime and where there has been inadequate prior pension provision. This conclusion is exacerbated to some extent by the necessarily cautious approach NEST feels it must take to the investment of participants' "pots" to address a widespread loss aversion culture.

We think employers will divide into four broad groups, namely:

Firstly, there are those presently offering no pension arrangement (the vast majority of smaller employers). Most will in our view auto-enrol employees into NEST, although we expect there will be widespread non compliance in the early years.

Secondly, there will be those offering pensions at present who will provide the minimum benefit for all employees, perhaps using auto-enrolment as an opportunity to level down provision that is currently more generous (albeit, they may have to do this to spread their spend over more scheme members) .

Thirdly, there are those who will retain existing and more generous provision for current participants and provide the minimum benefits for others. This is an option that DWP research indicates will be commonplace. On reflection, we wonder whether this option will be tenable in many cases. For instance, in many firms, there will be a heavy preponderance

of women amongst those who are presently not in a pension scheme. Will it be possible when auto-enrolment comes in for a higher percentage of women to be offered a lower value pension scheme than existing scheme members, where the preponderance of the membership is male? If not, then option two levelling down seems all the more likely unless government is able to provide a statutory exemption from the sex (and age) discrimination requirements.

Fourthly and finally, there are those who will provide provision for all employees that is more generous than the minimum.

We have no feel at present for the proportion of employers that will fall into each of these groups, although our 2010 surveys on attitudes towards auto-enrolment amongst both larger and smaller employers¹ suggested close to 40% of employers with schemes were considering levelling down due to increased scheme membership (admittedly this was prior to the certification easements in the current Pensions Bill). With more and more DB closures since the surveys were conducted and the levelling down policy adopted by the Coalition in respect of public sector pensions, it is difficult to see how the optimistic approach to pension trends at a time of a harsh economic backdrop can be sustained.

Depending on the experience of opt out rates and employers' actions, we feel it may be necessary to make enrolment compulsory and / or to increase the total minimum contribution level above 8% in the longer term. Automatic age and service triggers, which are widely used in the USA, could form a useful part of this picture. However, such action may have to be deferred until the economic climate changes and earnings growth reverts to being higher than cost of living increases.

Q4: Why do employers provide pensions? What is the role of the employer in providing retirement income, and where does this responsibility end? Does this vary by size of employer?

The reasons for employers providing pensions are to recruit and retain staff, to satisfy the legal requirements and for reputational reasons. In some sectors, providing workplace pensions is still the norm and an employer that did not do so would stand out. On the other hand, the decline in the generosity and type of such "normal" provision in the private sector has changed dramatically since 2003 and there are now in effect two communities: those covered by generous, usually closed, expensive and heavily-regulated and (over-)protected DB schemes and those only eligible for the less generous (and usually DC) open schemes.

We consider that all employers have a responsibility to provide pension provision to some extent. Should it be enacted, a sensible basic State pension of £140 per week should allow more risk to be borne by many employees (rather than by their employers) because in the worst scenarios, members always have the core basic pension to fall back on. On the other hand, a sensible diversification of individual savings risk must argue for a balanced spread of State-provided, employer-sponsored and personally accumulated sources of retirement income.

It is perhaps unrealistic to expect micro-employers to bear any responsibility above the NEST minimum, but for larger employers the pendulum seems now to have swung too far towards too ungenerous and too "risky" provision being made.

¹ See: *ACA 2010 Survey of Smaller Firms' Pensions* and *ACA Survey of Auto-enrolment and NEST* at www.aca.org.uk (publications page)

Q5: What priority will employers give to pensions compared to other workplace benefits – including other saving vehicles – in their remuneration policy post 2012?

The auto-enrolment requirements will lead to employers looking more closely at their pension offerings and to some perhaps giving a higher priority to pensions. As indicated earlier, however, some employers are likely to reduce the pension provision they are currently providing to the minimum 8% level.

We believe that the trend towards providing flexible benefits will continue and feel that this risks exacerbating general under-provision of pension benefits. This is because many employees will see other benefits, such as additional pay or holiday, as being more attractive than pension. In effect a poorly designed package of flexible benefits, however popular, can be an invitation for workers to favour current over deferred consumption.

Q6: Where are the remaining gaps in coverage both in terms of types of worker who will be at risk of under saving for retirement and sectors of the labour market? What are the potential policy solutions?

The remaining gaps in coverage are likely to be employees who opt out, people who transfer jobs regularly for whom refunds of contributions are paid and the self-employed. Compulsory enrolment may need to be considered if opt out rates turn out to be high. We would not welcome any requirement for auto-enrolment schemes to have to retain benefits for employees with less than two years' service because of the disproportionate administration burden that this would impose on employers. However, a possible alternative would be to allow employers to force such short service members to transfer their benefits into NEST or other competitive arrangements.

Whilst we recognise that there is no easy solution in respect of the self-employed, we feel that the government should give consideration to at least encouraging, if not forcing, them to make retirement contributions. This could be supported by a targeted education campaign for self-employed individuals.

Q7: What level of income should individuals be targeting in retirement?

We feel it is far too simplistic to attempt to provide a single percentage figure. This will vary significantly by individual. We agree that one factor will be income levels, with the target percentage being higher the lower the in-work income. There are however other factors (e.g. other savings, property, inheritances) that will cause the percentage to vary hugely from person to person on the same income level. For example, it will be dependent on the individual's lifestyle, the extent to which they are willing or able to vary that lifestyle, family circumstances and their living accommodation.

However, we feel that 45% is too low as a minimum target replacement rate for median earners. Given that the BSP may move up to around 30% of median earnings, a minimum target replacement income of 50-55% is surely sensible.

As a general observation we are concerned at the widespread reliance on property as a retirement "pot". Quite aside from the general dangers of over-allocation to a single asset class, those who believe the mantra "my house is my pension" often overlook their intrinsic reluctance to downsize, the cyclical illiquidity in the housing market, the imperfections of

equity release schemes and that, potentially, houses may also be needed to help defray long-term care costs.

Q8: Is an 8% total contribution enough to achieve the desired outcomes? If not, what are the potential policy responses and how might these be delivered?

Please refer to answers to **Q2** and **Q3**.

Q9: What effect has the financial crisis had on confidence in saving for retirement?

The financial crisis came towards the end of a decade of volatile but also very disappointing returns on equity investments. For those in pure DC schemes (whether invested in unitised or with-profits vehicles) this has caused many to question the point of such savings. For retirees the problem has been exacerbated by historically low interest rates and rapidly improving life expectancies making annuities much more expensive. In a nutshell, this has been a period where many DC savers have been faced with getting less and less for each £ of pension savings. That the causes are not always understood is both a consequence of poor communication and even poorer general financial literacy.

Current pensioners have been impacted very considerably too. Firstly, they have suffered and are suffering from high inflation eroding the purchasing power of their pensions. Secondly, many pensioners of moderate means rely on interest on their voluntary savings and, with most safer investment vehicles losing value in real terms (and paying a hugely reduced level of interest), the prudence of setting aside past resources has been called into question.

There appears to be scant government consideration given to this section of the population with the policy focus clearly on the indebted. In effect, to many it appears the reckless are being favoured over the prudent, which is a message incompatible with the changed savings mindset that urgently needs to be implanted and nurtured.

Whilst saving generally might be encouraged by improved tax reliefs available to the moderately and less well off savers (because, arguably, the wealthy are already provided for through VCT and EIS reliefs) the ACA considers that more could be done for the already retired (say the recipients of State benefits). For example, perhaps NS&I could be instructed to issue an investment product guaranteed to provide a real return (before tax) relative to pensioners' price inflation and available only to pensioners?

Q10: What can be done to improve trust and confidence in pensions?

We feel that if NEST is successful then this will increase trust and confidence in pensions. Complexity, increased legislation and changing legislation can also hinder understanding and in turn reduce trust and confidence. We welcome the government's current proposals on State pension provision and believe that at long last this is a change that could lead to simplification rather than additional complexity. As indicated earlier, we also welcome the fact that this should remove one of the primary obstacles to saving (the concern over lost means-tested benefits).

There has been plenty of talk of deregulation but far less delivery. We accept that politically it might prove impossible to "turn back the clock" on the DB regulatory framework but government must now accept that, however well-intentioned, the never-ending torrent of new regulation has been an important factor in killing off what was once a widely-admired private sector pension industry.

Neither trust and confidence, nor any prospect of reinvigoration, can have been helped by recent events; to name but a few:

- 1) the high earner tax changes (even accepting the fiscal imperative);
- 2) the mis-handling of the RPI to CPI changes;
- 3) a potential (DWP-driven) requirement to “sex equalise” Guaranteed Minimum Pensions (GMPs), but in the absence of any robust European precedent or test case, and
- 4) the never-ending saga that is the Equitable Life compensation exercise.

Q11: What are the respective roles of government, employers, individuals, employees and other groups (e.g. trade unions) in helping to improve understanding about the need to save for retirement?

As indicated in our response to **Q2**, we feel that there is a strong need for basic financial training both in schools and elsewhere. The removal of a compulsory retirement age gives a particular incentive for employers to ensure that their employees make adequate retirement provision; i.e. to minimise the extent to which people feel that they have to keep on working when their productivity has fallen through old age. Trade unions may have a part to play in some industries, but often this is around vainly (but with some justification) trying to defend the status quo, rather than trying to address the wider issues.

Q12: Are there barriers that prevent or discourage employers from providing support to their employees when it comes to saving for their retirement?

There is a fear of employers being held responsible for any unfavourable outcome that might result from guidance / support that they may give to employees. We feel that action should be taken by the government that would allow employers to give appropriate generic guidance / support that is distinct from individual financial advice in the clear knowledge that they cannot be held accountable for any unfavourable outcome that may result.

A further barrier in the current financial environment is the pressure on employers to minimise discretionary spend. Some employers might argue that they are already burdened with having to re-train employees ill-prepared and ill-equipped for the world of work and that to expect them to spend time and money on financial illiteracy is too much to expect unless there is some very clear incentive.

Q13: In saving for retirement, how much risk is it appropriate for the employee to bear, and how much is appropriate for the employer to bear? Could risks be shared differently or more equitably? Does the capacity for risk alter with firm size?

As indicated in our earlier responses, a £140 per week basic State pension, if enacted, would be sufficiently large to allow employees to bear a greater proportion of risk. On the other hand, many are ill-equipped and unwilling to do so.

In our view employers should be encouraged to bear some of the risk and we do not believe that the current legislative framework is helpful here. The legislative and regulatory framework is essentially bipolar with one party (employer or employee) having to effectively

bear all of the risk. Risk-sharing options are very difficult to accommodate and this is borne out by the low levels of adoption to date.

Creation of a new, lighter touch, regime would not in the ACA's view be at odds with the Coalition Agreement undertaking (cited in our covering letter). As a general rule we consider that smaller employers have less appetite and capacity to bear risk but that there has also been a steady decrease on the part of all employers to accept avoidable risks (other than in the public sector where the taxpayer is the underwriter).

The DWP has on many occasions argued that there are no real obstacles to risk-sharing (which we and others dispute) and that there is no appetite for risk-sharing (which is at odds with several ACA surveys). However, this is a sterile debate because you cannot reasonably assess the demand for an opportunity that simply does not exist in any real sense.

Turning this around, insistence on the preserving the status quo in the private sector occupational space must be an acceptance that delivery on the Coalition Agreement undertaking was never intended. Furthermore, Ministers simply cannot argue that auto-enrolment fulfils any part of that undertaking as this is merely an extension of (almost) compulsory saving; not reinvigoration of the occupational pensions that have been in serious decline for over a decade.

Q14: To what extent does the regulatory system push risk disproportionately to the employer or disproportionately to the scheme member? If this is a problem, what are the solutions?

We observe that market practice is polarised between the defined benefit system where risk sits with the employer and the defined contribution system where risk sits with the participants. Our view is that the regulatory regime inhibits the use of innovative risk-sharing ideas such as the concept of conditional indexation of pensions (dependent on investment performance).

Relaxation of the regulatory regime to allow development of hybrid schemes which share risk more equitably between employer and scheme member would be welcomed.

The government has already demonstrated its ability to change State Pension Age (which we agree is sensible) but it is telling to note that this effectively applies to both the accrued and the prospective State pension which people expected to enjoy. There appears to be a reluctance to extend these flexibilities to the private sector, although the arguments are the same. At present the notorious section 67 prevents occupational pension schemes from making a change of this kind; a selective derogation from section 67 seems to be needed.

Were the government to develop a mechanism whereby State Pension Age ("SPA") was periodically adjusted then it seems to us that both the private sector and the public sector should be able to have normal pension ages set at SPA (or a fixed number of years before or above SPA) which automatically changed as SPA changed. .

Q15: Will additional flexibility lead to an increase in saving? What would it mean for the balance between long term and short term saving? What issues might any additional flexibility raise for employees and employers?

We believe it is important that individuals have incentives to save more for their retirement. Our view is that an arrangement that permits savers to have early access to part of their savings in limited circumstances could be a valuable incentive. In responding to a

consultation on this point the ACA suggested restricting lifetime withdrawals from pensions to something equivalent to the overall tax-free cash limits of 25% of funds, suitably adjusted for timing differences, and with the qualifying reasons for early access confined to a relatively short list such as house purchase, university fees for children, etc. This view does not seem to have gained any traction but we still believe that inaccessibility of committed funds remains a powerful deterrent to early saving for pensions. This should be of concern because the earlier the saving is made the better the eventual outcome.

Consideration could usefully be given to bridging the gap between ISAs and pensions to strike the right balance between accessibility (which can be crucial for younger savers) and locked-away saving (more essential as retirement approaches). It is a moot point as to whether this would increase the level of savings (not least because we feel that is a more fundamental issue) but anything that encourages saving earlier must help with creation of a saving mindset. Furthermore, there is perhaps a greater need to create a framework for saving which is more empathetic with the changing needs of savers as they age.

Q16: Are there additional issues that need to be addressed in the “at retirement” market that have not been addressed so far in the Government’s legislative programme?

We welcome the relaxation of the rules about compulsory annuitisation and we do not feel there are any additional issues to be raised.

Q17: What impact will the increase in the State Pension Age and the abolition of the default retirement age have on a) employee behaviour and b) employer behaviour?

The increase in State Pension Age may encourage individuals to potentially re-think their retirement aspirations (both in terms of timing and income targets) and to re-consider whether they need to save more (or perhaps less) now. The recently announced review of State pensions may add clarity to this thinking. To achieve a step-change in attitudes we believe this needs to be supported by a long term commitment to educate individuals about the need for long term saving and the realistic costs of a comfortable retirement.

Employers on the other hand may feel pressure to review their long term level of provision given that, typical defined contribution arrangement may not been seen to provide sufficient income for people to retire in line with their business plans (i.e. employers risk employees having to work longer than both employer and employee would ideally like).

Q18: What are the pros and cons of having a long tail of small schemes? Are any new policy initiatives needed? What lessons can be learned from abroad?

We do not have a strong view on this, and see it largely as a matter for scheme sponsors and pension / insurance providers to manage as these schemes run-off. We do think, however, that there could be merit in allowing transfers to NEST to allow consolidation of smaller pensions savings “pots”.

Q19: Are pensions in the UK too expensive to the consumer? Is this perception or reality?

We think part of the reason employers have been put off providing high quality pension schemes has been the ever-increasing cost of compliance with layer on layer of regulation and legislation, sometimes launched with inadequate consultation or thought as to the wider

consequences (as, for example, the move to a full buy-out solvency guarantee in June 2003 which was in many cases an effective doubling of the previous level of “underpin”).

Egged on by the media, there is perhaps a growing concern that many saving and investment products are too expensive. The ACA considers that the lower charges of NEST are likely to be a force for good in this area. Equally, we believe that a sole focus on, for example, the costs of investment products misses the point that it is investment performance after costs which is critical; especially in any DC vehicle.

Costs for individual savings products are almost inevitably higher than for aggregated ones; this being yet another reason why encouragement of willing sponsors to offer group schemes (and so exercise their buying power) is so important, even in a pure DC world.

The cost of annuities is a special issue (often misunderstood and misinformed) but European developments (such as unisex rates and Solvency II) only bring the potential for far greater consumer disillusion.

Fundamentally, however, we do not feel that cost alone is a particular barrier to long term saving – lack of trust and inflexibility are much greater reasons.

Q20: Does the current structure of tax relief incentivise the right people? If not, what would a more effective structure look like?

We believe the structure of tax relief is essentially fit for purpose. We strongly believe that the retention of the tax-free retirement lump sum is an essential incentive in encouraging long term pension saving.

There have been recent major reductions in tax relief available to higher earners on pension savings. In our view it is essential that the government is not tempted to go any further here as any further reductions might seriously undermine pension savings amongst middle income groups, which would be counter-productive. In any event, the higher earner changes (which will often hit the most senior management) may further disincline decision-makers from any real interest in employer-sponsored schemes.

We believe that the removal of the tax credits available to pension funds on dividend income in the first budget of the last government was disastrous for pension saving and we welcomed the fact that a planned reversal of this was included in the Conservative Party's election manifesto. Whilst we recognise the need for the government to focus on deficit reduction in the short term, we strongly recommend that this damaging measure is reversed as soon as the public finances allow.

Q21: Should pensions be more (or less) tax favoured than other forms of saving?

Unlike in the past, there are no powerful incentives for employers to provide good quality, long term savings arrangements. We feel that to really reinvigorate retirement saving may require the introduction of an additional tax relief for employers willing to offer pensions of (or above) a certain benchmark standard which would be set at a much higher level than the minimum 8% contribution.

Q22: Do we have the right balance of risk and regulations in UK pensions and right regulatory architecture? If not, what policy solution would deliver the right mix? Is there a case for an alternative, principles-based, approach?

Our view is that the increasing burden of regulation in relation to defined benefit provision has led to its decline. In short, employers wishing to provide defined benefits have been moved from a “best intentions” promise with a sensible degree of risk-sharing to an over-prescribed and over-regulated system which, ultimately, has been felt too burdensome.

Any impartial observer of developments in the last decade will quickly spot that the propensity of private sector employers to provide “good pensions” has declined in inverse proportion to the weight of regulation and compliance. The over-protection of a favoured few (those in usually closed DB schemes) has been to the massive detriment of all other private sector workers, adding still further to inter-generational disparities.

Q23: Does the way in which pensions are currently regulated act as a barrier to employer-provided pension provision or determine the form of that provision, and to what extent is it a barrier to innovation?

Please refer to several earlier answers which have addressed this question.

Q24: What is the optimal form of governance for pension schemes, whether DB or DC?

We feel it is important to achieve a level playing field across occupational and contract-based defined contribution schemes and see benefit in some form of employer supported governance of defined contribution schemes.

We feel the governance structure for defined benefit schemes is adequate, given the current regulatory regime but clearly not conducive to any new provision of this type.

Q25: What are the trends in the role that pensions and savings institutions play in the wider economy? How might this change in the future?

Defined benefit schemes are significant investors in the UK and we expect there to be a significant transfer of funds from equities (UK and overseas) to bonds with a view to reducing risk. This will tend to dampen the long term rise in equity prices. We may also see a corresponding reduction in the level of shareholder activism in relation to UK companies.

It remains to be seen how the role of pensions saving in the post-auto-enrolment world will offset this trend.

Q26: What steps need to be taken to meet the Government’s Coalition Agreement commitment to “reinvigorate occupational pensions”?

The first and essential point is to accept the need to “simplify rules and regulations” (or equivalently to create a lighter touch regime) as the only way to deliver on the Coalition pledge. Given the serial occurrence of events which have had a clearly negative effect (see our answer to **Q10**) and the inaction in this space whilst the rapid (and forecast) DB decline has gathered pace, the policymakers clearly have a massive task ahead of them.

However, we do not believe that these trends cannot be arrested, or even to some degree reversed, but that will require a change in ministerial (and civil servant) mindset to “we have to do something” rather than “we are right so let’s ignore the pleas from all those special interest groups”.

As recently as last Autumn the ACA put several ideas to the Pensions Minister (please refer to the paper **Appendix B, attached**) but very little interest was shown in many of these ideas. Arguably our thoughts around GMPs could now be even more relevant given threats about a need to “sex equalise” and the cessation of DB contracting-out.

Besides these ideas we see “reinvigorating occupational pensions” being helped by:

- Building trust in long term savings;
- Removing the complexity and uncertainty inherent in the current State pension system;
- Improving education (e.g. through schools, colleges, public information channels and employers) to help individuals understand their need for long term saving and the savings options available;
- making it easier (and worthwhile) for employers to provide support in both saving itself and education; and
- encouraging the widest possible participation in some form of long term retirement saving; i.e. by making auto-enrolment a success and potentially considering compulsory enrolment if there are widespread opt-outs or if the general preference for current over deferred consumption cannot be countered.

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Appendix B (Paper submitted to DWP in October 2010 at Pension Minister's request)

Simplification of contracting-out and treatment of deferred members

We have been asked to suggest ways to reduce the complexity imposed on pension provision by the sex inequality created by the pre-1997 contracting-out regime and by contracting-out's own inherent complexity. This note contains suggestions we think would be widely supported by employers, although some might be more difficult to present to scheme members. We have provided summary information: at this stage. We would be very pleased to produce a more detailed paper to take matters further.

Partly taking the lead from the Government's stance in relation to the use of CPI, we have attempted to cut through, rather than work around, current difficulties. Although we have tried to ensure no one's pension would fall as a result of our proposals, there could be winners and losers. Further work is likely to produce ways to mitigate this.

We focus on Guaranteed Minimum Pensions (GMPs), although we extend our remarks to other areas towards the end of this paper.

These proposals draw on our experience of the few schemes that have attempted to equalise their benefits in the face of the unequal definition of GMP. Because of the complex interaction between GMP entitlements and scheme benefits, the practical difficulties of 'GMP equalisation' seem disproportionate compared to the outcome, particularly as few pension scheme members have complained about the issue. The consequence is typically an overall increase in liability of around 3%, although the cost is spread unevenly across the membership, with many getting nothing, and only a few getting significant (larger, say, than 10%) increases.

GMP simplification

Point 1 – achieve equalisation by restoring the position of GMPs as an underpin to scheme benefits, rather than as a separate tranche of benefit

The Government is urged to re-position the legislative effect of GMPs so that they provide a simple underpin test that can be applied at a single point in time.

Because of the way contracted-out scheme benefits have developed, it is not possible to say, with any certainty, that GMPs have been equalised at any particular point in time. This is because future differences in the indexation of different parts of a member's pension are likely to un-do the effects of previous attempts to equalise. If, however, the contracting-out test was retrospectively clarified as a simple underpin to the level of pension provided by the scheme, then equality could be achieved.

This test could be applied at State Pension Age (SPA) but see point 4 below. The revised test would be to compare and pay the higher of:

- The equalised GMP, revalued to SPA in line with the existing preservation regime (although we have some comments on this as it applies to GMPs); and
- The pre-1997 accrued scheme benefit, revalued to SPA in line with the current preservation requirements as they relate to “non-GMP” pension.

The resulting benefit would thereafter escalate in line with the existing scheme rules as they relate to pre-97 non-GMP pension, although a ‘value’ test could also be applied to ensure that post-1988 GMP increases were properly allowed for.

Once this test was met, there would be no further obligation on the Scheme in relation to contracting-out requirements and anti-franking rules. Actuarially equivalent early or late payment could be made as an alternative, cash could be commuted, other optionality exercised, all without any further testing necessary. Certification requirements could then be removed. Substantial consequential simplicity would be achieved.

On the face of it, there would be no need to alter the existing arrangements regarding how SERPS entitlement is reduced to reflect the GMP coming into payment. The measure would be neutral to Government in this respect.

Members of schemes which give no increases to (non-GMP) pensions in payment accrued before April 1997 could lose value; conversely, where pre-97 non-GMP pension increases are provided at a higher rate than increases to post-88 GMPs, there could be an overall increase in liability. This is one area where the risk of winners and losers and the benefits of mitigation (vs. the increased complexity that would result) could be investigated further.

Point 2 – reconsider the role of fixed rate revaluation

People who have fixed rate revaluation on their accrued GMP, but who also have substantial non-GMP pension earned before April 1997, could also become losers under proposal in Point 1 above. Whilst we support including the value of increases to GMPs in payment in the underpin test, we believe it could be possible to make some easement in respect of GMP revaluation in deferment. Employers accepted that there could be a cost associated with exchanging the uncertainty of providing earnings linked revaluation with the certainty of fixed rate revaluation. However, in some cases the cost has proved extreme and provided unreasonable relative advantage to some members. The table over-page shows the fixed rate revaluation applied to GMP for sample leaving dates, compared with the average annual increase in earnings over the period until State Pension Age (SPA) is reached.

Table – Average annual rate of salary growth between year of exit from contracted-out service and year reaching SPA, compared to annual rate of revaluation applied to GMP

Year of exit	Year reached SPA						Fixed rate revaluation
	1985	1990	1995	2000	2005	2009	
1980	9.0%	8.8%	7.4%	6.7%	6.1%	5.7%	8.5%
1985		8.6%	6.6%	5.9%	5.4%	5.0%	8.5%
1990			4.7%	4.6%	4.4%	4.0%	7.5%
1995				4.5%	4.2%	3.8%	7.0%
2000					4.0%	3.5%	6.25%
2005						2.8%	4.5%

The current position considers the part of the accrued pension deemed to represent the GMP separately from the remainder of the accrued pension, and revalues each 'tranche' differently. The purpose is to prevent scheme rules from using the excess pension over the GMP to 'frank' GMP revaluation. The proposed test would compare the total accrued pension revalued according to scheme rules with the revalued GMP and provide the higher of the two.

Although this effectively introduces some degree of franking, recently it has become hard to defend the current fixed rate revaluation regime. The rates, which are determined by the date of exit from contracted-out service, were set in very different economic climates. For people reaching SPA in recent years, they have enshrined revaluation rates considerably in excess of the experienced rate of salary increase. Reducing the effect of this poorly designed arrangement (which would be the effect of our proposal) might not be popular with those affected, but it would remove the cross subsidies that currently exist because of the fixed rate revaluation regime's inflexibility.

Point 3 – extend the underpin treatment to pensioners in payment

The proposals apply most naturally to people whose benefit is yet to come into payment, but it could be extended to people with pensions in payment. However, if the newly "clarified" legislation was posited as an underpin and combined with the removal of other onerous requirements, then perhaps no revision would be necessary:

- Most people over SPA and with some non-GMP elements in payment would, by definition, already have passed the revised test
- There would be no need, requirement or facility to make reductions to in-payment benefits
- An additional test might be needed to those with only a small proportion of pension in excess of their GMP, to ensure an 'equalised' GMP underpin would not provide a higher benefit.

Point 4 – GMP payment age

A difficulty remains with regard to different SPAs for men and women. Some of the uncertainty with regard to the need to equalise benefits in relation to GMPs arises because GMP is provided in lieu of a State pension. However, it is considered subject to private pension legislation, so legislation should have equalised GMP ‘pension ages’ following the Barber judgment. Retaining different payment ages for GMPs, depending on the member’s sex, complicates equalisation. The ACA proposes that, as an underpin benefit, each member’s entitlement to GMP should be tested either at the scheme’s normal pension age, or at the female SPA if this is lower.

Post-97 benefits

Contracting-out under the post-97 regime has not given rise to further sex inequality. However, there are a number of restrictions and certification requirements, which could be removed or simplified. In our view, the reference scheme test and the statutory scheme funding regime provide sufficient quality and quantity tests. Since the Government has seen fit to remove the additional prudential legislation in the case of contracted-out benefits provided via money purchase arrangements, it seems inconsistent to retain them with regard to contracted-out salary related schemes.

Buy back Option

In addition to, or instead of, the proposal to re-position GMPs, the Government could consider reinstating an option for contracted-out pension schemes to buy back contracted-out rights into the State scheme by payment of a premium (previously achieved via a payment called the Contributions Equivalent Premium, or CEP).

There may well be merit in re-establishing such a mechanism, provided it could be done simply. The following bullets outline how this might work, at least in relation to the GMP element of contracted-out defined benefit schemes. Post-97 accrual would follow by analogy, although the buy back option could be restricted only to GMPs.

- There would be no deduction from SERPS in respect of the GMP element, as there is at present.
- A premium would be paid to the State scheme in respect of the additional future SERPS pension payable in respect of pre-97 accrual. From the occupational pension scheme’s point of view, it would be desirable if this capital payment could be spread; for example, in line with its Recovery Plan or over some other reasonable fixed term. However, this would place more risk on, and provide less immediate benefit for, the Government.
- Some deduction from the total accrued pension scheme benefit would be made to offset the GMP purchased in the State scheme. This would need to be on a sex-neutral basis (i.e. not mirroring exactly the GMPs themselves, or the equalisation problem remains in place).
- The residual pre-97 pension scheme benefits would be revalued and increased in line with current scheme rules.

ACA members have considered in some detail how this would work in relation to deferred pensions, and we would be happy to share this thinking with Government were it of interest. However, we have not extended the concept to pensions in payment in any detail. Neither have we considered the difficult responsibility the decision to buy back places on trustees, where the outflow of a premium to the State might be seen to jeopardise the funding cover for some members more than others, although in principle this is no different to a decision to buy out part of the benefits.

Initially, buy back would be revenue-raising for Government, but at the cost of taking over additional forward liabilities. More revenue would be raised if the terms established were relatively favourable for employers, but this would increase the risk to the Government. Overall, the terms of the buy back option would have to be carefully considered, to avoid the risk that trustees and employers choose to select against the State scheme. However, ensuring 'fairness' between members and schemes could produce an overly complex regime, which would undermine its usefulness. Reduction of scheme benefits in this way would reduce the liabilities potentially exposed to underpinning by the Pension Protection Fund; this might also be of benefit to Government if there is any risk of it being seen as the guarantor of last resort were the PPF to become unsustainable.

Deferred benefits

The requirement to preserve members' accrued pension rights (which the ACA supports) imposes sometimes disproportionate cost on employers, particularly when retirement provision is being reviewed and/or revised. Under current legislation, trustees cannot pay transfer values to alternative arrangements without a member's consent, unless the scheme is winding-up. The intention is to ensure scheme members' rights are respected and that decisions that could affect the security of their accrued benefit are not taken arbitrarily without the members' knowledge.

The ACA considers that legislation should allow employers the right to compulsorily transfer risks out of all schemes; both defined benefit and defined contribution. This would allow a scheme to 'right size' relative to the sponsor, to reduce risk, reduce PPF levy, reduce administration and shorten the duration of a scheme. Currently, whilst defined benefit schemes are largely underfunded, it would be difficult for trustees to agree to buy out certain members' benefits and not others (the same comment was made in relation to buy back), but should market conditions change (or a particular scheme's position allow), employers should have the right in law to buy out deferred members' benefits. A desirable aim would be to preserve the defined benefit nature of the benefit, but to buy the benefit on standard terms so that it is more attractive from the insurer's perspective, both from a financing and administrative point of view. This approach might also result in a greater degree of certainty to the member, particularly for those above maximum PPF levels of benefit.

For defined contribution arrangements, it should be possible for trustees to identify personal pension contracts with sufficient prudential characteristics, including the nature of the funds selected and controls on charges, that no consent transfers become acceptable.

Other ideas

Triviality

The rules on commutation of trivial pensions are excessively complex and could be very much simplified, with consequential cost savings. A simple limit, applicable to any pension entitlement in isolation, might be set at say a capital value of £18,000 (the current aggregate limit), or a pension of £50 per month.

Contracted-out schemes in particular give rise to small residual funds or deferred benefits that must be preserved within the scheme. Whilst the recent introduction of a £2,000 limit is appreciated, this could be extended.

Pension conversion

By this, we mean conversion from multiple tranches of pension increasing at different rates depending on when they were earned, to a single (non-increasing) pension of actuarially equivalent value but increased headline rate. Although this is currently permissible in some limited circumstances, it could be extended to all pensions, irrespective of the period in which they were accrued. Indeed, this might be a precursor move to an approach to the simplified equalisation of pensions in payment in conjunction with the points made under the GMP heading at the beginning of this note.

The Government's decision to reference CPI rather than RPI when determining statutory rates of revaluation and increase is relevant here. Although in principle a CPI link should be less costly than an RPI link, because there are no matching investments the cost of insuring the former is no less than the cost of insuring the latter. This position is likely to remain so long as there is no deep market in CPI linked products: and given evidence that the market for RPI linked products is still less than the demand, inflation linked (particularly LPI linked) benefits are likely to be costly to secure relative to the underlying benefit. Employers should have more flexibility to alter scheme benefits to reflect changes in financial, economic and employment markets.

Keep it simple

There are practical and simple ways of reducing the complexity in pension provision, but they are likely to give rise to winners and losers, so the Government might ultimately consider them unpalatable. However, as far as GMP equalisation is concerned, many will become 'losers' only because, retrospectively, changes in regulation have conferred additional rights that were not originally envisaged.

Our first thoughts extend only to those whose pensions are not in payment. It is likely to provide more complex to unravel pensions in payment, but some simplification could also be achieved as mentioned above. We would be happy to develop some or all of ideas described above.

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