



Pension Reform: a pig in a poke?

**Report 2
2009 Pension Trends Survey**

**Produced by
Association of Consulting Actuaries**

September 2009

Six out of ten companies will review their pension arrangements ahead of 2012 introduction of auto-enrolment and personal accounts...

“Only one-third of employers so far have budgeted for the costs of auto-enrolment and personal accounts – just 16 per cent of smaller firms are financially prepared”

The Association of Consulting Actuaries’ (ACA) latest 2009 Pension trends survey was conducted in June and July of this year. Over 300 employers of all sizes responded to a wide range of topical questions, including emerging views on personal accounts and pension reform in the run up to 2012 – the subject of this second report. The first report, published earlier this month, examined changes in pension design over the last two years.

A final report, including all the statistical tables, will feature in the Association’s Biennial Review, to be published later this year.

Unless the present or an incoming Government next year has second thoughts, the UK’s 1.2 million employers face radical change from 2012 with the introduction, perhaps phased over a few years, of auto-enrolment of all employees into an existing workplace pension or, in its absence, into the new national scheme of personal accounts. The changes will affect all employers – even if they have just one employee. Our latest survey found UK employers are pretty unprepared. Overall, **only 32 per cent have so far budgeted for the additional costs (which there will be) and, of these, just 16 per cent of smaller employers** (those with fewer than 250 employees). Whilst some employers have already begun preparations, overall **59 per cent of employers (including 86 per cent of smaller ones) are set to review their pension arrangements over the next three-years in the run up to 2012** (see Figure 2).

Figure 1: The Survey respondents

309 employers responded to the survey, made up as follows:

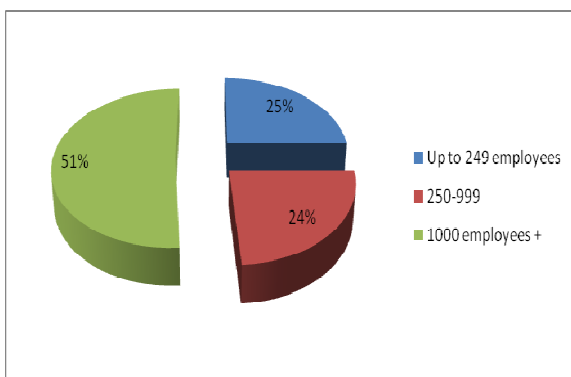
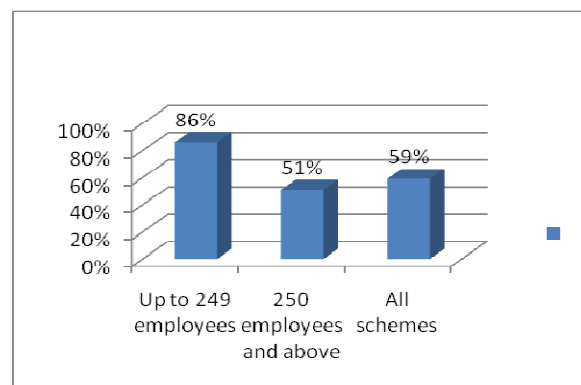


Figure 2: Will auto-enrolment and personal accounts lead employers to review their current scheme(s) ahead of 2012?



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UK employers largely unprepared for reforms ahead

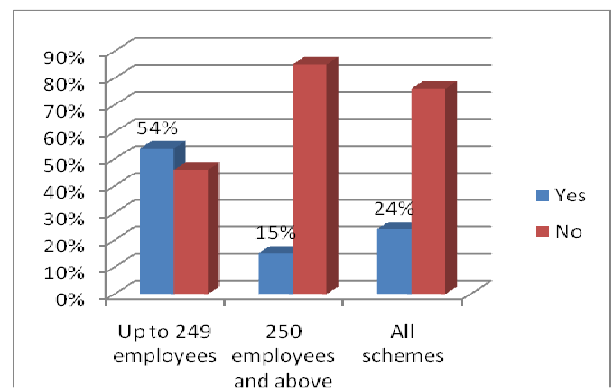
The employers responding to this survey are by and large much better prepared for personal accounts and auto-enrolment (where employees are joined up to a scheme automatically on engagement or shortly thereafter, with a right to ‘opt out’) than the vast majority of UK employers, who presently operate no workplace pension arrangement whatsoever. However, the reality is that even amongst our survey respondents, preparedness is quite low – **only a third have budgeted for the potential cost increases arising from auto-enrolment and personal accounts** (see Figure 4). These extra costs are likely to come in the shape of auto-enrolment into existing schemes, whereby higher membership of an existing scheme, if offered, will involve additional employer contributions. Or they will come by way of employer contributions into personal accounts for all those employees who are not presently offered entry to an existing workplace scheme and who do not ‘opt out’. And, of course, on top of this there will be the inevitable administrative costs associated with running one or more schemes, including new statutory obligations on employers. For the vast majority of smaller employers who do not presently offer workplace schemes, the cost increases could be particularly significant, albeit phasing of contributions is likely to spread this increase in costs over a number of years.

Are costs being properly considered?

The survey found that, at present, just one in five employers responding to the survey auto-enrol employees into their workplace scheme, and only around one in twenty smaller employers do. A further one in five is likely to introduce auto-enrolment ahead of 2012. **Come 2012, some 59 per cent of employers who have not auto-enrolled by then are likely to auto-enrol all their employees into their workplace scheme, with 28 per cent saying they will restrict entry, mainly by employment category, and auto-enrol the balance into personal accounts.** What is perhaps puzzling, is that **far more employers seem to have decided to auto-enrol staff into their workplace scheme than have budgeted for such a decision (just 32 per cent of employers).** Of those that have budgeted, **payroll costs are expected to increase by between 3 – 4 per cent**, as a result. The concern must be that as 2012 approaches, and more employers do their sums, the number of employees excluded from existing schemes will rise, particularly if the economic position remains unstable and taxes on business increase.

“Over a half of smaller employers say they will mitigate the cost of auto-enrolment into their workplace scheme by revising pension benefits”

Figure 3: If employers auto-enrol their employees into existing schemes, are they likely to revise benefits to mitigate the extra costs of additional members?



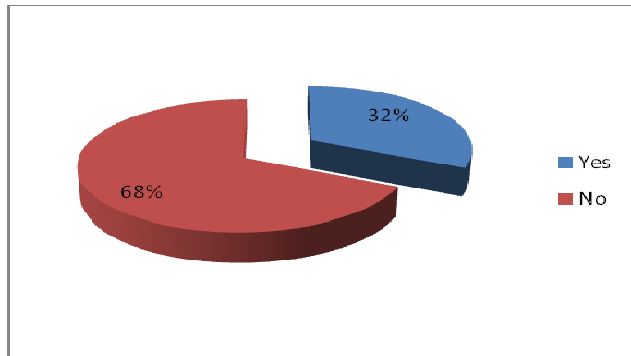
“Four out of ten smaller employers will consider closing their workplace schemes in favour of offering personal accounts”

Huge closure threat cannot be ignored

What certainly will happen, our survey found, **over the next three years is a widespread review of most existing pension schemes, by 59 per cent of employers, including 86 per cent of smaller employers.** This comes over and above the high level of re-examinations that has taken place over the last few years as employers have withdrawn from defined benefit provision and, in some cases, from trust based in favour of contract-based defined

contribution, in an attempt to reduce regulatory costs and administration. **A worrying sign is that 41 per cent of smaller employers say that they will consider closing their existing scheme in favour of offering just personal accounts to all employees and 54 per cent are likely to revise benefits to mitigate the costs if, instead, they auto-enrol all employees into an existing scheme** (see Figure 3). As most UK pension schemes are run by smaller employers – 90 per cent of UK schemes have fewer than 100 members – the scale of such a potential change in workplace provision is huge, not least in terms of the likely loss of superior pension benefits for very many employees of smaller businesses. Again, the state of the UK economy in the run up to 2012 and immediately thereafter is likely to have a big influence on decisions to revise schemes and, by members, to opt-out.

Figure 4: Have employers budgeted for the potential cost increase from auto-enrolment and/or personal accounts?



It is noteworthy that compared to two-years ago far fewer employers expect to be able to meet the extra costs of auto-enrolment and personal accounts by increasing prices to their customers (just 7 per cent now, compared to 26 per cent in 2007). Close to half expect the costs to be met by lower profitability and by reducing headcounts.

Pension reforms beyond personal accounts

The survey investigated other pension reforms, including a number of ways to preserve and extend quality pensions, and proposals that it is argued would lead to more individuals being prepared to save into pensions.

73 per cent of employers support proposals that above a certain size of individual pension ‘pot’ (below which an annuity should normally be purchased to ensure State

benefits are not claimed in retirement), retirees should not be constrained as to how they invest or use their pension savings. Whilst the Treasury and HMRC can be relied upon to oppose such flexibility on grounds of some spurious loss of tax revenues, it seems increasingly likely that such a reform could emerge, given the stated positions of the two main Opposition parties on this issue. The possible impact on UK annuity rates of implementing capital requirements on annuity providers under Solvency II may hasten such a decision.

“76 per cent of employers believe public policy should be more supportive of ‘middle way’ pension designs”

However, employers are much less enthusiastic about proposals to allow pension scheme members access to accrued pension savings ahead of retirement to meet major lifetime events such as the need for house deposits, children’s education costs or the costs of a sudden illness. **56 per cent of employers oppose this greater flexibility to draw on pension savings early**, presumably on the grounds that this may be abused, reducing pension savings to the point where State benefits will be claimed in retirement, as a result.

Three-quarters of employers say that existing legislation does not allow for simple ‘middle way’ designs so schemes can share investment, inflation and longevity risks between employers and employees. A similar number say these new pension designs should be better supported by public policy with 51 per cent indicating they would consider introducing such a scheme if legislation was changed to ease their introduction. At present, with the demise of defined benefit schemes (which largely place 100 per cent of risks on employers), most employers feel they have little option but to opt for defined contribution (which places 100 per cent of risks on members). Whilst it is possible to get around current legislation by building hybrid arrangements, these are often contrived and complicated for members to understand. Greater flexibility to offer a range of ‘middle way’ designs offers a way to re-build pensions where the costs to the employer can be controlled into the future, whilst also providing employees with a more stable benefit platform than is possible with just defined contribution.

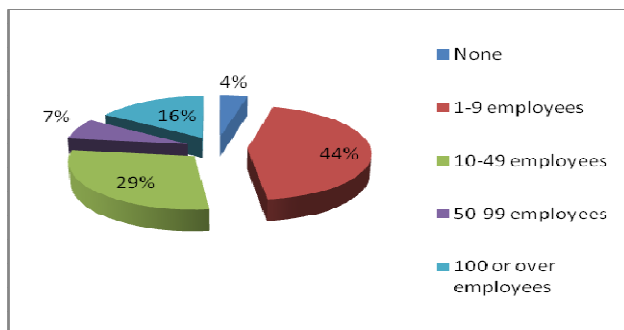
Figure 5: What should the Government’s MOST IMPORTANT PENSION POLICY CHANGES be?

	2009	2007
1	Deregulate/simplify pensions	(Reduced regulation/increased simplification)
2	Better financial incentives for pension saving/reverse ACT change	(Better financial incentives to encourage pension saving)
3	Reverse 2009 Budget pension tax changes	(Remove over-regulation of good quality schemes)
4	Close private/public sector pension gap	(Reduce means-testing)
5	Improve Basic State Pension	(Improve Basic State Pension)

Whilst Government would argue that there is an ongoing deregulation exercise underway to simplify pensions, employers seem in general to be dissatisfied with the outcome to date. As with two-years ago, **deregulation and simplification remains the top priority for employers in terms of changes in pension policy** (see Figure 5). The present Government has clearly found meeting this demand, whilst also strengthening the security of members’ pension rights, a balancing-act too far. It may be that a new approach is needed that is more effective than the endless, largely unproductive, consultations of recent years. Certainly the procession of short-stay Pension Ministers and Secretaries of State at the Department of Work & Pensions has not helped – as a result there has been an absence of political leadership in this vital area of public policy.

“Only 6 per cent of employers feel the Government’s stated policy of supporting quality workplace pensions is working – down from 38 per cent two-years ago”

Figure 6: Number of employees affected by 2009 Budget capping of pension tax relief by employers with 250 employees or more



Budget cap on pension tax relief for those on higher incomes. Close to a quarter of larger employers (250 employees and above) said they had over 50 employees affected by the change (see Figure 6). Overall, 68 per cent of employers felt the impact of the change would be wider on schemes, presumably in terms of the reduction in active involvement by senior executives in pension saving within employers’ schemes.

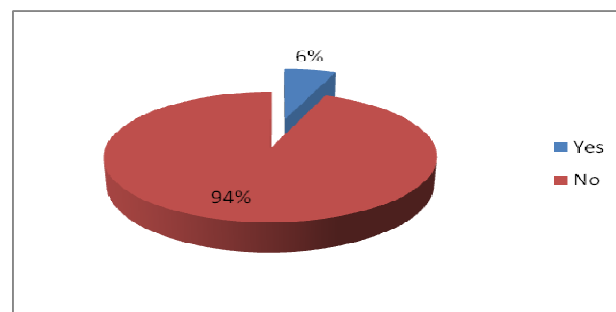
Again, as with two-years ago, **employers see better financial incentives to encourage pension saving and/or the reversal of the 1997 tax change withdrawing ACT relief, as the second highest pensions policy initiative.** Unfortunately, the desperate position of the public finances suggests such hopes are far distant at the moment. However, history shows that financial incentives do spur on both employers and employees to save into pensions and it is to be hoped the public finances do recover so taxes can be generally reduced to allow room for pension savings, rather than the obverse approach of more and more compulsion, inevitably leading to ‘lowest common denominator’ levels of provision.

The third most important pension policy change sought by employers is a **reversal of the Chancellor’s 2009**

Moving up the list of policy changes sought by employers is a **narrowing of the gap between private and public sector pensions**, underscored by the closure of quality defined benefit schemes in the private sector as against their general persistence within the public sector, increasingly financed by larger calls on the taxpayer. Whilst there are signs that the Government appreciates the need to address the issue, not least by the announcement of a review of Parliamentary pensions, it remains to be seen whether our politicians have a stomach for what is likely to be a big fight with the trades unions, whose principal membership is now drawn from public sector occupations.

What has changed over the last two-years is employers’ perception as to whether the Government’s stated policy in support of quality workplace pensions is working. Whereas close to four out of ten employers gave the benefit of the doubt to the Government two-years ago during the passage of the last Pensions Bill, which purported to help existing schemes, now **just 6 per cent of employers feel Government policy of supporting quality workplace pensions is working** (see Figure 7). Given the ongoing acceleration in scheme closures this can hardly come as any surprise, but it is a desperately worrying position as it suggests, in the absence of new initiatives in pensions policy, there will be limited employer resistance to further erosions in quality provision in the near-term.

Figure 7: Is the Government’s stated policy of supporting quality workplace pensions working?



Conclusion: the run up to 2012 and the implementation of auto-enrolment and personal accounts will have a profound impact on the future of UK private sector workplace pensions...there should be a delay in their introduction

The survey findings on auto-enrolment and personal accounts highlight the huge impact that these reforms, still scheduled for 2012, are likely to have on existing and forward workplace pension provision. Whilst it is the official line that personal accounts have been designed to 'fill the gaps' in workplace provision, it is clear from the survey, particularly in smaller firms, that as a result of these reforms very many existing schemes are vulnerable to closure, with employees being moved into personal accounts, albeit with members having the right to 'opt out'. Whilst phasing may delay some of the impact on employers' costs, the longer any announcement to that effect is delayed, the more likely it is that decisions to revise pension arrangements will be taken and cast in stone.

For smaller employers, auto-enrolling all employees over and above current members into even a slightly more expensive existing scheme than personal accounts may be judged simply 'too risky' and potentially costly, given the current and anticipated economic climate. Choosing personal accounts for future accrual may seem the safest, State approved, choice. The concern, for employees currently in existing schemes affected in this way, is that future pension contributions into personal accounts, with its restricted band of eligible earnings, may be somewhat lower than into an existing scheme (reducing the likely pension outcome). And, of course, there may be the loss of additional scheme benefits presently enjoyed, such as life insurance (which, presently, is not part of the personal accounts package).

But the damage may not stop with smaller employers. For larger employers, the need to auto-enrol all employees into an existing scheme (or personal accounts) will inevitably lead to a wholesale review of existing schemes in the run up to 2012 – the survey found this was on the agenda for six out of ten employers – the reforms simply cannot be ignored. Reviews will concentrate the mind on the potential increases in costs that are involved in auto-enrolment, most particularly for employers with relatively low pension participation rates, for example, many in the retail sector. Here, the economic position and the tax backcloth for business are likely to persuade many that existing pension arrangements either have to be pared back or replaced by a less generous scheme (in the main, the survey findings suggest personal accounts will not replace existing schemes in larger employers, albeit they may 'fill gaps' in provision). Already, we have seen that many employers have taken the opportunity, on review, to close defined benefit schemes to new entrants and our first report in this series, published earlier this month, shows many closures to future accrual may now follow.

What has perhaps been less well noticed, is the 'silent' run-down over the last few years of trust-based defined contribution schemes as employers have given up on these more heavily regulated schemes in favour of contract-based schemes. The recent paper by The Pensions Regulator, *DC Trust: a presentation of scheme return data* has highlighted the huge reduction in scheme numbers over the last decade (by over a half), with just 12 new schemes (with more than twelve members) opened in 2008. So, as more employers review existing provision, even if they persist with schemes that are 'better' than personal accounts, it seems very likely many more will close their trust-based schemes and opt for contract-based schemes, where there are real question marks over governance and administration, as well as investment concerns for and by members.

We recommend that an early and final decision, no later than the summer of 2010 after next year's General Election, is needed as to whether both auto-enrolment and personal accounts are to be implemented from 2012. Such an announcement should only be made if, at the same time, legislation is proposed, to be implemented no later than July 2011, to radically reduce regulatory requirements and to free up 'quality' middle way pension designs from that date, so they are available to employers ahead of auto-enrolment and personal accounts. Delay may be wise for other reasons. The reforms are much more likely to achieve their desired results if they are introduced at a time of rising incomes and/or reducing taxes on employers and employees. As things stand, the exact opposite situation seems more likely. Holding to 2012 could mean very high member opt-out rates as well as undermining existing schemes.

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