

## UK Pension Trends Survey Report...1

# Views on: Pensions Policy and 2004 Pensions Act



### pension trends survey: disquiet at direction of pensions policy

The Association of Consulting Actuaries (ACA) latest *Pension Trends Survey 2005* was conducted in January and February this year. Over 390 schemes, with assets exceeding £131 billion and over 2.8 million members, responded to a wide range of topical pension questions. This first report focuses on their views on current pension policies, the *2004 Pensions Act* and responses to ideas posed by the Pensions Commission in its initial report.

The survey reveals disquiet at the direction of pensions policy in respect of both occupational and State provision. Few firms expect the *2004 Pensions Act* to contribute towards promoting occupational arrangements. Indeed, in this important area of extending occupational provision, most firms say the Act will be counter-productive. It is acknowledged that certain measures, such as the introduction of the Pension Protection Fund, may bring added security to present members of defined benefit schemes, but in other respects the 2004 Act is found wanting.

Schemes strongly support further pension reforms that will allow private schemes greater flexibility in confronting issues such as increased longevity - reforms that were largely subsumed by the protection-dominated 2004 Act. Just as important, firms say genuine reform of the State pension schemes is essential if the private reforms are to take off.

## the key findings

### **government policy in promoting occupational schemes not working**

68% of firms say Government policy of promoting occupational pension schemes is not moving in the correct direction.

### **2004 Pensions Act will reduce provision and add to costs**

62% of firms say the Act will reduce occupational provision and 82% say it will add to costs (not reduce them).

### **scheme simplification agenda remains an unfulfilled promise**

71% of firms support flexibility allowing them to reduce scheme costs retrospectively. 63% want schemes in deficit to be able to suspend Limited Price Indexation.

### **higher pension savings and later retirement ages are policy priorities**

Firms say the priority in resolving the pension crisis identified by the Pensions Commission is higher pension saving and later retirement ages.

### **support for lower-cost defined benefit schemes**

73% of firms think the move from defined-benefit is irreversible, but 63% support the encouragement of lower-cost defined benefit schemes.

### **state pension reform is essential**

90% of firms say the voluntary system of pension saving will not work effectively without State pension reform. 89% support consolidation of the Basic State Pension and S2P.

# pensions policy: not heading in right direction

**Close to seven out of ten firms say the Government's stated policy of promoting occupational pensions is not moving in the right direction.** This view probably reflects the general reaction of disappointment with the final shape of the *2004 Pensions Act* (see below). It had initially been hoped this legislation would radically simplify occupational pension provision (the 'Pickering agenda'). However, it is now felt this opportunity was overtaken by events and, as a result, the legislation focuses to a much greater extent than was originally envisaged on detailed and complex measures designed to protect current members of defined benefit

schemes. Firms are very critical of the failure to pass legislation that will genuinely promote occupational provision and this is reflected in their views on the **most important pension policy priorities (in ranked order, see below)**. Aside from reduced regulation of occupational pensions, as evidenced elsewhere in the survey, firms also rank reform of State pensions as of key importance, ahead of greater incentives to encourage long-term saving and occupational scheme provision:

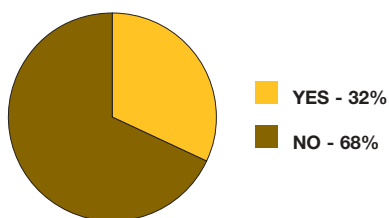
**More encouraging for the Government is the support firms give to greater financial education and the policy initiatives**

**associated with the *Informed Choice* agenda.** 65% of firms are positive in saying that greater efforts in these areas will have a significant impact on pension provision.

Responding to more recent Government policy statements that have expressed an interest in encouraging more firms to automatically enroll members where an employer's contribution is made, 76% of firms say this is not their present policy. Of these close to four out of ten are prepared to consider moving to automatic enrollment.

1.	Reduce regulation on occupational schemes
2.	Reform State pensions including higher Basic State Pension and consolidation with S2P
3.	Greater encouragement / incentives for long-term savings
4.	More incentives to run occupational pensions / reintroduce ACT credit
5.	More compulsion on both employers / employees
6.	Remove / reduce means-tested benefits
7.	Increase retirement ages
8.	More financial education inc. schools
9.	Long-term strategy: stop playing with pensions / need for cross-party approach
10.	Restore trust in occupational pensions / better security

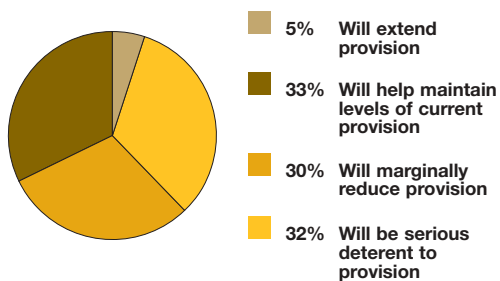
**Figure 1:** Overall do you feel the Government's stated policy of promoting occupational pensions is moving in the right direction?



## pensions act 2004: a lost opportunity?

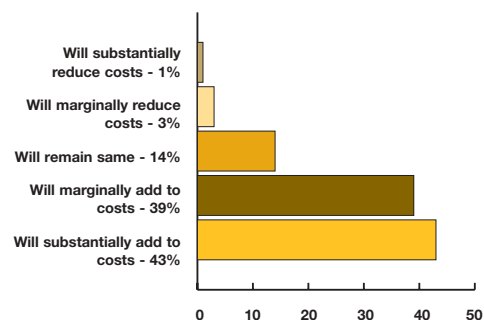
Only 5% of firms say the 2004 Pensions Act will help extend occupational provision. 62% say it will reduce provision, of which half say 'seriously'. This must represent uncomfortable reading for the Government, but it does explain why, with the ink hardly dry on the Act, the Government has already itself been openly considering further pension reforms in response to criticisms from Opposition parties and, it has to be said, much of the pensions industry.

**Figure 2:** Do you feel the 2004 Pensions Act will be helpful in extending occupational pension provision?



Just as worrying are perceptions of the cost of the 2004 Pensions Act. Whereas the Government valiantly claimed the overall impact would be to reduce costs, firms are totally underwhelmed by this argument, not least because of the costs flowing from the levies to finance the Pension Protection Fund. **Only 4% of firms expect the 2004 Act will reduce the cost of occupational provision, with 82% expecting higher costs. Over half of these think the added costs will be substantial.**

**Figure 3:** In your judgement, will the 2004 Pensions Act add to or reduce the cost of occupational pension provision?

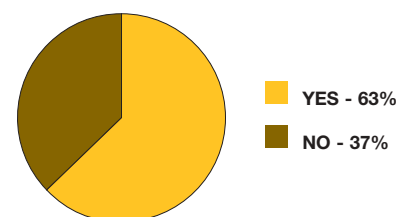


Two-thirds of firms say the Act will either make it less likely they will wind-up their defined benefit scheme (or make no difference). However, 34% of firms say it will make wind-up 'more likely'. Given the costs associated with wind-up under the Act, this is both surprising and alarming.

**Given the increasing costs falling on defined benefit schemes due to longevity and other factors, 71% of firms say that there should be a more general relaxation of s67 (which was designed to protect accrued rights) of the 1995 Pensions Act than has occurred in the 2004 Act.** Firms believe that they should be allowed to reduce the cost of a scheme on a retrospective basis, particularly if this allows the employer to keep the scheme open to members. In many cases, these extra costs will have arisen from rapid increases in longevity and legislative measures (neither foreseen when the scheme was designed).

Over two-thirds of firms (68%) support Limited Price Indexation (LPI) not being obligatory for money purchase schemes from April 2005. However, 63% of firms support a further change to LPI rules so that if a defined benefit scheme is in deficit, the trustees should be able to suspend LPI until a satisfactory level of funding is achieved. This would mirror the 'safety valve' given to the Pension Protection Fund in the event that it gets into financial difficulties.

**Figure 4:** Should it be permissible for a scheme that is in deficit to be able to suspend LPI until a satisfactory level of funding has been achieved?



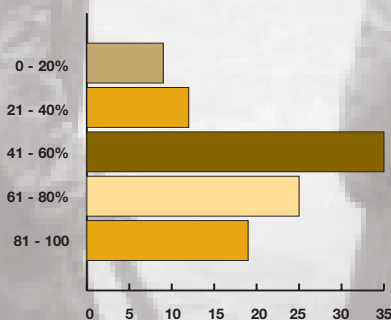
## pension protection fund: new challenges

**52% of firms are satisfied that the level of Pension Protection Fund (PPF) benefits is 'about right'. The balance of firms is split between those who think they are too high (22%) and those that think they are too low (26%).**

In the first year, the PPF levy is to be flat rate (raising £150 million in 2005/06 and approximately £300 million from 2006/07). There is an ambition that the levy will move over to being risk-related. Perhaps reflecting the present state of deficits in many schemes, the majority of firms are looking to no more than 60% of the levy being risk related - related, in other words, to scheme funding, the likelihood of employer insolvency and investment strategy. In the longer-term, the legislation looks to 80% of the pension protection levy being risk-based, but these findings suggest that such a level may need to be imposed gradually. Two-thirds of firms would like to see the risk-related levy come in within a year, although 14% are happy to wait 5 years.

Data upon which to base the risk-related levy will be a key issue and schemes will need to have in place procedures whereby they can inform regulators, trustees and their members of changes in levels of funding. **93% of schemes reporting to the survey conduct formal actuarial valuations every 3 years, with a further 5% doing this every two years.**

**Figure 5:** Figure 5: How much of the PPF premium do you feel should be risk related?

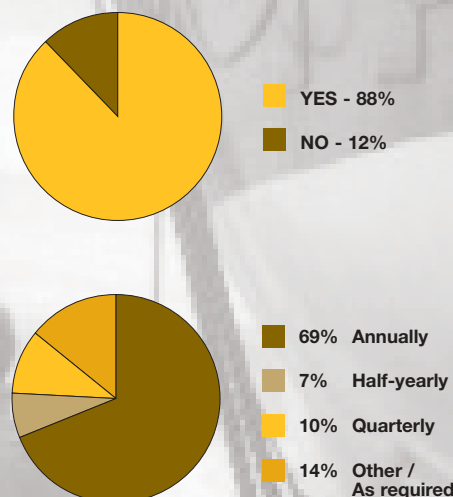


Between these formal valuations, 88% obtain informal updates, with the majority doing this annually or more regularly, such as half-yearly or quarterly.

Increasingly, regulators and the PPF will want to know more about the employer covenant and the degree to which the employer has the financial strength to fund the scheme in both the short and longer-term. **Whereas 58% of the schemes responding to the survey are sponsored by firms with a credit rating, under a half of schemes (44%) know what the credit rating is of their sponsoring employer. Fewer than 1% of firms at present have their own scheme rated.**

A clear majority of respondents feel the risk-based pension protection levy for small schemes (schemes with less than 100 members) should be based on under-funding

**Figure 6:** Do you obtain informal scheme valuations between formal valuations? If so, how frequently?



## pensions commission report: the emerging agenda?

The Pensions Commission, under the chairmanship of Adair Turner, published its initial report in December 2004, with an intention that its full report (including firm recommendations) will be published by the autumn of 2005.

The initial report describes the current private pensions scene, whilst also straying into how private pensions sit alongside and are influenced by the shape of State provision. The initial report was direct in its conclusions that to address the demographic challenge of an increasing proportion of the population aged over 65, society and individuals must choose between four options or (more realistically) a blend of those four options. We put a number of the key issues raised by the Pensions Commission Report and ideas

(89% support), credit risk (73% support) and asset allocation (66% support). Despite the cost of the PPF levies, the Government also remains keen to secure additional funds for the **Financial Assistance Scheme (FAS)** over and above those committed by the taxpayer via the DWP budget (£400 million over 20 years). FAS has been established to compensate scheme members (at present, those nearest to retirement) who have lost some or all of their pension ahead of the introduction of the PPF. It is generally felt that the funds committed by the Government are insufficient if compensation is to be extended beyond those very close to retirement. **Fewer than 1% of firms say they are prepared to provide additional funds over and above the PPF levy.**

When the survey was conducted, details of the new **statutory funding objective** designed to replace the minimum funding requirement from September 2005 were thin. The proposed rules were published in mid-March. **At the time of the survey, 59% of firms felt that the new rules were likely to place a pressure on contribution rates.**

Where firms were prepared to disclose whether the trustees or the scheme actuary has unilateral powers to set contribution rates, on a ratio of 4:1 this lay with trustees, with very few firms intending to alter scheme rules to remove unilateral powers.

flowing from this to firms. They said that the ranked priority order of the four options given by the Pensions Commission should be:

1. Savings must rise
2. Average retirement age must rise
3. Tax / NI devoted to pensions must rise
4. Pensioners to be relatively poorer

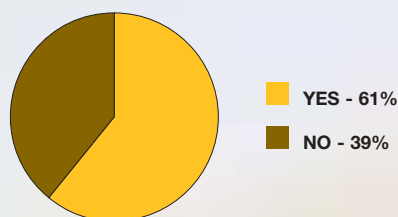
As might be expected, very few firms felt the solution should be just one of the options. Most looked to a blend of all, with 'savings must rise' running well ahead of either raising average retirement age or higher taxes / NI devoted to pensions. 'Pensioners to be relatively poorer' was given a low priority in policy terms by most, but, of course, this is the most likely outcome if society and

individuals fail to address the issue in a positive way through public policy initiatives or individual actions.

Firms seem well on the way to accepting, even wanting, some greater degree of compulsion than is presently the case. **74% of firms say they favour a higher level of compulsion as a means of reducing pensioner poverty and means-testing over and above current Basic State Pension and S2P requirements.**

**This is underscored by the fact that even if the Government established a higher State pension by consolidating the Basic State Pension and S2P, set at a level to meet essential living costs (updated reflecting changes in average earnings), a clear majority of firms would still favour individuals and employers being required to save at a higher level.**

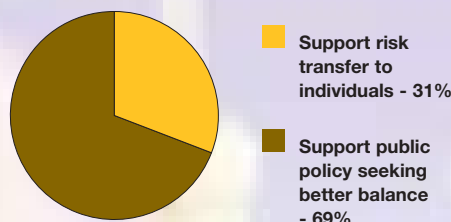
**Figure 7:** If the Government established a higher minimum State pension by, say, consolidating the BSP and S2P, do you believe the State should require individuals or their employers to save at a higher level?



Hitherto, the difficulty for Government in endorsing such an approach to compulsion has been that requiring compulsory contributions over and above the levels necessary to fund essential living costs in retirement might be viewed as extra taxes, reducing individual choice. **Whilst 73% of firms say the move from defined benefit to defined contribution is irreversible**, the Pensions Commission poses the question whether the transfer of risk that is inherent in the move is acceptable? And, whether public policy should attempt a better balance of risk between individuals, employers, the financial services industry and Government? **Whereas the switch to defined contribution was judged to be irreversible, over two-thirds of firms preferred that public policy seek a better balance of risk** (rather than transferring this entirely to individuals).

Reflecting this view, **63% of firms support the encouragement by employers and Government of lower-cost defined benefit schemes, with lower benefit targets and / or later retirement**, as one means of

**Figure 8:** Do you support the transfer of risk to the individual that is inherent in the move to defined contribution or do you feel public policy should attempt to achieve a better balance of risk between individuals, employers, the financial services industry and Government



addressing the imbalance of risk that otherwise is inherent in the move to defined contribution. Whilst it is felt many employers would be sympathetic to such schemes, the major problem remains that such defined benefit arrangements are subject to costly red-tape (unfortunately, redoubled with the establishment of the PPF), which the Government has been unsuccessful in addressing with sufficient purpose or resolve.

The Government has until recently set its face against major changes to the State pension schemes. Instead, it has chosen to date to focus on targeted means-testing that has significantly raised the income of those with the lowest incomes in retirement. It has thereby retained a relatively low Basic State Pension supplemented by earnings related S2P or contracted-out private pensions. Many in the pensions industry and beyond see this as a complex structure that defies comprehension by individuals. Moreover, it is argued that the structure is such that it may deter private savings.

**90% of firms say that in order for the private voluntary system to work effectively, there need to be changes to the State pension system** over and above those in the *2004 Pensions Act*. Those changes most favoured are:

- **89% support consolidation of the BSP and S2P**, (although only 48% support the move if this were to lead to higher NI contributions for employers)
- **72% support an end to contracting-out, with voluntary private pensions built on top of the consolidated State pension**

Only 51% of firms support an increase in the State Pension Age, which perhaps is a little surprising given the lead this would set in helping private schemes to raise their pension ages to higher levels.

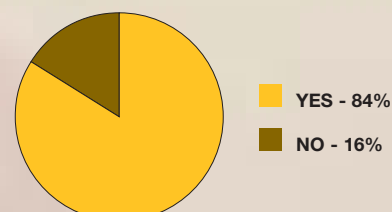
A sizeable minority (42%) of firms would support an improvement in rebate terms to encourage more contracting-out. Whilst this may in part be a reaction against the poor rebate terms at present, it seems also to reflect the mounting recognition that contracting-out presents individuals with complexities that are beyond the reasonable understanding of most individuals.

On means-testing there is a very clear message to the Chancellor. **84% of firms say the increase in means-tested benefits acts as a disincentive to pension saving and 74% say that without a marked reduction in means-testing, there cannot be a voluntary solution to the problems identified by the Pensions Commission.**

If the State reforms supported by schemes are not implemented by Government then, reflecting the views expressed earlier in the survey, **72% of firms say there will be a need to introduce compulsory minimum pension contributions, with employers and employees each contributing around 5% of earnings.**

Whilst this may be an understandable stance, it needs to be recognised that minimum pension savings at these levels would be considerably below that presently being made by employers and individuals into (mostly) defined benefit schemes. Logically, lower contribution rates in due course will lead to lower levels of pensions in payment and may well set a standard to which those presently paying much higher contributions would gradually move. Such a trend would be bad news for millions of existing scheme members. For those joining schemes at these relatively modest contribution levels (particularly if contributions did not increase with age), there would also be a danger that pension outcomes would be uncertain (if contributions were generally into defined contribution schemes) and fall far short of expectations.

**Figure 9:** Do you believe that the increase in means-tested benefits for those in retirement acts as a disincentive to pension saving?



## conclusion and public policy recommendations:

The stark message of this first report on the findings of the *Pension Trends Survey 2005* is that firms feel the *2004 Pensions Act* was a major 'lost opportunity' in addressing the need to promote wider occupational pension provision. Whilst the Act has attempted to better secure the pension benefits of members of existing defined benefit schemes, the absence of any significant measures designed to simplify the burdens of red-tape and to allow much greater flexibility to reduce forward liabilities means provision is, at best, becalmed in the doldrums.

Very few employers are likely in such a situation to offer afresh or continue defined benefit provision other than for those already in such schemes. As we have reported in previous surveys, around 70% of private sector defined benefit schemes are now closed to new entrants and the expectation is that this figure will continue to rise. Contributions into most defined contribution arrangements remain at levels below those that will provide anything like similar levels of pension to that enjoyed by most members of defined benefit schemes. We will report shortly on the most recent trends in these areas in our second report on the findings of this 2005 survey.

The public policy recommendations that would appear to follow from the findings of this latest survey are:

- The Government must enact genuine pension simplification.
- In order to control long-term costs, employers should have the option to change scheme rules retrospectively to avoid increases in cost due to unforeseen longer life expectancy, for example by raising normal retirement age.
- **Means-tested benefits should be reduced in scope with the Basic State Pension and S2P consolidated into a higher-level Basic State Pension.** This would be set at a level sufficient to cover essential basic living costs, to be reviewed on an annual basis to reflect earnings growth. **Whilst the ACA has called for a higher State Retirement Age to help finance such a change, it is clear that because to date public policy has opposed such a move, there is much that needs to be done to persuade people (including many respondents to this survey) that this is the correct strategy.**
- **Contracting-out should be abolished.** The public would find a pension regime whereby private pensions are built on top of a consolidated State pension much easier to comprehend.
- **The Government should provide a better incentive to encourage the development of good second-tier private pensions,** particularly where employers continue to or decide to sponsor schemes that meet a certain standard.
- **The Government's encouragement of private pension provision above the higher consolidated Basic State Pension should continue by way of tax relief,** with longer-term saving attracting a higher rate of relief than shorter-term savings products.
- Should the Government be unwilling or unable to address the above pensions policy agenda, then calls for greater compulsion will grow as the failure of present policies in the occupational sector unfold. **It is important that public policy, in responding to calls for greater compulsion, is supportive (in regulatory / incentive terms) of employers and schemes that offer superior arrangements to any proposed compulsory regime.**



### Report Produced by:

Association of Consulting Actuaries  
Warnford Court, 29 Throgmorton Street,  
London EC2N 2AT  
Tel: 020 7382 4594  
Fax: 020 7374 6220  
Email: [acahelp@aca.org.uk](mailto:acahelp@aca.org.uk)  
Web: [www.aca.org](http://www.aca.org)

© Association of Consulting Actuaries, 2005. All rights reserved. References to the research statistics herein must be attributed to the Association. Otherwise, no part of this publication may be reproduced, stored in a retrieval system or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without the permission of the Association of Consulting Actuaries.