



**PERSONAL ACCOUNTS
ACA EVIDENCE TO
THE HOUSE OF COMMONS WORK AND PENSIONS COMMITTEE**

1. Executive Summary

1.1 The **Association of Consulting Actuaries (ACA)** welcomes the intent of Personal Accounts to extend private pension provision to those not presently covered by employer pension schemes. We broadly support the proposed design and arrangements for implementation.

1.2 The important next step is that the Government takes really positive steps to strengthen and encourage existing and new work place pensions that are better than the minimum provided by Personal Accounts. Measures to do this need to be included in its legislative program for 2007/08 otherwise we believe there is a real danger that many employers will level their pension provision down to Personal Accounts with minimum contributions.

1.3 We have some more specific concerns:

1.3.1 The impact of volatility in investment returns

We remain concerned that the volatility of investment returns and annuity conversion rates and the potential impact on benefits will not be fully communicated in the publicity that will surround the launch of Personal Accounts. This incurs a significant risk that individuals will receive much lower benefits than they expected and this will lead to Personal Accounts becoming discredited.

1.3.2 The impact on State Means Tested Allowances (SMTAs)

There are many lower paid men and women who will, for the foreseeable future, be better off getting SMTAs than saving in a Personal Account. It is probable that there has already been mis-selling of Stakeholder contracts as a result of this issue. We believe a simple analysis could prove whether this has occurred and believe that this analysis should be undertaken to inform the design of Personal Accounts.

1.3.3 The Maximum Annual Contribution Limits

These are proposed as £10,000 in the first year of operation and £5,000 p.a. thereafter. This should be reduced to nearer the £3,000 maximum suggested by the Pensions Commission. The higher limits exacerbate the risks mentioned in paragraph 1.3.1. We also believe that these higher limits significantly increase the risk that other employer pension schemes will level down to the Personal Accounts level.

1.3.4 Encouragement of Good Employer Schemes

Personal Accounts must complement better workplace pensions. We welcome and are very supportive of the Government's stated intentions to support and encourage the provision of good work place pension schemes. The exemption test that will allow employers to provide pensions through their own pension schemes, and not have to contribute to Personal Accounts, should be kept as simple as possible. In addition it is vital that legislation simplifying the existing complex regime for workplace pensions, progresses at the same pace as Personal Accounts.

2. About the Association of Consulting Actuaries (ACA)

2.1 The Association of Consulting Actuaries (ACA) is the representative body for consulting actuaries, whilst the Faculty and Institute of Actuaries are the professional bodies. The ACA has over 1500 members working in around 80 firms. Members of the ACA provide advice to thousands of pension schemes, including most of the country's largest schemes. ACA members include the scheme actuaries to schemes covering the majority of members of defined benefit pension schemes.

2.2 ACA Members are all qualified actuaries and are subject to the code of professional conduct of the Faculty and the Institute of Actuaries. Advice given to clients is independent and impartial. The ACA forms the largest national grouping of consulting actuaries in Europe.

3. The Evidence

3.1 Volatility of Investment returns and annuity rates

3.1.1 Depending on the period over which contributions are invested and on the investment strategy adopted, the funds available at retirement to purchase a pension can vary considerably within defined-contribution schemes. While investment strategies such as "lifestyling" (the use of less volatile investments as the member approaches retirement) can reduce the variation, not all members will choose investment options that reduce investment volatility. Variations in fund values of 30% to 40% or more for the same level of contributions are not unusual.

3.1.2 Rates at which funds can be converted into pensions (annuity rates) also vary over time and between different providers. Typically the rates can vary by more than 10% between different annuity providers at any one time.

3.1.3 It is important that members of defined-contribution schemes are aware of these risks and take sensible steps to mitigate them where possible and appropriate. The proposal to offer a default fund is welcome as a way to mitigate some of these risks. However, it will be very difficult to communicate effectively the nature and extent of the investment risks without personal financial advice. The white paper contains little information on how this will be achieved. This part of the communication exercise needs to be carefully considered.

- 3.1.4 The white paper mentions documentation and the necessity of choosing a competitive annuity provider in sections 5.17 to 5.19. However, the details of this important element of scheme design are left for a future review of the operation of “Open Market Options”. There is little information regarding the expected expenses of annuity purchase, what if any advice should be provided and how the process will be administered.
- 3.1.5 The potential for unpleasant surprises for individuals and disappointment of expectations is a significant risk for all defined-contribution schemes. The larger the funds involved the greater the significance of these risks. We are concerned that, with the maximum contribution limits suggested, some members will be investing substantial proportions of their income, potentially in excess of 10%, into Personal Accounts with insufficient advice.

3.2 The Impact on State Means Tested Assistance

- 3.2.1 Some lower paid employees, specifically lower paid women now aged 45 to 60 and men aged 50 to 65, would be very unlikely to build up sufficient benefits in Personal Accounts to exceed the value of the State Means Tested Assistance (SMTA) that they would lose as a result of saving in Personal Accounts. This is addressed in sections 1.18 to 1.21 of the white paper but we suspect the impact has been underestimated.
- 3.2.2 Paragraph 54 of the Executive Summary states "Those who want a simple approach to saving will only have to decide whether to remain in the scheme and how much to contribute ". This is an oversimplification: men and women who may fall into the trap outlined above need advice over when or whether to opt-out of Personal Accounts. This is supported by paragraph 2.28 of the white paper "...many UK consumers find choice in pensions.....overwhelming ...many ...are reluctant to seek information ...research reveals a widespread lack of confidence ...in their ability to make decisions about pension provision. This lack of confidence is underpinned by low levels of financial capability.."
- 3.2.3 There is growing concern that there has been some pensions mis-selling of Stakeholder Pension Contracts because vulnerable groups of the lower paid were left with the complex decision tree device as ‘best advice’. While there were suggestions that individuals should refer to IFAs, it is unlikely that this was effective due to the cost of providing such advice and the complexity of SMTAs. It is now practicable to provide a fairly straightforward comparison of an individual’s personal account and the SMTA: we believe this should be done as it would provide a useful guide to the likely interaction of SMTAs with the Personal Accounts for this vulnerable group.
- 3.2.4 Paragraph 112 of the executive summary includes the statement that “It will be Government’s role to ...[provide] appropriate degrees of consumer protection”. How will this be achieved? It is only fair that Government should make sure that the interaction of Personal Accounts with SMTAs does not disadvantage individuals when Personal Accounts are introduced.

3.3 The Maximum Contribution Limit

- 3.3.1 We agree with the White Paper's conclusion that a contribution limit should be imposed. We believe this is essential to limit the risk of levelling down existing good employer pension provision.
- 3.3.2 We challenge the proposal that this limit should be set as high as £5,000. Paragraph 5.18 of the Regulatory Impact Assessment states that a £3,000 p.a. limit would be sufficient for median earners to earn a pension of 67% of pre retirement earnings about 75% of the time. The justification for increasing this figure to £5,000 p.a. in respect of median earners is not clear.
- 3.3.3 Paragraphs 5.19 to 5.21 of the Regulatory Impact Assessment provide information which is used to justify increasing the maximum contribution limit to £5,000 p.a. However, this appears to be based on the fact that average contributions to existing defined-contribution schemes for members earning over £30,000pa averages £3,970 for employed individuals and £4,460 for the self employed. This statistic will include contributions by individuals earning well in excess of £33,500. Such individuals are not part of the target group for whom Personal Accounts are aimed, and their inclusion must significantly distort the analysis. As a result, our view is that the required maximum contribution level is significantly lower than the government proposes. We do not believe this is sufficient evidence to justify a substantial increase in the maximum recommend by the Pensions Commission.
- 3.3.4 In June 2006 the Government Actuary's Department (GAD) published "Occupational Pension schemes 2005, the thirteenth survey by the government actuary". Paragraph 8.8 of this report states that "[Average] Contributions to defined-contribution schemes were lower [than defined-benefit schemes] at 2.7% from members and 6.3% from employers." The ACA Pension Trends Survey 2005 found that average contributions to defined-contribution schemes were 5.9% from the employer and 4.1% from the member. This suggests that a £3,000 limit would cover average contributions to defined-contribution schemes for earnings in the £5,000 to £33,500 range. These figures certainly do not support the idea that the maximum contribution limit should be £5,000 or above.
- 3.3.5 We would also note that Personal Accounts are intended to complement existing pension schemes and that under current HMRC rules it is permissible for individuals to contribute both to a Personal Account and to another scheme such as a Stakeholder or a personal pension. There is nothing to stop individuals who find the annual contribution limit too low directing some or all of their excess contributions in to another savings vehicle. Since it is likely that additional investment advice will be needed for individuals that take this route it would also alleviate concerns about the lack of advice associated with Personal Accounts when significant amounts of members money are being invested.

3.4 Encouraging Employer Provision

- 3.4.1 We welcome and are very supportive of the Government's stated intentions to support and encourage the provision of good work place pension schemes that provide higher benefits than Personal Accounts. The proposals to allow employers with qualifying schemes to opt-out of personal Accounts are welcome and we support making the qualifying tests as simple as possible.
- 3.4.2 Historically UK employers have been willing and able to support good pensions but their ability to continue doing this has been undermined by escalating long term costs and the lack of control that employers have over these costs.
- 3.4.3 Many employers have reacted by switching from defined benefit to defined contribution provision thereby switching all of this risk from the employer to the individuals. Individuals are, in general, far less able to manage this risk than their employers.
- 3.4.4 Our experience of dealing with UK employers suggests that many are willing to provide good occupational schemes but are deterred by a lack of flexibility in current regulations. Legislation needs to progress alongside the development of Personal Accounts in order to encourage employers to support good work place pensions and remove the current legislative discouragement from offering good occupational schemes.

4. Recommendations

- 4.1 Compare personal accounts of individuals with Stakeholder pensions with the SMTAs that they would otherwise have received to determine whether losses have occurred. Use this information to help design information and packs and any available advice for Personal Accounts.
- 4.2 Reduce the maximum annual contribution limit to nearer the £3,000 pa recommended by the Pensions Commission.
- 4.3 The existing complex regime for workplace pensions should be simplified and legislation developed that encourages employers to offer schemes that are better than Personal Accounts.

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16 January 2007