



ASSOCIATION OF CONSULTING ACTUARIES

UK PENSIONS STRATEGY

About the Association

The Association of Consulting Actuaries (ACA) was established over 50 years ago and draws its membership from consulting actuaries working in over 80 consulting firms. Members of the Association are all qualified actuaries – either Fellows of the Faculty of Actuaries in Scotland or Fellows of the Institute of Actuaries – and all actuarial advice given by members is subject to the code of professional conduct of the Faculty and the Institute of Actuaries.

The major part of our members' work is as advisers to UK pension funds with assets in excess of £650 billion. The vast majority of the country's largest pension schemes are advised by ACA members and they, amongst thousands of other pension funds, companies and organisations take advantage of a wide and varied range of services offered by our members.

Introduction

The purpose of this paper is to set out the principles that the Association of Consulting Actuaries (ACA) believes should form the basis of the UK's future pensions strategy.

At the heart of these proposals is the role played by employers who provide employer sponsored pension schemes for their employees. The Government's Green Paper published in December 1998 acknowledged that employer sponsored pension schemes were one of the great welfare success stories of the twentieth century. The ACA believes that this success story is now under very serious threat. The Government needs to set in hand effective policies that will re-establish a framework that encourages employers to set up and continue to finance employer sponsored pension schemes.

The recent and disturbing decline in occupational provision and evidence of low levels of contributions into 'new' defined contribution schemes points to an urgent need for action.

The ACA recognises that resources are limited and difficult decisions will lie ahead. However, the ACA would appreciate the opportunity of working with the Government to assess the choices that are available. The ACA also believes that cross-party support is vital in order to build a stable and coherent strategy that will be sustainable over the long-term.

State Pension can be simplified and improved

1. *The State Pension should be a single flat-rate pension linked to earnings inflation rather than price inflation.*

- The existing two-tier structure (the Basic State Pension and the State Second Pension) is a failure in terms of complexity and should be replaced by a simple single State Pension. This could be achieved by progressing the introduction of the flat-rate State Second Pension but, at that stage, combining the two tiers of State pension (BSP and S2P) into a single State pension;
- The proposed single flat-rate pension should provide a subsistence level of income. It should be available to everyone regardless of income and should not be means tested. Whilst it is accepted that this might not be achievable in one step, it should be a policy target that the complex structure of means tested benefits for retired people (and the disincentive this presents to pension savings) should wither away over time;
- A mechanism should be introduced to enable a link to earnings to be restored to ensure that the State pension remains adequate over the full period of retirement.

2. *The State Pension Age should be increased although there should be greater flexibility regarding the age at which the State Pension comes into payment.*

- An increase in State Pension Age is justified by the significant increases in life expectancy over the last few decades;
- There is also a need to provide greater flexibility in retirement and to counteract the anticipated decline in the working population;
- This change should be announced immediately but not introduced for a number of years. For example, the period over which the State Pension Age for women is currently being increased from 60 to 65 could be extended to increase the State Pension Age still further for both men and women;
- As described above the amount of State Pension should be set at a level to provide a subsistence level of income possibly in consultation with an independent 'pensioner income' review body. The State Pension Age would then be determined by the Government as the age from which that level of income was deemed to be affordable. Similarly, any flexibility regarding the age at which the State Pension is paid should be cost neutral to the State.

Contracting-out should be abolished

3. *Contracting-out should be abolished.*

- Contracting-out was successful in the past when the contracting-out terms provided genuine incentives to replace the second tier of State benefits with alternative forms of pension provision. This is no longer the case and, for many employers, contracting-out does not represent an attractive option. Worse still, the incentive has been replaced by costly complexity for many schemes;
- If contracting-out was to be retained then this should be done against the background of greater protection and security of benefits for contracted-out employees. A defined benefit scheme is the only type of scheme that can offer the necessary guarantees. The contracting-out terms would also need to provide employers with a financial incentive to contract-out alongside measures that simplify past regimes.

Favourable tax regime / incentives needed to promote occupational pensions

4. *Pension benefits in addition to those provided by the State should, wherever possible, be provided by employer sponsored pension schemes against the background of a favourable tax regime.*

- Additional pension provision is necessary to ensure that more pensioners have the opportunity to enjoy a comfortable, rather than a subsistence, standard of living in retirement;
- For reasons of recruitment and retention employers have genuine business reasons for providing their employees with high quality pensions and occupational pension schemes have proved to be the most effective and efficient way of delivering these additional pension benefits. The sheer cost of provision is, however, undermining this commitment.
- All the evidence highlights that individuals find it hard to plan and save enough for their own retirement (even when offered access to low-cost stakeholder products);
- The tax regime for retirement saving should encourage saving and **must** be more favourable than other forms of short term savings arrangements such as ISAs reflecting the extended lock-in period associated with saving for retirement;
- The seriousness of the decline in occupational pensions also requires that the government give serious consideration to direct financial incentives to employers to establish or retain schemes in the short-term. Such support should be seen in the light of the £20 billion extra taxes paid by pension funds

over the last 5 years by way of the withdrawal of ACT (and the consequent extra financial pressures this has placed on schemes).

Comment [DR1]:

Compulsion may reduce existing pension savings levels

5. *Employers should be encouraged rather than forced to provide employer sponsored schemes.*

- Compulsory employer contributions to pension schemes would put a large number of UK employers at an immediate disadvantage compared to overseas competitors. It would be perceived as another tax on business and would encourage mediocrity with employers reducing contributions to the minimum level;

Security of pension benefits on wind-up

6. *The Government should take early action to reduce the inequity of treatment between pensioners and other scheme members*

- The Government should take early action to reduce the inequity of treatment between pensioners and other scheme members, particularly those nearing retirement, when schemes wind up with inadequate funding. A first step would be to bring forward the introduction of the "post-2007" priority order, which could be done without primary legislation.
- The degree to which employers need to underwrite under-funded schemes on wind-up should be settled properly by clarifying the Government's existing proposals.

Occupational pensions: conclusions

- Employers should have the freedom to reward employees with whatever pay and benefit structure the employer deems appropriate;
- The current polarisation between final salary and money purchase is unhelpful. Employers should be positively encouraged to provide defined benefit schemes at a level they can afford, which may be more limited than the traditional final salary model. Lower investment returns and greater longevity means that many employers simply cannot afford 1/60th schemes. However, many more would be willing to consider continuing defined benefit arrangements with accrual rates of 1/100ths plus a later retirement age, say 68 or 70;
- Defined contribution schemes are often inappropriate for many individuals especially the lower paid and those who do not have the financial

sophistication to assess and manage the significant risks inherent in a defined contribution pension arrangement;

- In addition, there has been a reduction in saving for retirement due to the replacement of defined benefit schemes with defined contribution schemes;
- An increase in the amount of saving for retirement is urgently required. Employers can play a major role in achieving this objective if they are provided with incentives to set up and run employer-sponsored schemes for their employees.

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