

*Pension policy will fail (again)
if the forthcoming Pensions White Paper
is not comprehensive...*

Pensions reform: NPSS alone is not enough

pensions changes beyond NPSS: three essential reforms highlighted

We may be about to witness yet again one of those adverse 'unintended consequences' of piecemeal pensions reform referred to by the Pensions Commission in their thoughtful reports. However well intended, piecemeal reforms over the last 20 years have been hugely damaging to workplace pension provision to the point that it is now in serious decline, particularly in the private sector. This paper considers what is needed to make a success of the latest

round of reforms, including three essential reforms to help retain existing provision and to boost new risk sharing schemes (see page 3).

Although the Government is giving mixed messages on what will appear in its forthcoming White Paper on pensions, this must address the 'big idea' in the second report of the Pensions Commission – a National Pension Savings Scheme (NPSS). The ACA's latest survey of *Pension Trends*



Pensions: increasingly a divided nation?

in *Smaller Firms 2006*, shows considerably more firms support the initiative than oppose it, which is good news for Lord Turner and his team. If NPSS genuinely extends (rather than replaces) existing pension provision well beyond parts reached in the past, it must be welcomed. But that is not to say we don't see real difficulties with the proposals (see pages 11-16, for a summary of the survey results). State reforms and changes to encourage schemes that are better than NPSS are also essential.

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**SURVEY
RESULTS**

investment and longevity risk: 100% with individuals

The exact way NPSS or an alternative scheme might be run is still being debated (see page 6-8, for a summary of the various proposals). Whoever manages the scheme, it is most likely to be a low-cost defined contribution scheme into which employees will be auto-enrolled on joining (or at age 21) by their employer if they are not in a better workplace scheme. Employees will be free

to opt-out and, in reality, many will because of their life-style choices or other financial priorities.

Under this kind of scheme, enrolled employees will bear 100 per cent of the investment and longevity risk. As a result their eventual pensions will depend on the condition of investment and annuity markets at retirement

(see page 5, for *What 100% investment risk can mean*). It is inevitable that there will be big variations in the pensions delivered for the same savings, depending on economic conditions at the time of retirement. This may be very difficult for those on lower incomes to grasp. But, say the reformers, at least many more employees will receive a better pension than at present. But are things that simple?

state reforms: essential to the development of all private pensions

Are we confident the State reforms championed by the Pensions Commission, which are pretty essential to making NPSS work, are also likely to happen?

Without something near to or acceptance of the earnings uplift in the Basic State Pension (BSP) proposed by the Pensions Commission, the numbers receiving means-tested benefits will climb - with perhaps as many as 70 per cent of pensioners receiving some top-up by 2050. The Chancellor is only committed to indexing the pension credit to earnings until 2007/2008. But, unless there is a marked reversal in policy

(which has hugely benefited many of the poorest pensioners), with BSP indexed to earnings (or, at least, higher than prices), the guarantee will remain well above the Basic State Pension, even if eventually indexed to prices. In interviews following the publication of the Pensions Commission's final report, the Chancellor appears to have softened his opposition to reforms of the State pension. However, his argument about the ultimate 'affordability' of any new package in the light of overall government spending commitments into the longer-term suggests that a BSP linked automatically to earnings rises is still unlikely.

The ACA would go beyond the State reforms proposed - they remain too complex for the public to understand (see page 9-10, *Simpler State Pensions*). That aside, if the State reforms proposed are scaled back considerably, but NPSS goes ahead, many of the auto-enrolled on lower incomes will be asked to build pensions that will in many cases only displace the means-tested benefits they would otherwise receive. This could mean high opt-out rates.

In such circumstances, the launch of NPSS could also be the 'mis-sale' of all time.

NPSS alone: simply not enough

But, without care, the launch of NPSS alone could prove deeply damaging. If there are no wider reforms, what will employers do who offer better schemes? Schemes that at present still cover millions of employees and which, in many cases, are provided on a risk-sharing basis, thereby securing greater safeguards for employees.

These schemes have been hit by many other 'unintended consequences' of reforms over the last two decades that have hugely added to scheme costs and forward liabilities. If they see no reforms that help them to better manage costs and forward risks, many employers will conclude that the time is ripe to move towards an NPSS basic package. This is a risk that the Pensions Commission took few soundings on. It is a risk that could undermine the pension plans of millions of existing scheme members.

The ACA does not believe it is right, just because workplace pension provision is in decline, for the Pensions Commission to argue this is a justification for the introduction of the basic NPSS scheme and nothing more. Many employers want to do more, but will be dispirited that this major report on private pensions came up with no

proposals that would help employers to provide something better. After all 'NPSS is not intended to be a replacement for good occupational provision and should not be presented as such' and at minimum default levels of contributions 'will not be sufficient to deliver conventional standards of pension adequacy' (see *Implementing an integrated package of pension reforms: The Final Report of the Pensions Commission*, page 39). The forthcoming Pensions White Paper is what could turn out to be the 'last' opportunity to provide an incentive to promote new (better than NPSS) risk-sharing schemes for the future. There are employers who are prepared to offer schemes that take on the investment risk prior to retirement and maybe some or all of the mortality risk (see page 4-5, *Risk sharing schemes benefit all*). But, what employers are increasingly unlikely to do is to offer such risk-sharing schemes into the future if present legislation remains so inflexible and out-dated. Leaving to a later date any reforms that might ease burdens on existing occupational schemes would be a big mistake - these changes need to run alongside the introduction of NPSS, if this goes ahead.



Time running-out for good pensions

three essential legal reforms: to boost private risk sharing schemes

If the levelling-down to NPSS is not to be another adverse result of the launch of NPSS, the Pensions White Paper needs to include three essential reforms (see box, *Three Essential Changes in Pensions Legislation*). If implemented, alongside the launch of NPSS, these changes offer the flexibility and reduced forward costs that are needed to provide the incentives for employers so risk-sharing schemes survive and are developed into the future.

Finally, a 1 per cent reduction in Employers NI for those firms that sponsor pension schemes that are clearly better than NPSS would provide an incentive to ensure NPSS does not undermine existing better provision. It would also promote new arrangements that are better than NPSS. This would cost around £1.7 billion per year. This may sound a large sum, but it probably represents only around one-third of the extra annual taxation the Government has

taken from pension schemes since 1997 – extra taxation that has done a great deal to ‘grow’ scheme deficits (and thereby scheme closures).

In a very real sense, schemes and their employers are owed a debt by government for a decision taken, as we now know, at the wrong time and based on the false assumption that investment markets would continue to generate pension surpluses.

THREE ESSENTIAL CHANGES IN PENSIONS LEGISLATION

- **Flexibility to modify pension age to reflect improving longevity:** legislation must allow normal pension age to be increased on grounds of improved life expectancy, subject to a report from the Scheme Actuary and agreement by the Pensions Regulator. Normal pension age should be allowed to increase in respect of past, as well as future, service benefits with members affected being given appropriate notice (e.g. 10 years in advance). Such a change would reflect the reform proposed for the State sector by the Pensions Commission. As with the State reforms, this is not a reduction in benefits – the actuarial value of the pension would be maintained as the pension will on average be paid for a longer period. Without this change in legislation, as mortality improves, an increasing number of established schemes will close to place a cap on their forward liabilities.
- **Harmonise LPI indexation with defined contribution schemes:** there is an urgent need to remove the requirement for Limited Price Indexation increases (price inflation subject to a 2.5 per cent maximum increase in any year) in respect of future service benefits. This would bring risk-sharing schemes into line with defined contribution workplace pension schemes. Employers would still be able to provide non discretionary or discretionary increases to pensions in payment, reflecting the financial condition of the scheme.
- **Ease revaluation terms:** for early leaver benefits before they come into payment, revaluation should be changed to price inflation up to a maximum of 2.5 per cent in any year. Reducing the annual ceiling from 5 per cent to 2.5 per cent is consistent with the reduction for pensions in payment brought in by the Pensions Act 2004.

pensions: increasingly a divided nation

Without these wider reforms, risk-sharing pensions increasingly will be confined to public sector employments. As this happens huge political resentments will build – and it can already be seen to be

emerging through the popular press – with every chance this will ultimately contribute to a taxpayers’ revolt, through the ballot box, as the divisions in society grow. Without these wider reforms, NPSS will

gradually displace superior pension benefits enjoyed by millions of people as employers, offered no incentives to do better, level down. Some wider thinking and action could achieve so much more.

Government needs to encourage good pension schemes...

A better pension alternative: Risk sharing schemes benefit all

The Pensions Commission report was stark in noting that we are probably near the peak of the benefits available from the private sector final salary pension schemes built up over the last 30-40 years. This change, coupled with the low levels of State pensions and evidence of declining numbers of employees covered by any type of workplace scheme, explains the Pensions Commission's radical adoption of a national auto-enrolled scheme, with minimum levels of contributions.

once 10 + 5

How the picture has changed in a short period. Not long ago, the UK was the envy of the world in terms of its workplace pensions – with most members enjoying risk-sharing schemes (usually final salary related). When most of these schemes were first established, it was often the case that the employer expected to pay contributions at around twice the level paid for by the members themselves. Typically, a 10% employer contribution and a 5% employee contribution would deliver the benefits offered. However, greater longevity and the significant extra statutory requirements added over the last 20 years has changed all that. Employers now find they must contribute at far higher levels to deliver the levels of benefits first proposed and, then,

to meet those benefits as enhanced by Parliament. Often, employer contributions of well over 20 - 30% are now needed to meet final salary pension benefits.

Inevitably, this has led to employers taking actions to reduce their forward liabilities. It has meant a widespread shift towards more lightly regulated defined contribution schemes, which place 100% of investment and longevity risk with employees. But, many middle-sized and larger employers, aided by their human resources and pension advisers, are increasingly wondering whether they can do more for their employees and in so doing preserve the huge advantage of greater security of pension income possible through other

types of risk-sharing schemes? Importantly, despite all of the disincentives, most of these employers still want to provide a decent pension for their employees provided the risks to the business and its shareholders are not too great.

The advantage of the risk-sharing models that are emerging is that they better protect members' interests than pure defined contribution schemes. For employers, by lowering the benefit level that is targeted, the cost of providing a risk-sharing scheme reduces. As these schemes are defined benefit, members' pensions remain protected by the Pension Protection Fund should their employer collapse.

risk-sharing models

Risk-sharing schemes vary in their type and can be tailored to the employer's workforce. Employers usually continue to retain pre-retirement investment risk. However, for example, in the case of a **career average scheme**, the pension is based on average career earnings adjusted for inflation. Whilst this will usually mean a lower pension than one based on final salary, it provides much greater certainty over the level of benefit that will be received than a defined contribution scheme (see page 5, *What 100% investment risk can mean*).

In the case of a **cash balance scheme**, a defined benefit, expressed as a lump sum, is delivered at retirement, often related to earnings. The cash balance is used to buy an annuity on retirement. This type of scheme protects the member from inflation and investment risk pre-retirement, but leaves them with the annuity / mortality risk.

Such schemes can be designed so employer contributions are 10% and employee contributions averaging 5%, with perhaps lower contributions at a younger age (when other financial commitments may be high) and higher contributions for those nearer retirement. For members, both schemes generally overcome criticisms of final salary schemes that these disadvantage early leavers whilst favouring senior executives attracting high salaries towards the end of their career.

Other types of hybrid scheme are also being considered by employers. Some blend defined contribution and risk-sharing features, whilst others might target (without any promise) an earnings related pension and adjust employer contributions through a defined contribution scheme to try to hit the target. Given the current regulatory imbalance, defined contribution

arrangements may often win a finely balanced argument, even though members may be left more exposed as a result.

For employers prepared to offer risk-sharing schemes, mortality risk – given the inevitable uncertainty over future projections – is a growing and major worry in terms of the scale of forward liabilities being taken on. Equally, regulatory risk remains high for the employer in that these schemes fall under the more rigorous regulation of defined benefit schemes. **Hence to encourage the development of these types of schemes, it is of great importance that the employer's risk is reduced by acceptance of the three 'key' legislative changes proposed (see page 3, *Three essential changes in pensions legislation*).**

tax relief

Should the Government accept one of the tax options posed by the Pensions Commission (to grant greater tax relief to the member on contributions or a reduction in NI contributions if NPSS does not offer a tax-free lump sum), then it would be logical to allow other pension schemes the same option.

the final word...

And what would Lord Turner say – the advocate of the 100% pure defined contribution NPSS? We leave the last words to him from his 2003 speech to the Actuarial Profession:

*‘The big problem with DC schemes is the irrational volatility of return. And it would be possible to construct part DB part DC contracts which remove **that** risk from the individual to the corporate but leave the other two risks with the individual. It would be possible to structure pension contracts which assure workers a proportion of average salary rather than final salary, and which promise it at a retirement age not precisely fixed in advance. We **could** write a formula which said “the retirement age in the scheme is currently X, but this will increase each five years by two thirds of any increase in forecast life expectancy at 65 calculated by GAD”. And if we did create such contracts we would remove the inflexibility of DB schemes in the face of rising life expectancy, remove a significant element of risk, and make it easier to create incentives for later retirement.*

And I suggest we should be encouraging employers, and actuaries should encourage employers, to think of these intermediate approaches, or of other varieties of intermediate or hybrid risk-sharing approach. Because if we do not think of these intermediate approaches, the alternative is almost bound to be a continuation of the shift to DC pure and simple.’

(Extract from Lord Turner’s speech to the Actuarial Profession on *The Macro-economics of Pensions*, 2 September 2003.)

Need we say more?

WHAT 100% INVESTMENT RISK CAN MEAN

Placing 100% investment and longevity risk with individuals (which is what NPSS will do) could be high-risk for Government. An auto-enrolled scheme is likely to be seen as one ‘backed’ by the Government, whatever Ministers might plead.

The ACA questions the indicative target pension income suggested in the Pensions Commission Report. This suggests an NPSS pension of between 15% to 18% of earnings for the median earner (after a fairly full working life). Our own calculations suggest that this range of outcomes is far too narrow, bearing in mind this anticipates equity investment returns for the majority of the working lifetime. NPSS also envisages ‘life-styling’ the investment and longevity choice, which means lower NPSS returns in say the ten years prior to retirement. The outcome could be considerably lower (and certainly more volatile) than suggested.

Indeed, falls in equity markets could well result in negative real returns for those retiring at particular times.

Recent experience shows how fund values, annuity rates and the pension delivered can change over just a few years.

Based on a man contributing £200 per month for 20 years in an average with profits policy

Maturity Date	Fund value at retirement	Annuity rate per £1000	Pension annuity amount (pa)
January 1996	£287,413	79.14	£22,706
January 1998	£263,716	66.16	£17,407
January 2000	£242,842	59.47	£14,402
January 2002	£206,501	56.70	£11,669
January 2004	£148,725	44.60	£6,593
January 2006	£121,452	41.20	£4,964

Source: Watson Wyatt Worldwide and the annual survey of with-profit pensions published by *Money Management* magazine. The picture remains much the same if mixed (managed) funds are used instead of with-profits.

Simply put, due to 100% investment risk being placed on members, would an 80% reduction in pensions via an auto-enrolled NPSS not raise a major political risk to Government if such wide variations emerge over a relatively short period?



How should the proposed NPSS or an alternative be run?

You takes your choice: The ins and outs of a new national pension scheme

the NPSS proposals: in brief

Because of low private pension coverage (and its cost) beyond the State scheme and mounting evidence of a decline in occupational provision, the Pensions Commission's second and final report has recommended that a **National Pension Savings Scheme (NPSS)** should be introduced from 2010. The main features of the proposal are:

auto-enrolment: employees at all UK firms would be auto-enrolled into either NPSS or an equivalent (or better) established employer's pension scheme from 2010. The proposals are not clear whether auto-enrolment would be for new entrants only at that date, but periodic offers to join the scheme are recommended every 5 years. Employees would, however, be able to opt out from NPSS or the employer's scheme. NPSS would also be open to the self-employed and those not in paid work.

defined contribution: as designed by the Pensions Commission, NPSS would be open to all employees aged 21 or over. It would be a defined contribution scheme with default level contributions set at 8% of

earnings on income between approximately £5,000 pa and £33,000 pa, made up of a 4% contribution from employees, 1% from tax relief / tax credit and 3% from a compulsory employer's contribution.

The contribution limits would be twice the default level of contributions. Employers that offer a scheme at least as good as NPSS would be able to opt out of NPSS, but must offer NPSS to any employees excluded from the company scheme who would otherwise be eligible to join NPSS.

investment options: NPSS would bulk negotiate a range of 6-10 funds with the fund management / insurance industry, including a default lifestyle fund. The target annual management charge would be 0.3% of each individual's fund, although Lord Turner seemed to accept, when commenting on the final report, that a level of 0.5% - 0.6% was tolerable. NPSS might allow access to a wider range of funds, but these would be likely to attract higher management charges.

tax and decumulation: the tax regime and annuitisation rules would be the same as

other pension schemes. However, the Government has been encouraged by the Pensions Commission to explore the feasibility of a scheme specific tax regime, with more generous up front tax relief, but no tax-free lump sum. The NPSS might also have reserve powers to bulk negotiate annuity purchases for specific groups.

cost to employers: the Commission says the proposals would increase private employers' labour costs by around 0.6%, rising to up to 1% for smaller businesses (although options to reduce the costs for smaller firms should be applied, says the Commission).

administration: contributions would be collected by the employer via payroll deduction and transferred via a newly created Pensions Payment System (or possibly via a reformed PAYE) to the NPSS, which would be set up as a non-departmental public body. The administration of the payments system might well be out-sourced to a third-party provider.

ACA comment: *the Pensions Commission's proposal could lead to a significant increase in pension coverage in a short time-scale. We doubt, however, that the low management charges are realistic in the UK financial services sector and already one life office has said the management charge needs to be double that proposed (i.e. 0.6%). The absence of any cost to cover even basic financial advice in the proposal seems both optimistic and unrealistic. We doubt Government, given recent criticisms from the Parliamentary Ombudsman, will feel able to rely on a totally advice-free sale of NPSS (particularly given current levels of means-testing) and given auto-enrolment, which employees will surely regard as effective endorsement by Government of the NPSS.*

Whilst the centralised administration of NPSS could have advantages, recent experience of new and untried large-scale Government-led services, depending heavily on computerised systems, are not good. Establishing a new payments system for

around 4 million enterprises in the UK will be a major administrative challenge, particularly given that the main target audience will be smaller firms. This is why the Government, according to some press comments, may be considering some hybrid NPSS, utilising a central clearing house and the tried systems of the pensions industry.

The ACA also believes that NPSS could have an adverse impact on existing workplace schemes and levels of pension contributions, particularly if existing schemes are given no new flexibility or freedoms to reduce longer-term costs and liabilities. The issue of whether all existing employees are offered on 'A-Day', in 2010, the option to join a company scheme (or NPSS) is also of some significance. Clearly offering auto-enrolment to new entrants only (as opposed to all those employers who have not presently joined available company schemes) will be significantly less expensive for employers.

other models: by invitation

Following the publication of the second Pensions Commission report, *A New Pension Settlement for the Twenty-First Century*, the Pensions Minister invited other bodies to propose alternate models to that proposed by the Pensions Commission. The Minister said that alternative models would be judged on whether they achieved a radical extension of coverage, reduced management and administration charges and offered greater portability, reliability and speed of delivery. A number of organisations responded and we highlight below what we see as the key features.

Partnership Pensions: the **Association of British Insurers** has proposed Partnership Pensions as an alternative to the NPSS. This approach would avoid the establishment of a new central body and build on auto-enrolment into existing pension schemes, including stakeholders (many of which are empty shells). Auto-enrolment would be expected to significantly increase pension coverage. Employers without schemes at present would choose from a list of providers (offering a standard contract) approved by a new Retirement Income Commission, which would take on a wider standing role similar in some ways to that of the Pensions Commission. Pension contributions from employers and employees would be paid via a simple electronic system such as BACS.

Because of the insurers' and stakeholder structure already in place, it is argued that a national scheme run through these arrangements could be up and running quickly and at low cost. That said, the ABI do not believe the management charges for such a scheme can be as low as the Pensions Commission propose – probably nearer 0.6% - 0.7% pa of funds under management as opposed to the 0.3% pa targeted by the Commission.

The **Investment Management Association** has proposed a variant to the NPSS and ABI model. They broadly support the advantages of central collection and administration through NPSS, but are proposing a governance structure that is independent from Government, with 'trustees' fulfilling the 'intelligent customer' role on behalf of scheme members. The NPSS would oversee the fund choice offered and Government would set the investment goal – such as a long-term link between fund growth and wage growth.

They are recommending a spread of both investment risk within individual NPSS funds and of fund manager risk within the default fund (which most savers are expected to invest in). Thus, components of a default fund could be managed with a diverse range of assets and investment styles, and by a number of different managers (effectively, a multi-manager fund). Managers would be appointed for a minimum of 5 years. Funds would be unitised, priced daily and could be published daily. Estimated management costs are 0.5% pa, but they point out value for money should be more important.

Super Trusts: the **National Association of Pension Funds** has plotted a different strategy. It is proposing *Super Trusts* which would be run in a similar way to existing large workplace pension schemes. They would be managed on a not-for-profit basis by a board of trustees with a duty of care to members.

Super Trusts would consist of up to 20 collective, defined contribution schemes into which employees would be automatically enrolled. These trusts might be industry, affinity or geographically organised. Because there is more than one trust, it is argued that this will lead to competitive

pressures between trusts that will hold down costs and ensure value for money services.

By adopting a pooled approach to scheme investment, members would share in the performance of a basket of assets designed with growth, investment return and security in mind. In so doing, professional trustees would take the risk away from individuals of complicated investment choices that they are in many cases unable to exercise properly, certainly without advice.

Management charges have been estimated at 0.4% pa of fund value, close to the NPSS figure.

Universal Protected Pension: the **Pension Reform Group**, headed by Frank Field, proposal is quite different from the rest. The proposal sets NPSS to one side, which it views as dangerous in terms of being damaging to existing schemes. It is also critical that the Pensions Commission proposals would leave over 30% of pensioners on means-tested benefits by 2050, leading to serious dangers of mis-selling of NPSS.

Instead PRG calls for the establishment of a new funded *Universal Protected Pension (UPP)* built on top of the BSP, together delivering a defined benefit pension of around 25% of average earnings, indexed in line with earnings. The guaranteed level of pension, says PRG, would remove any fears of mis-selling that presently dog sales of top-up savings products to the lower paid. The UPP would be funded with compulsory contributions collected via the NIC Agency. Governance of the scheme would be modelled on the Monetary Policy Committee of the Bank of England, with trustees appointed by the Governor and ratified by members.

A famous TV sketch re-visited, what our characters might say today...

Cleese: 'I look down on them (Barker and Corbett) because I'll retire at 60 on two-thirds of final salary thanks to my public sector index-linked pension.'

Barker: 'I look up to him (Cleese) because he's got a pension paid by tomorrow's taxpayers come what may, whilst my private sector employer struggles to meet the increasing cost of providing a funded pension. I will be lucky to retire at 65. But I look down on him (Corbett) because my pension is still better than his.'

Corbett: 'I look up to him (Cleese) 'cos he's obviously much more important than me. He's got what I'll never 'ave. I look up to him (Barker) less 'cos his pension is a bit like mine – uncertain, because of shocks and scares. I know my place – first a 'stake-burger' pension, now a 'Nat-pss' one!'



conclusions

Overall the Secretary of State for Work & Pensions has said that the eventual reforms proposed must be based on four principles – fairness, affordability, simplicity and sustainability. Setting aside the State reforms (which are not simple), but where the Government appears to be moving in the right direction, NPSS might be judged to pass most of the tests, but to struggle in terms of fairness and affordability for some employers. In passing the simplicity test, it fails the ‘advice’ test, which most savers still need when exposed to 100% investment risk. NPSS could also pose a threat to many established schemes – the quantum of damage though is difficult to assess.

One concern is that in asking for alternative proposals, the pensions and savings industry has failed to come together and propose one simple package. Rather, the alternatives go in a number of quite different directions, which is likely to mean the

Government may see sense in either holding onto the initial recommendations made by the Pensions Commission or devising their own hybrid NPSS package that blends a national scheme with the experience and structures of the private pensions industry.

Of the alternatives, the NAPF proposals have the advantage of being built on the successful model of UK occupational provision, but it has to be asked whether the proposed *Super Trusts* might not undermine existing ‘better’ arrangements? The ABI model has the disadvantage that it appears more fragmented and, although relying on a wide range of life offices might mean quicker implementation, the Government will probably have lingering concerns about whether public trust in the life industry is as strong as it needs to be to make their proposal fly. The IMA proposal is close to the NPSS and their proposed governance structure has attractions. The PRG

alternative is probably far too revolutionary for the Government, but it does have the advantage of establishing a solid State pension (part pre-funded), largely removing the savings disincentive and mis-selling threat posed by means-tested benefits.

All the main proposals look attractive in terms of the fund management charges they have put forward, but there must be serious questions as to whether these are achievable or sustainable. Aside from the need to consider financial advice and value for money, not just rock-bottom charges, the likely regulatory burden that will be added by Whitehall and Parliament ahead of and during the passage of any Bill will probably undermine the delivery of the low figures currently touted. Indeed, the menace of over-regulation probably hangs like a dark cloud over all the proposals, waiting to pour rain on all comers!



Pension reform: which way to turn?

We need a simpler State pension sooner rather than later...

State Pensions: Simplicity is the key to future

background brief

Current state pension provision rests on a flat rate basic state pension (BSP), supplemented by the state second pension (S2P), which has both flat rate and earnings related characteristics. When S2P was first introduced (in 2002), the Government intended it to become completely flat rate once stakeholder pensions had demonstrated that they were a popular mechanism for people to make private pension saving (expected to be in 2006/7).

The Government has not acted on this intention, but S2P's design means that, unless the rules are changed, by about 2050 its accrual will have become flat rate without any need for intervention.

The BSP has been indexed in line with prices since 1980 and, although it has sometimes been increased faster than this, it has not kept pace with the growth in earnings. Even so, many people in

retirement rely on the BSP for the majority of their income, so its decline in absolute value has led to an increasing proportion of pensioners having to live below the poverty level. Current Government policy means that, for an increasing proportion of retired people, the Pensions Credit, a means tested benefit that has been indexed to earnings, will have to substitute for the inadequacy of BSP.

pensions commission: reform proposals

The Pensions Commission has proposed that, from 2010 the BSP should become indexed in line with earnings and that the rate at which S2P becomes flat rate should be escalated. Increases in the Pensions Credit would be linked to prices, so that the proportion of retired people eligible for means tested benefits would not continue to grow. Eligibility for the BSP would be changed to be based on a residency test (at present undefined) and S2P will continue to be based on the payment of National Insurance contributions.

The Pensions Commission has acknowledged that one of the reasons for the present weakness in the UK's pension provision is its complexity. Yet instead of taking the opportunity to simplify the design of state provision, its proposals just introduce a new set of complex rules for accruing entitlement to the state pension.

The reasons the Pensions Commission gives for retaining the two strands of benefit include:

1. of the various options it considered, this is the least disturbing to existing defined benefit pension arrangements;
2. merging the BSP and S2P into one benefit would be inefficient from a distributional view point; and
3. two strands enable more flexibility.

effect on existing defined benefit schemes

Retaining S2P as a separate stream allows contracting out to continue and so, the Pensions Commission believes, props up the remaining contracted out defined benefit schemes for at least a few years longer. However, the National Insurance rebate given to employers with contracted out defined benefit pension schemes is less than the cost they incur in providing alternative benefits. At the current levels of rebate, contracting out only serves the Government by getting future pension benefits off its balance sheet relatively cheaply. The proposed rebates from 2007 worsen this position.

Many private sector employers have realised this already. When defined benefit schemes

are replaced with defined contribution provision, invariably the replacement has not been contracted out. It has been more difficult to move to contracted in defined benefit provision because of the complexity in S2P's design. However, now the earnings related part of S2P is nearly mature, designing contracted in defined benefit schemes becomes much simpler, and the incentives to do so have increased in recent years.

Maintaining a contracting out structure does help the Government avoid the politically sensitive task of changing the pension arrangements of public sector employees, who increasingly constitute the bulk of those contracted out. However, reforming state

pension to meet the Government's needs as an employer seems unlikely to produce good policy, and the private sector should not be expected to pay for this in increased complexity.



distributional effects

If the full, flat rate, S2P were merged immediately into the BSP, then the larger flat rate benefit would be paid to existing pensioners, many of whom are not in immediate financial need. This would be costly, and inefficient from the perspective of targeting government expenditure. Provided S2P retains an 'accruals' basis, then changes in its structure need only benefit future generations of pensioner.

This seems a good reason to retain the distinction between the two state pensions during the transitional phase, but it does not seem to justify its retention once S2P becomes flat rate.

The Pensions Commission suggests a transitional period from 2010 to 2030 to eliminate the build up of S2P. Someone accruing benefit in 2030 may not retire for 50 years longer, so achieving a full flat rate

system will take considerably longer – the Pensions Commission suggests that it would be largely complete for those retiring in 2050.

There may be merit in shortening this period and hence the overall time-scale for transition to the new system. Whatever the period chosen, once it is complete there seems little benefit in retaining the two separate state pensions

flexibility

The Pensions Commission finds the idea of a separate BSP and S2P attractive because it would enable different eligibility criteria, different rates of uplift and different pension ages to apply to each section. Unfortunately, flexibility and simplicity rarely make good companions: expecting to provide useful flexibility via a benefit that is

likely to be fundamental to many people's retirement incomes is unrealistic. The 'flexibility' offered might serve just to make people's entitlements harder to understand, so undermining a major purpose of the reform and making it more vulnerable to Government tinkering.

The main goal for the first pillar of pension provision should be a straightforward benefit that meets the needs of most low paid individuals and enables those with slightly higher incomes to make additional savings that they can be confident are not at the disposal of HM Revenue & Customs.



conclusion

If the Government is to reform State provision, it seems a missed opportunity to leave employees to flounder in a morass of complexity, for the perceived convenience of retaining contracting out for a small group of mainly public sector employers. Instead, BSP and flat rate S2P should be put together as one benefit, with one set of eligibility criteria, at the earliest opportunity. The simplicity this would offer will not only help individuals, it should also help Government to provide the benefit successfully.

*Dr Deborah Cooper
ACA member*

***Today, we're entering the
State pension scheme...***

Pensions Commission report: Support for NPSS, but State reforms must be simpler

survey report: NPSS set to re-shape pension provision amongst smaller firms

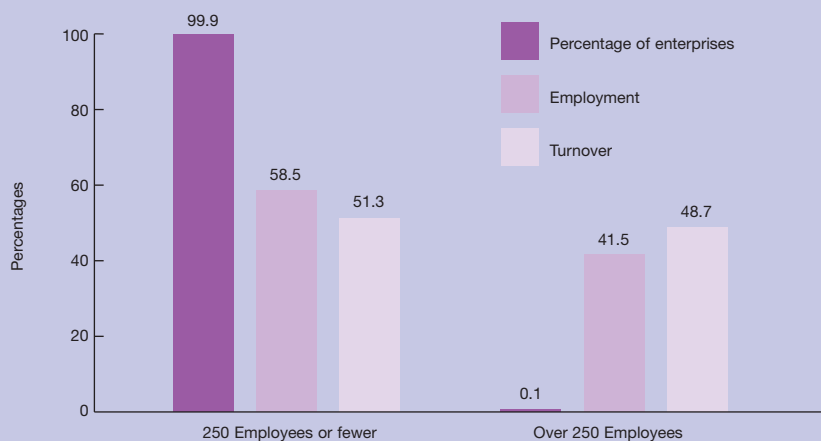
The Association of Consulting Actuaries (ACA) latest 2006 Smaller Firms Pension Survey was conducted in January and February this year. Firms employing 250 staff or less responded to a wide range of topical questions, including a special section on the second Pensions Commission report published in November 2005. This first report focuses on responses to the recommendations posed by the Pensions Commission report.

smaller firms: bigger than they look

The smaller firms sector – firms employing 250 or fewer employees – is the largest part of the UK economy. It employs over 58% of the working population (up 2 per cent on 2 years ago) and generates over half of the UK's business turnover of £2.4 billion (DTI figures: August 2005). These smaller firms make up 99% of UK enterprises – there are only 6,000 businesses including public corporations and nationalised bodies

that now employ over 250 people. The importance of pension trends in the smaller firms sector is therefore clear in terms of the coverage of employees and the potential of some of these firms to be the larger firms of the future. It is also a key market where the success of the proposed National Pension Savings Scheme (NPSS) will be most tested.

Figure 1: Share of businesses, employment and turnover (by size of business)



(Source: DTI Small and Medium sized Enterprise Statistics, 2005)



Incentives as well as auto-enrolment will be needed to boost pension provision in smaller firms

background to survey: signs pension provision is weakening

This is the fifth *Smaller Firms Pensions Survey* the ACA has conducted since 1996. The survey attracted 462 responses from firms to a questionnaire issued in January 2006. Of those responding to the survey:

- Just under a fifth employ 50 people or fewer, over half employ between 51 - 150 employees and a quarter between 151 to 250 employees.
- The firms covered by the survey are active across a wide range of sectors, with the largest groupings being manufacturing, engineering, retail, logistics, hi-tech and business / financial services

Whilst the majority of firms responding to this survey offer pension schemes, employees in smaller firms are not generally well covered by pension arrangements. And, where pensions are provided, take up is often poor. The *2004 General Household Survey*, for example, found that only 49% of full-time men (and 55% of women) working in establishments employing 25-99 people are members of workplace schemes, down from 52% and 60%, respectively, in 2002. Over 20% of employees in this size of firm have not joined schemes and over 25% say they do not work for employers who offer a scheme. Workplace pension coverage in firms employing fewer than 25 staff falls well

below 40%, with over half of employees saying no scheme is available.

Firms responding to the ACA survey predominantly rely on Group Personal Pension (GPP) and Stakeholder offerings. Whilst just over a fifth of the generally larger firms in the sector offer defined benefit schemes, 74% are closed to new entrants and 41% to new accruals. There is also evidence of closures of both GPPs and trust-based defined contribution schemes in favour of lower-cost (and lower coverage) Stakeholder plans. This is a worrying leveling-down, where provision is already weak, ahead of any impact from further reforms such as NPSS.

Figure 2: Types of pension arrangements offered by respondents

Type of pension scheme	Percentage of firms with type of schemes	Percentage closed to new entrants	Percentage closed to new entrants and future accruals	Average scheme with membership (of eligible employees)
Group personal pension scheme	45%	9%		61%
Stakeholder scheme	43%			22%
Defined benefit scheme	22%	74%	41%	63%
Defined contribution occupational scheme	18%	24%	7%	60%
Mixed defined benefit / defined contribution.	2%	40%		77%
Career average scheme	1%			NA
Industry-wide scheme	1%	25%		83%

Firms that offer pension schemes in the sector generally do so because they consider it their responsibility as an employer to make adequate arrangements for their employees. Smaller firms, however (under 50 employees) say offering a scheme to gain competitive advantage in attracting skilled staff is of greater importance.

Firms that do not offer workplace pension schemes placed 'cost' as the key reason, ahead of employees' preference for non-pension benefits. Many also said that there were insufficient competitive pressures to justify offering a scheme.

These reasons are mirrored in the three main reason given by firms as to why individuals do not join schemes, where these are available.

Figure 3A: 'Top 5' reasons why firms do not provide a pension scheme and / or an employer's contribution to a stakeholder scheme

Ranked order	
1	Cost – cannot afford employer contributions
2	Employees prefer non-pension benefits
3	There are insufficient competitive pressures to justify scheme
4	Cost – have had to withdraw employer contributions
5	Scheme inappropriate due to staff turnover

Figure 3B: 'Top 5' reasons why firms think individuals do not join the firm's existing pension scheme

Ranked Order	
1	Cost – employees cannot afford
2	Employees prefer to spend income
3	Lack of interest
4	Employees don't trust financial services industry
5	Have own personal pension

pension contributions: most schemes little better than NPSS

With the exception of defined benefit schemes, where combined employer and employee contributions have increased to around 24% of earnings, most of the open defined contribution schemes in the sector are receiving combined contributions of between 9 - 10%. This is a slight improvement on average contributions

recorded in 2004. Nevertheless, the joint contributions are often barely above the proposed NPSS default level and this may explain why so many smaller firms, elsewhere in the survey, rate their own scheme as not equivalent to NPSS. Stakeholder contributions on average fall below 7% of earnings, with still many

schemes receiving no employer contribution.

If NPSS encourages higher take-up rates of workplace schemes, then the pension costs of many smaller firms will increase, or schemes – as we comment later – may be revised or abandoned.

Figure 4: Average of contributions paid into pension scheme (as a percentage of total earnings)

(Source: ACA 2004 and 2006 Smaller Firms Survey)

Average employer contributions	2003	2004	2005	2006	Longer-term
Defined benefit scheme	13.8%	15.5%	15.6%	17.7%	16.3%
Defined contribution scheme	5.7%	5.8%	6.0%	6.1%	NA
Group Personal Pension	NA	NA	5.4%	5.5%	NA
Stakeholder scheme	2.2%	2.4%	3.2%	3.3%	NA

Average employee contributions	2003	2004	2005	2006	Longer-term
Defined benefit scheme	5.1%	5.5%	5.8%	6.1%	7.4%
Defined contribution scheme	4.1%	4.1%	4.1%	4.2%	NA
Group Personal Pension	NA	NA	3.2%	3.7%	NA
Stakeholder scheme	2.4%	2.4%	3.1%	3.1%	NA

Average combined employer and employee contributions	2003	2004	2005	2006	Longer-term
Defined benefit scheme	18.9%	21.0%	21.4%	23.8%	23.7%
Defined contribution scheme	9.8%	9.9%	10.1%	10.3%	NA
Group Personal Pension	NA	NA	8.6%	9.2%	NA
Stakeholder scheme	4.6%	4.8%	6.3%	6.4%	NA

national pension savings scheme: support, but...

The good news for Lord Turner and his team is that firms are generally much more supportive of the NPSS recommendation than they are opposed. Only 17% of firms actively oppose the proposal, rising to 30% of the smallest firms employing fewer than 50 people.

Only half of the firms responding to the survey say their firm's scheme is equivalent to NPSS. Of those saying their scheme is not as good, a third say this is because of restrictions in eligibility rules, with 80% saying their contribution levels (taking into account charges) fall below NPSS levels.

Figure 5: The National Pension Savings Scheme is likely to impact on pension strategy at almost all firms. Overall, how do firms react to this proposal?

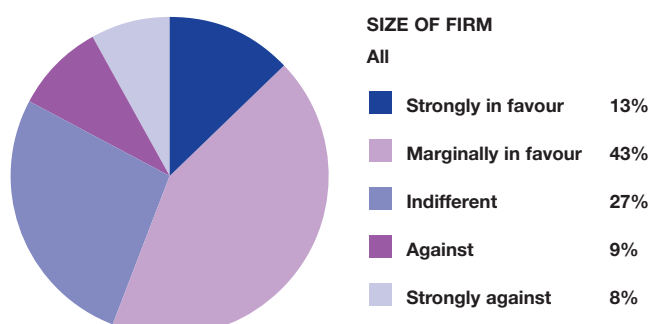
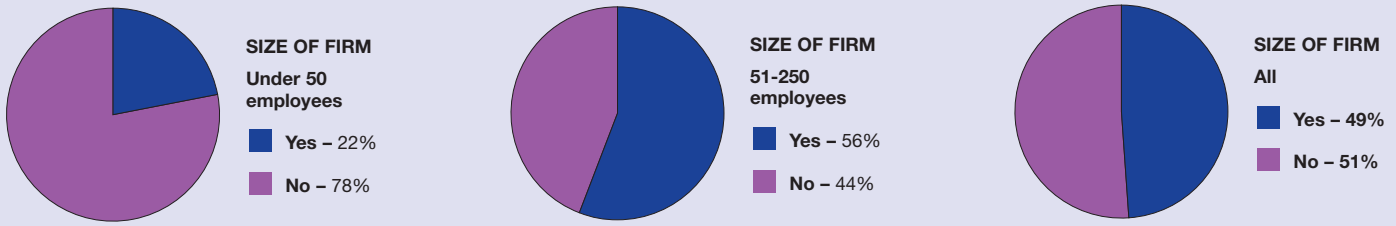
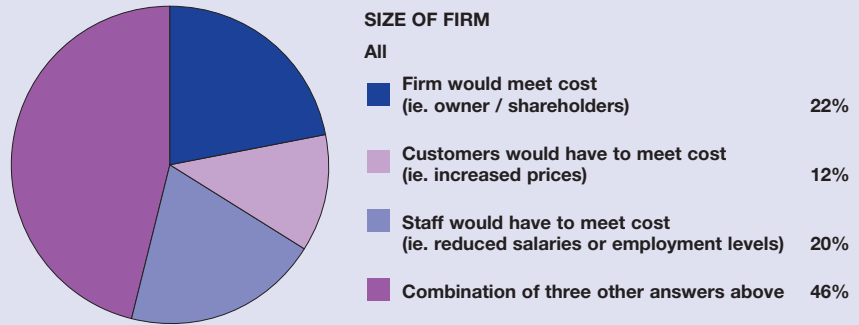


Figure 6: Percentage of firms with pension scheme(s) that offer for all employees over age 21 a scheme that is at least as good as the proposed National Pension Savings Scheme



A fifth of firms say that if NPSS adds to costs, then this will have to be met by reducing salaries or employment levels. The largest group, however, would look to share costs between the firm, customers and staff. The Pensions Commission report recognises that the costs of NPSS falling on smaller firms may be higher than larger concerns and it seems likely there may be financial concessions proposed by Government to smooth the introduction of NPSS into smaller firms.

Figure 7: If the NPSS goes ahead, and this led to an increase in costs, how do firms expect to meet the extra cost?



auto-enrolment: quarter of firms will revise schemes to reduce costs or will abandon them

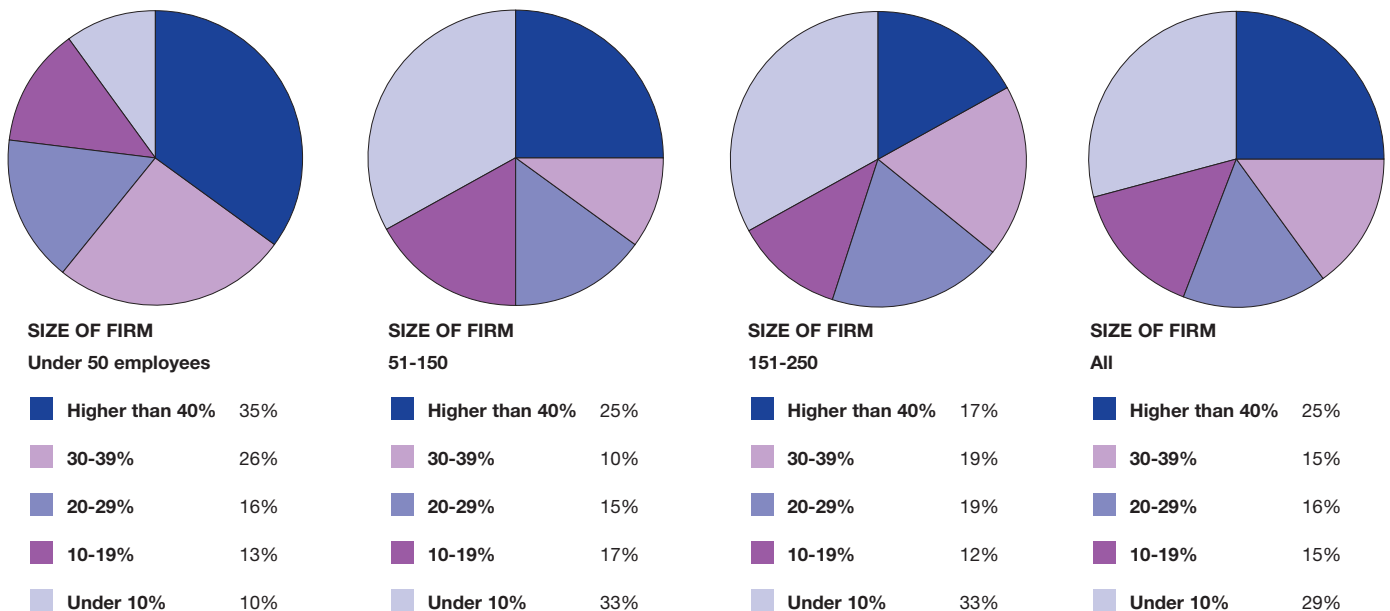
Presently, only 12% of firms in this sector auto-enrol employees into their pension scheme, with on average 38% of employees either not joining schemes or actively opting out.

If auto-enrolment is required in the future as proposed by the Pensions Commission,

either into company schemes or NPSS, firms expect opt-out rates to be quite high. 40% of schemes expect opt-outs to exceed 30% of employees, with the incidence of opt-outs at this level rising to over 60% amongst the smallest firms. Whilst these levels would be a marked improvement on

current take-up rates, it would be disappointing if these levels of opt-outs were exceeded. Much will depend on the confidence employees have in the new scheme and whether it is viewed as a welcome simplification.

Figure 8: If auto-enrolment is introduced from 2010, how many employees are expected to opt-out?



Perhaps more worrying is the likelihood that 16% of schemes would look to revise their scheme to mitigate against the higher cost

of a greater number of members. A further 9% say they would abandon their scheme in favour of NPSS, presumably on the basis

that their scheme is presently either only marginally better or worse than the proposed NPSS default contributions.

Figure 9: If auto-enrolment is required by Government from 2010, what will be the likely response of firms?

	Yes
In 2010, we would probably opt-in all employees to the firm's existing defined contribution scheme	34%
In 2010, we would probably seek to offer the NPSS only to those that have not already joined the firm's scheme(s)	29%
By 2010, we would probably revise the firm's scheme(s) to mitigate against the increased cost of higher scheme membership post-2010	16%
By 2010, we would probably close our firm's scheme(s) so all employees would then opt-in to the NPSS	9%
We have no firm's scheme, so in 2010 we would opt all employees into the NPSS	8%
In 2010, we would probably opt-in all employees to the firm's existing defined benefit scheme	4%

state pensions: greater simplicity needed

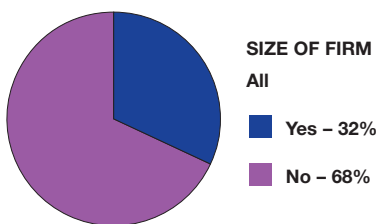
The acceptance of the need for later retirement would appear not to be as widely accepted as the Pensions Commission might like amongst smaller firms. Only 56% of firms responding to the survey think that because of greater longevity, retirement ages should rise, with the smallest firms split 50:50 on the issue. This is underscored by the view they have that 71% of their employees do not feel

retirement ages should rise, albeit that a majority (56 per cent) accept that a later State Retirement Age (SRA) is inevitable. However, here again, the smallest firms oppose a later SRA by 3:1.

On State pension reform, 81% of firms are clear that employees do not generally understand the present system, but the reforms proposed by the Pensions

Commission, which would retain the State Second Pension, with this evolving into a flat-rate payment by closing the gap between the highest and lowest qualifying earnings, is judged to be too complex by 61% of firms (and 73% of the smallest firms). Worse still 68% do not feel the reforms will create the clear incentives and understandable base on which private savings can be built.

Figure 10: Overall, do firms believe that the proposed Pensions Commission structure will create clear incentives and an understandable base on which private saving can be built?



Under the Pensions Commission's proposal, in 2050, still close to 30% of pensioners will be in receipt of means-tested benefits. This is as opposed to close to 40% today and 70% if there were no policy changes. 80% of firms say that retaining this level of means-testing is too high and will continue to discourage private saving. A clear majority support further work being

undertaken to explore a simpler State pension through the consolidation of the Basic State Pension and S2P, with a majority supporting indexation linked to earnings. However, underscoring the Chancellor's 'affordability' message, close to half of those supporting this consolidated State pension would only support the change if it did not lead to higher costs or taxes.

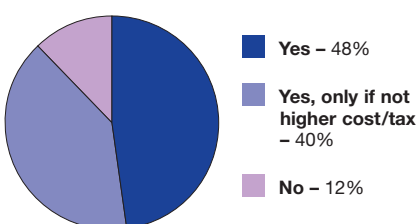
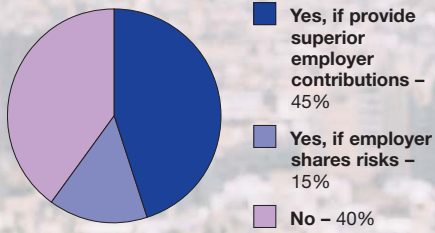


Figure 11: Do firms think more work should be undertaken to explore the idea of a consolidated State pension before a final decision is taken on State pension reform, even if this might lead to a higher cost and higher tax solution?

Figure 12: Would firms prefer to see contracting-out replaced in the future by a direct financial incentive from government to employers who provide a superior workplace pension to NPSS?



A majority of firms (58%) with defined benefit schemes no longer believe contracting-out is a valuable incentive supporting the continuation of their scheme (the survey pre-dated the most recent announcement of rebates to apply from

April 2007). A majority would prefer that the rebate is replaced by a direct financial incentive from Government to employers who offer a scheme that is superior to NPSS.

public sector pensions: government should set an example

A majority of firms say the Government should set an example by raising public sector retirement ages for existing employees as and when changes in State Retirement Age take place.

Figure 13: How do you believe the Government should approach the retirement of its own employees?

