



The Actuarial Profession

making financial sense of the future

consultation response

THE RESPONSE OF THE ACTUARIAL PROFESSION
TO THE HOUSE OF COMMONS SELECT COMMITTEE
INQUIRY INTO PENSIONS REFORM

Responses to the Committee's questions

30 March 2006

RESPONSE FROM THE ACTUARIAL PROFESSION TO THE SELECT COMMITTEE ON WORK AND PENSIONS INQUIRY INTO PENSIONS REFORM

Summary of points:

- The Pensions Commission proposals introduce more complexity into the retirement savings arena, and it is not certain that the advantages of their proposed reforms merit this;
- Any reform must be sensitive to existing retirement saving, particularly occupational provision, and not undermine it;
- If a quasi-compulsory savings scheme is to be introduced, state retirement provision must be such that it does not devalue that saving.
- There needs to be clarity about the purpose of the state pension.

Whether the proposal for an NPSS is the right way forward and, if so, how it should work.

Auto-enrolment appears an attractive way of getting people to save 'voluntarily' and features of the NPSS appear attractive, for example extending access to employer savings to all employees. Its structure effectively imposes a consistent level of employee/employer saving across most income groups and all ages. However, appropriate levels of saving differ for different people, and at different times of people's lives, and auto enrolment could prove expensive for employers. It is not obvious that providing additional employee remuneration through pension saving, rather than some other medium, is optimal for employees, or for their employer. The actuarial profession believes a lot more thought needs to be put into considering the correct balance between immediate and deferred pay, particularly for low to medium earners.

Setting to one side whether the proposal for quasi-compulsory additional saving, in addition to what the state already provides, is reasonable, several bodies have put forward alternative mechanisms to the NPSS, such as the ABI's 'partnership pensions' and the NAPF's 'super trusts'. Apart from preferring not to add to the existing complex mix of savings products by establishing a new structure for collecting contributions (which the NPSS clearly would, although there might be some attractions due to economies of scale) the actuarial profession has no decided preference. We believe that it is more important that the context in which any additional level of quasi-compulsory saving is introduced is appropriate.

The 'context' is the level of state provision that would underpin the additional saving, and the alternative private provision that might continue to be available.

Unless the proposals the Pensions Commission has made regarding the level of pension the state targets (although not necessarily the approach it suggested for achieving this) are adopted in conjunction with the relative reduction in means tested benefits, the merits of any additional saving will be doubtful for a large proportion of the population at whom the Pensions Commission's proposals are targeted.

There are also risks that the reducing coverage of defined benefit occupational provision will accelerate, if the NPSS or similar system is introduced. This is most likely to affect middle income employees, since higher paid people will be able to argue more convincingly that the NPSS is not targeted at them. To avoid this decline in occupational provision, the existing incentives for employers to provide occupational pension schemes need at least to be maintained and, in some regards, strengthened.

The impact of saving behaviour on the reforms and of the existing incentives (such as tax relief).

It is difficult to determine whether imposing or incentivising a particular form of saving leads to new saving, or just replaces other saving that would have taken place in any case. It seems to be possible to find evidence that supports either view. So, rather than making the macro effects of the NPSS a major consideration, the impact on individuals should be the prime concern.

It is not clear that making employees and employers pay into a pension will make those employees intrinsically better off. There are periods when people should not save into such an illiquid medium as pension savings, because it could increase the risk that they will incur debt in the future. To maintain the integrity of a quasi-compulsory system of saving, it must be clear that contributors are getting reasonable value from their savings. Unless the relative values of the Pension Credit and state provision are revised, as the Pensions Commission has proposed, this will not be obvious.

Providing tax relief and incentives, relative to those available to other forms of saving, will make it easier for the 'value for money' argument to be made. However, if the system is viewed as 'compulsory' then people might argue that 'incentives' are not necessary, so this form of saving clearly faces a political risk that existing incentives will not be maintained. This, in turn, could undermine the justification for incentives for providing other forms of occupational pension provision, which would further undermine this source of employer saving.

We do not view tax relief on pension saving an 'incentive', except to the extent that other forms of saving are more heavily taxed, since to some extent tax is not relieved, it is deferred. The exception arises due to the tax free lump sum, which clearly distorts this relationship and necessitates a lot of complex and otherwise unnecessary legislation to protect HM Revenue & Customs from loss. The only incentive for the employer is the reduction in their National Insurance contributions bill, since employer pension contributions are not subject to these. This is a valuable incentive that we believe should be maintained.

The future of employers in pension provision and the impact on this of proposals for reform.

The NPSS, or similar arrangement, would give more people a chance to participate in employer savings. However, there is a risk that those employees who already have access to occupational pension provision will see a reduction in the benefit provided.

Although there are weaknesses in occupational provision, it has contributed to the real increase in average pensioner incomes over the past two decades. If this were further undermined, it is not only the more affluent who are likely to lose access to schemes.

Employers who provide occupational pensions sometimes perceive themselves to be at a disadvantage to their competitors since it is often unclear that employees appreciate the value of the benefit being provided. Those with defined benefit provision also have to carry the risks of underfunding, which are also not understood by employees. These forms of provision could be shored up by providing additional incentives, via mechanisms such as corporation tax, for example.

Employers who voluntarily make pension provision at present will feel particularly beleaguered – as well as having to deal with the costs imposed by past and present legislation, they are having additional real and implicit tax charges loaded on them. Real charges include the PPF levy, changes to the tax treatment of special contributions, and the low level of the contracting out rebate; implicit charges include the requirement for increased consultation with employees and compliance costs associated with new legislation. This is not a good environment in which to encourage employers to remain, or new employers to join, in the market for occupational savings.

Proposals for reform of the state pension system.

The proposals for the state pension do not meet the Commission's (and the DWP's) criteria of simplicity. However, we believe that the target level for someone with full entitlement on median pay will provide a modest but adequate level of income, which is an important condition for sustainability.

On balance, we would prefer a single-tier system rather than a two-tier system, with contracting out phased out gradually.

However, if there is to be fundamental reform to state pension provision then, before considering managerial aspects around its delivery, there should be debate on why the state provides a retirement pension and what it is intended to achieve. For example, is it intended to provide an adequate level of income for everyone older than some age, which is selected because a significant proportion of the population consider it reasonable to reduce or stop

working at that age; or is it an insurance against poverty at extreme old age. If a consensus could be reached on this high level principle, then it might be easier to reach a sustainable solution to the means by which the benefit is provided.

Whether, when and by how much the SPA should be increased.

State pension age should not just be a function of demography. The choice of retiring early on a modest level of income is just as valuable for some people as being able to retire later, but with a higher pension. However, SPA is more than just a time at which people retire – it also triggers a change in eligibility from one form of welfare, which is work related, to another, which is retirement related. It is important that the criteria that trigger this change in eligibility are chosen wisely – for example, there must be appropriate and adequate opportunities in paid employment for people aged less than the state pension age and eligibility for other social benefits for those who are not able to take advantage of them.

Measures to facilitate later working and flexible retirement.

For it to be possible for people to save for a comfortable retirement, as people live longer it is clearly necessary for them to work longer. However, longer working lives require individuals to be adaptable to changes in the working environment and able to take advantage of different sorts of working opportunities as they arise. Not everyone will have this degree of flexibility and it is likely to be those in the least advantaged social groups who have the most constrained choices. As with an increased SPA, policies for later and more flexible working need to be designed with these groups in mind.

The impact of reform proposals on the pension income of different groups, including the self-employed and those currently at particular risk of being 'under-pensioned', such as women, disabled people, ethnic minorities and people with varied work patterns.

A DWP report has said that men's and women's entitlement to state pension is expected to converge over the next two decades. Although there are still some weaknesses in the eligibility criteria for state pension, most of the 'under pensioned' are so because of the work status – that is, they are 'under paid'. Since pension accrual over and above the basic state pension and first tranche of S2P is a function of pay, their 'under pension' is a function of this.

It would be a mistake to design a pay related pension system to address inequalities in pay, because this will necessarily lead to further inequalities.

Whether proposals for reform adequately address inequalities in pension provision.

Based on our knowledge of scheme design and the conclusions of the DWP report, we believe that concerns about 'inequalities in pension provision' are overstated. However, we do agree that there are inequalities in employee remuneration that lead through into unequal pension outcomes. The Government can address this to some extent via eligibility to, and the design of, state provision. However, pension outcomes will always be unequal, so long as there are inequalities in the workplace.

