



The Actuarial Profession

making financial sense of the future

consultation response

Pensions Commission Report:
Pensions: challenges and choices

Response from the Actuarial Profession

February 2005

**PENSIONS COMMISSION – *PENSIONS: CHALLENGES
AND CHOICES***

RESPONSE FROM THE ACTUARIAL PROFESSION

Address for correspondence:
Martin Hewitt
Social Policy Programme Manager
The Actuarial Profession
Staple Inn
Holborn, London
WC1V 7QJ

Tel: 020 7632 2185

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Introduction

The Actuarial Profession welcomes the Pensions Commission's Report as a thorough and thoughtful review of the current situation with pension provision in the United Kingdom.

We welcome the opportunity to engage in discussion as to the best way forward for retirement provision in the UK, as we have with previous consultations into this sensitive area. Our response follows the guidelines set out in Chapter 9 of the report, starting with comments on the opening sections of Chapter 4. We have not responded to all the questions asked by the Commission, but concentrated on those where we hope we can add most value.¹

The Commission's 'philosophical' question

What should be the role of government in pensions? Should it be limited to poverty prevention and to making well-informed choice possible? Or should government seek to ensure that people up to some level of income have made provision that they will consider adequate: and if so what level?

The Actuarial Profession's position on state pensions is driven by the observation that what the private sector does, or is prepared to do, depends heavily on what the state provides. There are certain conditions we believe are necessary for a strong and healthy private sector, although we concede that they might not be sufficient.

1. State pension provision needs to be considerably simplified. The system at the moment, with several different potential sources of state pension income, each with different eligibility conditions, makes it difficult for individuals or their employers to plan an integrated system of benefits.
2. The role that means tested provision, in particular the Pension Credit, now plays in retirement incomes creates further difficulties, primarily for those on low incomes, but also for employers considering how best to remunerate those on low incomes. We agree with the government that the Pension Credit has helped improve the situation for people who are currently in retirement and on low pensions, who have opted to claim benefit. However, it sends conflicting messages to those of working age and will do so increasingly, as increases in the Guarantee Credit are linked to earnings, whilst state pensions are only indexed in line with prices.
3. Government should aim to make provision for people over state pension age that will be coherent and sustainable over the long term. This should enable

¹ Some of the questions asked by the Commission were also asked by a House of Lords select committee in 2003. Here is a link to the Actuarial Profession's submission to that committee: 'A submission from the Actuarial Profession to the House of Lords Select Committee on Economic Affairs Inquiry into aspects of the economics of an ageing population', http://www.actuaries.org.uk/files/pdf/ageing_pop/HoLageingpop_resp.pdf

individuals and employers to be more confident that their private provision is appropriate.

4. Thus, we believe that:

- The government should ensure that state retirement provision is as simple and secure as possible. To this end, it should ensure that 'as of right' retirement benefit is the 'headline' benefit and that means tested benefits act only as a safety net for the small number of people whom the state pension's eligibility rules fail to include adequately.
- One possible way to simplify the state pension would be to replace the basic state pension and state second pension (S2P) with a combined pension, set at a level that would ensure that everyone could meet at least their basic needs without a high degree of certainty. There is, in any case, provision in legislation for S2P to become flat rate and to have two, low level and flat rate benefits with different eligibility and indexation rules seems absurd. Many organisations have suggested ways the two pensions could be combined, partly financed via an increased state pension age. The Actuarial Profession has no centrally agreed view on this. However, we would support a consultation into how such a revised pension could be afforded and agree that raising state pension age is one, obvious, approach.
- If the state provides a simple and adequate level of benefit, then we do not believe it is necessary to impose additional, compulsory, saving on people of working age. Thus, compulsion should stop at the level of the tax or National Insurance required to finance the state pension.
- The government can use existing incentives to encourage further private saving for retirement, including tax deferral and employer national insurance relief. It should also encourage increased financial literacy and appropriate regulation of the financial services industry. Then those people who would like to afford more than basic goods during their retirement should be able to make relatively secure saving, certain that they will not have to share some of their investment gains with the government, via regressive marginal tax rates imposed by means testing.

The Commission's specific questions

What should be the balance of responses to the demographic changes described in Chapters 1 and 2?

The Commission has proposed four possible options:

- Poorer pensioners
- Higher tax
- Higher saving
- Later retirement ages.

The Actuarial Profession would be uncomfortable with any policy predicated on the belief that pensioners (as a class) should become poorer relative to the rest of society. However, those people reaching retirement age more recently are better off than

previous generations. Although pensioners are still over-represented in the bottom two quintiles of the income distribution, they are no longer the group most disproportionately represented in that area. The report *Households Below Average Incomes 1994/5-2002/3*,² published by the DWP, indicates that this unfortunate status now falls to single parents and those of working age outside the workforce. Both higher tax and higher compulsory saving will disadvantage these two groups, which also seems an undesirable policy consequence.

Thus, the Actuarial Profession does not believe that higher voluntary savings or taxes is either necessary or desirable amongst some groups. We will not rehearse the macro economic arguments that question whether increased saving can lead to greater overall prosperity in retirement, but we broadly agree with the conclusions you reached in your lecture to the Profession in September 2003.

We do believe that a higher average retirement age is a policy objective that should be pursued and expect that Age Discrimination legislation, due for 2006, will contribute to this. Even at the individual level, higher saving will not always increase benefits proportionately and the flexibility to defer retirement can enable employees to manage this to suit their individual circumstances. Increased ageing in the workforce and higher reliance in defined contribution benefits are likely to induce this behaviour naturally.

As well as encouraging employees and employers to consider later retirement ages, we would encourage the government to review the state pension age as well. In some ways, the ability to spend longer in retirement could be viewed as a measure of increasing affluence in our society. The paper 'W(h)ither State Pension Age' discusses these sorts of issues.³ However, if there is no upward adjustment to the age at which retirement starts, then this affluence is not being shared equitably between those in retirement and those still in work. Given the increase in healthy life-spans, and the reference above to DWP research, it seems unreasonable for people of working age to have to pay extra tax to support longer periods in receipt of state pension without the consequences, and any other options, first being explored.

Data does show that life expectancy is greater for those in higher social classes, and state pension age, as the trigger for payment of state retirement benefits, is of most relevance to those in lower social classes. However, this has always been the case. All social classes have experienced some increased longevity, so we do not believe it is a strong enough argument to excuse the government from giving serious consideration to the problem.

The government could influence behaviour by increasing state pension age (albeit gradually) and tying the increase to initiatives to improve financial literacy. It could also help, although probably only to a limited extent, by keeping tax and benefit incentives similar, regardless of age, rather than applying differential rates as at present.

² <http://www.dwp.gov.uk/asd/hbai/hbai2003/chapters.asp>. This document was not referenced in the Pensions Commission's report.

³ W(h)ither State Pension Age, SIAS paper, June 2003, <http://www.sias.org.uk/papers/whitherSPA.pdf>

The Commission asks the subsidiary question, ‘How far should government or society in general have a point of view on this trade-off versus leaving it to individuals to make their choice?’

We believe that, once government has intervened to ensure that all people over a certain age will be adequately provided for, the level of intervention in people’s decisions should be lower. However, clearly there is a role for government to determine:

- The point at which the government should start to provide its ‘adequate’ state pension
- What is ‘adequate’?

These judgements could be left directly to government, via parliament and the ‘democratic process’, to determine. As with any form of democracy, this leaves the risk that interest groups can dominate the decision so that ultimately it is not generally perceived as ‘fair’. Consequently, some groups have suggested an ‘independent’ body, appointed by government, should be given the responsibility of determining these issues. At present the Actuarial Profession has no view either way: both are likely to face difficulties and allegations of self interest.

Is there broad agreement with the description of trends in the UK pension system set out in Chapter 3?

We start by observing that the analysis in *Households below average incomes* indicates that, by age, the group of pensioners most likely to be disproportionately represented in the lowest income quintile is those aged over 70 (and those aged over 75 are even more likely to be in this group). So the reasons for existing pensioner poverty are unlikely to be due to relatively recent shifts in occupational provision. Instead, they are likely to be due to:

- Immaturity in state earnings related provision;
- Inadequate indexation; and
- Inadequate provision for dependants.

Thus the problems are largely historic, except that personal pensions do not (and, from April 2005 occupational defined contribution pensions will not) have to be indexed. The rest of the comments in this section indicate likely patterns in future pensioner poverty.

Is the Commission’s assessment of the DB-DC shift and its implications for the future level of total contributions reasonable?

We agree with the evidence presented in the Commission’s report. The shift from defined benefit to defined contribution provision has been reported in surveys by several organisations and there is evidence that it has been associated with a reduction in the overall contribution rate being paid toward occupational pension provision. The level of contribution paid to some defined contribution arrangements is likely to be insufficient to provide the levels of pensions needed or expected by the members.

However, some employers who have changed to defined contribution (DC) provision have done so at rates that are no less than had been paid to the defined benefit scheme

replaced. Also, some employers are still committed to providing defined benefit (DB) schemes, although it seems that there is a desire to find a way of sharing the associated risk with their employees – for example, via hybrid arrangements. It is possible that, as employees become more aware of the value inherent in occupational retirement saving, more employers will be prepared to reconsider the remuneration package they offer. This would be more likely if the state pension system became clearer in the way suggested above.

What is the appropriate risk-sharing balance between the state, employers, the financial services industry and individuals? Is the large shift of risk to individuals that is currently occurring acceptable, and if not is it avoidable?

Since the 1980s there has been a shift of risk away from the state:

- To individuals via reductions in the real value (relative to earnings) of the basic state pension;
- To individuals via reductions in the benefits provided under the state earnings related pension scheme (SERPS);
- To employers providing contracted out pension schemes via reductions in SERPS, reductions in the value of the contracted out rebate, and the transfer of SERPS indexation to occupational schemes;

There has also been a shift of risk from employees to employers providing defined benefit schemes, due to heavier regulation and an increased incidence of new regulation (for example, the requirement to index deferred benefits and pensions in payment).

More recently there has been a shift of risk from employers to employees:

- By replacing defined benefit schemes with defined contribution schemes;
- By paying lower rates of contributions to the replacement DC scheme than would be required by the replaced DB scheme.

As we have said, we believe the government should provide a state pension up to a level that meets basic needs, financed through the tax and NI system – that is, we see no intrinsic need for the state pension to be pre-funded. If individuals could be certain that their basic needs in retirement would be met, then they would be better placed to take on the additional risks imposed on them due to the changing nature of private pension provision.

The Actuarial Profession does not have a view as to the level of financial risk it is reasonable for an individual to bear. The received wisdom is that some individuals (that is, the better off) are better placed to accept these risks than others, and we would not argue with this. Where people are less prepared, or more reluctant, to bear risk we expect that financial markets could develop products that can limit these risks to an acceptable level. For example, individuals can limit risk exposure by participating in risk pooling arrangements. Some insurance products (for example, annuities) are examples of this, but government and employers also offer similar opportunities.

However, risk is fundamental to the way investment markets and most developed economies operate, and can only be reduced at a cost. We are concerned that poor

financial understanding, in some cases exacerbated by poor product design, means that many savers do not understand the consequences of this 'risk/return' trade-off. The government's drive toward greater financial literacy should equip people to manage these issues more competently, but we should not expect a huge shift in behaviour. Few individuals get the opportunity to become familiar with making investment choices, as they might with purchasing other products, and so saving is always likely to present people with difficulty, particular when it is long term.

HM Treasury has recently issued a consultation document⁴ indicating that the government might also consider taking back some of the risk it has passed on to employers by raising its borrowing costs via longevity gilts. The Actuarial Profession's response to this consultation welcomed the suggestion that the government would consider issuing ultra long gilts. However, if these were to go a stage further and provide direct protection for longevity risks, we note that the government is already highly exposed to longevity risk via its unfunded pension obligations, so we are not convinced that this is a sensible additional burden for it to take on.

Is Chapter 4's assessment of the adequacy of existing and likely future provision reasonable?

Is the Commission's benchmark definition of 'adequate' income replacement sensible?

We believe that the benchmark definitions of adequate income are sensible (they are consistent with the findings of research carried out for the Profession's Social Policy Board⁵). However, we have no evidence to suggest that individuals have achieved these in the past and would prefer them to be thought of as indicating a 'satisfactory' level of income, which could enable people to continue their standard of living in retirement. 'Adequacy' has connotations of 'barely sufficient', and we do think these replacement ratios are likely to be more than barely sufficient for those on higher incomes.

Is the Commission's macro-model of likely future pension contributions and pension incomes too pessimistic or too optimistic?

The model seems adequate as far as it goes.

Once expenses are taken into account we think the net rates of the individual assumptions are probably reasonable, but as gross rates they seem slightly optimistic. The report notes that historic real equity returns in the UK have been 5.5% and goes on to say that it expects equity returns to be lower in the future. It seems odd, therefore, to select a 6% real return assumption. However, using point estimates for future investment returns is an inexact science. It is far more important to provide an indication of the variance implicit in the results, and we feel further consideration of the implications of this would considerably strengthen the Commission's analysis.

⁴ A response from the Actuarial Profession into the consultation on the issuance of ultra-long gilt instruments,

http://www.actuaries.org.uk/files/pdf/finance_invest/dmo_gilts_resp.pdf

⁵ Family Fortunes: a guide to saving for retirement, BAJ, 2002,

http://www.actuaries.org.uk/Display_Page.cgi?url=/sessional/sm0204_report.xml

The returns used for the central projections assume 60% investment in equities, so there is a high probability that the fund will under-perform (although it will also over-perform in other circumstances). Since one outcome from the Commission's final report could be increased compulsory saving in defined contribution arrangements, it is important that the effect of this is well understood. For example, whilst some market volatility can be limited by diversification, some is unavoidable, so a policy that leaves people relying for the bulk of their income on private saving could result in cohorts of poor (and other cohorts of rich) pensioners.

We have seen research (not yet published) based on historic returns that suggests that a 15% contribution to a defined contribution scheme invested half in equity and half in bonds for 20 years, would have produced replacement rates of between 10% and 65% of pay for people retiring between 1985 and 2005. The mean replacement rate was just over 30%.

This variance ignores stock selection, since the investment was assumed to be in underlying indices, but includes an estimate of variability in annuity prices, so the evidence is that cohort effects could be very strong.

Are the conclusions of Chapter 5 reasonable?

Is it agreed that housing wealth, especially via inheritance, could play a significant role in pension provision, on average and overall, but that it does not provide a sufficient solution because of the pattern of distribution of pension rights and housing assets?

We agree that those with greater housing wealth are more likely to also have better pension rights, so that housing wealth is unlikely to provide a solution to the pension crisis. We enclose a copy of a recent report completed by the Equity Release Working Party, which was sponsored by the Profession.⁶

Is there agreement that the current voluntarist system, combined with the current state system, is unlikely to deliver an acceptable solution to the problems for the reasons set out in Chapter 6?

In principle, can a voluntary system work at lower income levels?

With improved state provision and greater financial literacy, as suggested in the section on 'philosophy', we believe a voluntary system could work better at lower income levels than it does presently. Those on low incomes would be protected by an adequate consolidated state pension scheme and, provided means testing were kept at a level below the state pension, small amounts of savings could increase their income without the worry of losing other benefits.

Saving is not cost free – it results in lower levels of consumption whilst it is taking place. The level of the minimum wage seems an indication of what 'society' thinks is a reasonable floor for remuneration, and over 5% of economically active adults are estimated to be paid around its level. It seems unreasonable to expect everyone on this

⁶ Equity Release Report, Jan 2005,
http://www.actuaries.org.uk/Display_Page.cgi?url=/equity_release/equityreleasejan05.html

