



The Actuarial Profession

making financial sense of the future

consultation response

**The Actuarial Profession's response to the
White Paper, *Security in Retirement – towards
a new pensions system***

September 2006

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1 Introduction

- 1.1 The White Paper proposals are intended to address perceived failings in the current design of state retirement provision, and in particular the difficulty the Pensions Credit has caused to some people of working age in understanding whether they should save for retirement or not.
- 1.2 The White Paper suggests that this problem will be solved for someone reaching State Pension Age (SPA) in 2050 with 40 or 49 years' contributions. However, this does not help people reaching SPA before this time, those who do not have a full history of contributions, or those whose pension does not retain its value in real terms during their retirement. These are potentially huge gaps in what should be a major and comprehensive reform. We understand that retirement savings are a long term proposition and that some gaps in provision are inevitable. But it is a gamble to rely so heavily on a system that is only successful following a consistent level of long term saving that receives reliable real investment returns.

2 Five tests for reform

- 2.1 The White Paper puts forward five tests against which its proposals should be measured. None of these tests sets out what the government is trying to achieve by its pension reform. For example, does the government see its aim as providing an adequate income for people once they are no longer able to work, or does it intend to provide a subsistence income for those over a particular age, so that they need not work if they choose not to? We believe this will make it difficult to satisfy the fifth test, 'sustainability', since any consensus reached will be built around managerial issues rather than basic principles.
- 2.2 It is perhaps a bit late for the government to open this debate, but it should consider this and build its conclusions into its subsequent consultations and reports, so that all parties understand what the reforms are trying to achieve (rather than concentrating entirely on the administrative features of the reforms).

3 Reform to state pension

3.1 Contributory principle

The actuarial profession agrees with the government's decision to retain a contributory test for the basic state pension (BSP). We believe that the contributory principle strengthens the contractual element between the individual citizen and government, and introduces a notion of accrual, which could have the effect that future governments would be less inclined to reduce the value of state pensions.

An additional test would require complicated new legislation, with little gain, since it seems possible to secure a higher level of flat-rate pension sooner under the proposed arrangements. It would also add complexity to the state system without making a material difference to the benefit's ability to reach those most in need.

3.2 Flat rate pension

The government appears to have decided that the most appropriate role for the state is to provide an adequate level of flat rate state pension, rather than to attempt to provide earnings-related benefits. In that case, we believe that the current two tier

system should be amended over as short a time period as is reasonable, to provide a single level of benefits.

Having two different flat rate benefits, each with different eligibility rules, accrual rates and uprating rules just maintains complexity within the system. This places an unnecessary obstacle in the way of people being able to see easily what their entitlement to state benefit at retirement is likely to be, and consequently to their ability to plan saving sensibly.

3.3 Eligibility

One difference in the eligibility rules between BSP and S2P is that men currently have to have 49 years' history of national insurance contribution payments to be eligible for full state second pension, whereas the proposal is that the full BSP will be payable to people with 30 years' contributions. Given that home responsibility protection has been extended so that most people will have full eligibility for BSP without the reduction to 30 years (DWP research paper) we wonder what the reduction achieves, in terms of policy. For example, many high earners will stand to gain from this change, since they are likely to have short contribution histories due to further education and sabbaticals supported by employers, but we assume that this was not the government's policy intention. The Government has used home responsibility protection to allocate notional national insurance contributions on behalf of those with caring responsibilities that the Government feels it worth supporting; if there are other breaks from paid employment it believes are worth encouraging, such as additional training, then these could be supported through similar mechanisms. The 30 year rule seems to us to be a somewhat arbitrary criterion that will not necessarily benefit the most vulnerable groups.

3.4 Level of pension

The level of the combined BSP and flat rate S2P, once the changes become mature and for those with full eligibility, will be about £135 per week in real terms. This is not high, but appears to meet the estimates of several organisations (e.g. Age Concern) of what is needed to maintain a slightly better than subsistence life style. We understand that the government must find a balance between benefit amount and cost. However, it will be important that the benefit maintains its relative value in real terms over each medium term, to retain credibility.

3.5 State Pension Age

We support the proposals that the state pension age (SPA) should be increased. However the White Paper appears to accept a state pension age of 65 (maintained in 'real' terms).

The effect of this is that broadly $2/3^{\text{rd}}$ of adult life will be spent in work compared with about $1/3^{\text{rd}}$ spent in retirement. Ignoring interest and assuming for the sake of the argument that people's standard of living does not fall after SPA, a simple rule of thumb would imply we must defer $1/3^{\text{rd}}$ of our pay to provide for our retirement – a statistic that will seem fantastic to most people. When SPA was first reduced to 65, the work/retirement leisure ratio was more like 5:1. The same rule of thumb then implies a saving ratio of $1/6^{\text{th}}$ – half the level the Government is now taking for granted we should make.

Having longer and healthier lives spent in retirement does appear a desirable goal, but not if the effect is that the pension provided by the state must be so low that means tested provision becomes a significant part of people's retirement incomes.

4 **Means test**

- 4.1 The White Paper estimates that the effect of the Government's proposals will be to reverse the increase in the proportion of people eligible for means tested benefits after state pension age, resulting eventually in a fall from the high percentage (nearly 50% by the DWP's estimates, but higher according to other organisations) currently eligible to about 30%. We accept that a certain proportion of people are always likely to be eligible for means tested benefits but are concerned that the percentage will still be too high. This matters particularly because many people will only be lifted above the means tested threshold if they accept the quasi compulsory arrangements underpinning the proposed personal accounts – and are lucky enough to benefit from the necessary investment growth.
- 4.2 For these people, the effect of the personal accounts is to replace a benefit provided out of general taxation with one that they have had to pay for themselves – so the progressive tax characteristics of current benefit provision are reduced. For this exchange to be reasonable, those people affected must have confidence that they are likely to get real value from their savings. If there is a high probability that people will become eligible for means tested benefits in retirement, then the new system will suffer the same criticism as the current arrangements, and nothing will have been achieved by the reforms being proposed.
- 4.3 The level of state contributory benefit (the BSP plus S2P) is crucial for this. If it is set too low, then a larger proportion of people will risk having their quasi compulsory savings being taxed at high rates due to means tested provision, which will undermine the will for many younger people to remain opted in to the personal accounts. The government will have to balance this risk against concerns that taxpayers will not be prepared to bear the cost. However, if the reforms do not result in a reduction in the proportion of people eligible for means tested benefits then there will have been no saving via reduced eligibility for means tested benefit and, again, nothing will have been achieved.
- 4.4 Low paid employees who are already in the workforce, and those who subsequently opt out of personal accounts and so do not have a full contribution history, will almost certainly continue to be eligible for pension credit in retirement, if the proposals are introduced as set out in the White Paper. Several million people are likely to fall into this group, so it is not an insignificant risk.
- 4.5 The employer contribution is one reason why it might be worth low paid groups deciding to remain opted-in to the personal accounts. However, this contribution will only be achieved at the cost of lower pay in the medium term, since employers are likely to compensate for their compulsory contribution by adjusting pay-scales downwards. This makes it even more important that the most vulnerable can be confident that they will get good value from their decision to defer their pay via the personal accounts.
- 4.6 The tax payer is also being asked to accept a different balance of inter-generational transfer. An increasing proportion of retirement provision is expected to be delivered via the private sector, involving pre-funding and passing the immediate effects of

market risks to individual investors (although taxpayers are likely to have to pick up the pieces of market failure), rather than the current pay-as-you-go arrangements

5 **Personal accounts**

- 5.1 It is hard to comment on the likely effect of the personal accounts because there is little information about how they will be provided. However, we can say something about the proposed level of saving and the outcomes the automatic opt in and (quasi compulsory) contributions are likely to achieve.
- 5.2 Assuming people remain opted in to the personal accounts then, once the reforms are mature, those with full working histories are likely to have adequate savings to lift them above the means tested threshold. However, there will be cohort effects, for example if there are market failures so that investment returns fall dramatically or annuity costs rise. There will also be individual failures, depending on investment choices made by particular savers. The costs of these are likely to be borne by the taxpayer. Very little consideration seems to have been given to how people are going to be supported in their investment choice (and in other decisions). We hope that there will be more information when the further consultation document is published. However, we note that one of the reasons the personal accounts are so apparently cost efficient relative to personal pensions provided by insurance companies, and smaller occupational schemes, is that no allowance has been made for 'compliance costs' – that is, the need for the provider to ensure that it is appropriate for the individual to direct their savings towards the product, and that the way their contributions are applied is also suitable.
- 5.3 The White Paper and the Pensions Commission's second report devoted several pages to illustrating why the NPSS or personal accounts could be provided at lower cost than stakeholder or occupational schemes. Neither appears to have acknowledged that some of the cost of these private sector alternatives will have to be picked up by the tax payer, so that the real cost of the personal accounts is unlikely to be as low as is suggested. In this respect the government has followed the practices of the insurance companies it implicitly criticises.
- 5.4 We agree that giving individuals limited investment choices and the ability to opt out of the personal accounts if they believe that they are unsuitable, given their particular circumstances, are important and necessary features of the design. However, the difficulty of managing these choices well should not be underestimated. The limited information contained in the White Paper suggests that the Government will help advisers and employers to produce generic information that covers these areas. Our experience of trying to produce 'generic' guidance targeted at individuals, on more straightforward issues than these, has not been productive. We infer from this that either the Government views the FSA's current stance as too strict, or is just prepared to take a more relaxed stance towards personal accounts at the risk of mis-selling claims.
- 5.5 Although we have concerns about several aspects of the proposed design, administrative structure and operation of the NPSS, we will reserve comment until the subsequent consultation document is published. However, the White Paper asked several specific questions:

Would offering a choice of branded provider add value to consumers?

- This depends on how 'value' in this context is interpreted and measured. An economic argument would be that the existence of choice would introduce competition into the market and so encourage providers to attempt to attract savers, for example by demonstrating that they can provide better 'value'.
- However, as has been remarked elsewhere, this introduces marketing costs and possibly also compliance costs, thus driving down the value of the 'value'.

Would a choice of branded provider give individuals greater confidence in the system and greater ownership of their accounts?

- There is evidence that this is the case. For example, where individuals make a conscious choice to save in a particular fashion, they appear to make other choices, such as saving at a higher level or more appropriate investments, that argue they are more 'engaged' with the process. However, the 'choice' could be limited to investment medium, rather than provider, and the same effect achieved.
- A variety of gateways to the personal accounts seems desirable only from the point of view of avoiding a concentration of power amongst a narrow group.

What is the connection between type of choice and cost?

- That will depend on the compliance costs the government feels it necessary to impose.

On what basis would individuals make a choice of pension provider?

- There are several grounds, including administration costs; choice of investment funds; flexibility at retirement; quality of literature and advice.

What are the pros and cons of vertically integrated providers, offering both administration and fund management?

- We have no preference for integrated or non-integrated provision.

With multiple providers, how could charges be set in a way that encourages competition to thrive?

- Prescribed charges (such as for stakeholder) are always likely to limit competition. However, making charges as transparent as possible will help people distinguish between different providers.

Would it be possible to restrict the number of providers to the scheme to provide scale economies and drive down costs?

- Yes.

In each approach what information would individuals need?

- Regardless of the approach to provision, individuals will need advice about the choice to opt in and the investment medium for their contributions. These decisions depend on their particular family, work and financial circumstances and so will be hard to provide on a generic basis.
- They will also need to know how their contributions are being managed, what expenses are deducted, and what their choices are whilst saving, when they choose to retire or drawdown their savings, and during the drawdown phase.

- Those able to save more than the minimum will need advice about whether to save more and, if so, whether to do so via personal accounts or another product.
- If flexibility is available at retirement, then the need for advice will continue throughout the drawdown phase.
- If there are multiple providers, then people will need information about the firms, where they are regulations and the charges levied.

5.6 Several of the questions ask about the pros and cons of concentrating personal accounts in the hands of a relatively small number of providers. We have mentioned the risks of weakening any beneficial effects of market forces by restricting the administration of the accounts to a small number of hands. We would also like to point out the risk that restricting the control of people's savings to a limited number of investment managers will concentrate considerable financial power within a narrow group of people.

5.7 The White Paper does not ask any questions about how accumulated funds might be used at retirement. There is a tendency to concentrate on accumulation phase, but the need for advice at the point of retirement and consideration of whether access to flexible annuities or drawdown arrangements would be appropriate must not be ignored. Pensions can be a very rigid form of saving and consequently can act counter to people's needs, both in the accumulation and drawdown phase. We would be happy to contribute more information on these design aspects.

6 **Standing Pensions Commission**

6.1 Pension saving is a long term commitment. Once someone has made a contribution to a pension plan, or once a provider has established a plan, it is not easy to change direction. Because of this we agree that a permanent Pensions Commission is probably unnecessary. However, we do think it is important that the Government establishes a process to ensure that regular reviews of the state of retirement provision and retirement saving are carried out. For such reviews to be effective, it will be important that reliable and comprehensive data has been collected regularly, even when reviews are not underway, and it would help the industry if the Government could facilitate this.

7 **Deregulatory review**

7.1 Although there is much regulation that, with hindsight, could be improved, improving it now is not such an easy task. Some of this regulation exists to protect members, and amending it will be difficult without undermining some of that protection – a step government has understandably been very reluctant to take in the past. Perhaps the government could use its resources more effectively by giving more consideration to the new legislation it is constantly delivering, ensuring that it is simple and straightforward and with no unintended consequences, rather than tinkering with old regulations. Even where they are imperfect, there is no guarantee that the replacement will be any better.

7.2 In particular, some in the industry are lobbying for employers to have the right retrospectively to reduce members' accrued rights in some respects. We would like to highlight what in our view are significant potential dangers of any such change. Although we can see the reasoning behind such calls, our view is that any such

change would have profound implications for trust by members in their employers or their schemes and could carry huge reputational risk for government and industry alike.

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