The Actuarial Profession
making financial sense of the future

Consultation response from the Institute and Faculty of Actuaries

Department for Work and Pensions

A state pension for the 21st century

June 2011

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

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24 June 2011

State Pension Reform Consultation Team
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Dear Sirs

Actuarial Profession's consultation response to "A state pension for the 21st century"

This is a response to the Department for Work and Pensions (DWP) consultation paper "A state pension for the 21st century", April 2011.

This response is from the Institute and Faculty of Actuaries (the Institute and Faculty) which is the chartered professional body for actuaries in the UK. Its Royal Charter requires it to act in the public interest and it regulates its members consistent with that purpose.

Summary

Options for state pension reform

The Institute and Faculty believes that the public interest should be well served by making the change to the single-tier pension as described by Option 2. We think it likely that the review of scheme benefits caused by ending contracting out may hasten the reduction in defined benefit coverage in the private sector. Nonetheless finding solutions to manage the ending of contracting out for the minority is preferred to contracting out being a barrier to single-tier reform to benefit the majority.

In this response we note areas where more detail on reform plans will be required; we identify areas of concern and/or where Government may need to carry out further work, particularly on communicating the proposed reform; and we suggest areas where actuarial expertise could be useful in the next stage.

State Pension age

We caution against an approach using a formula based on life expectancy that makes increases in SPA automatic. We outline how a multidisciplinary regular Review could operate. We believe actuarial expertise would be valuable as part of this Review process.

The Institute and faculty looks forward to being of further practical assistance as the detailed shape of the reform progresses.

Chapter 1 - The current pension system

Question 1

1. The Institute and Faculty agrees with the Government's diagnosis of problems in the current system (Chapter 1). This shows that the current state pension system, if left unchanged, does not meet the Government's principles for reform nor provide an effective foundation for saving.

2. Especially worrying problems are the complexity of the current pension system and the uncertainty of what it will turn out to deliver in each individual circumstance. It is currently difficult to estimate with any confidence what state pension any individual will receive in future. This makes planning additional individual or employer-based pension provision more difficult than it should be. A single pension with wider coverage than the State Second Pension, set above the means-testing level, will reduce the uncertainty of future state provision for individuals.

3. If the state pension continues to fail to provide a certain amount, and so the value of saving continues to be unclear, the success of the auto-enrolment policy due to start in 2012 will be threatened.

Chapter 2 - Options for state pension reform

Questions 2-6

4. Option 1 (speed up change) retains the problems of the current system beyond 2012. It contains no obvious significant improvement on the current system.

5. Option 2 (rapid transition to a single-tier pension) appears, in principle, the better way to resolve the problems in a timescale to complement auto enrolment reforms.

6. While in principle we support Option 2, there are many points of detail not covered in the consultation paper to explain exactly how the transition to the new pension would be made and what the impact would be: for example, how many people's pension entitlements would be affected by what amount and what arrangements would be in place to protect accrued rights to the state pension. **We look forward to the next phase of consultation to review these points of detail.**

7. We expect that these details would involve some complexity, because the current pension system is so complicated. Actuaries are used to dealing with this complexity as we work on the interface of state and private pensions, mainly in the design of individual or employer-based private pension provision. **We would be happy to work with Government to examine transition proposals from this practical point of view.**

8. We note that current pensioners, and those who reach state pension age before the transition to the new single tier pension, will not receive the new single tier pension. There has been some media commentary that this creates unfairness. We understand that the proposed single tier is a cost-neutral proposal. We understand this to mean that the proposal is a simplification of the existing system rather than there being new money available to make pensions more valuable for younger cohorts than current pensioners. On this understanding, there should not be significant "winners or losers" from the single tier pension.

9. If this interpretation is correct, then the change to a single tier pension on a given day should be an acceptable way to achieve the simplification which the Institute and Faculty believes is in the public interest.

10. However, the Government did not provide enough information in the consultation paper for the impact of the single-tier pension to be clearly understood. **We suggest that given the likely difficulties in comparing new and current systems, largely due to the complexities of the *current* system, the Government needs to explain both systems, and the process and effects of the change well, in terms that non-expert consumers can understand.**

11. As paragraph 95 of the consultation paper notes, one potential perceived complication of the single tier pension is that, because of contracted-out pensions, not all of the £140 single tier pension will be received by an individual with a contracted-out pension(s) as “government money”. The contracted-out portion(s) will come from an occupational or personal private pension scheme(s). *This is not a consequence of this reform*. It happens under the current system and will unwind over time as the legacy of old contracted-out schemes reduces. However, it may influence individuals’ understanding of the “£140 pension”. **We urge the government to take great care in communications about the new pension reform, with the aim of enabling individuals to understand clearly what is happening and the impact on them. We suggest Government engage with the pension industry and consumer advocates to ensure that communications across state and private sectors are clear, consistent and in language the consumer can readily understand.**

Question 7

What would be the impact of ending contracting out, as implied by any single-tier model?

12. A pensions system without contracting out will be considerably simpler than one with contracting out. However our experience is that contracted out schemes and their sponsors have generally come to terms with the complexity of current arrangements. For these sponsors, ending contracting out may bring complexity in the transition.

13. We note that there has been, for many reasons, a trend away from defined benefit towards defined contribution employer-based pension provision in the private sector, and this is likely to continue. Contracting out of defined contribution provision is ending in April 2012. Meanwhile, defined benefit is still the norm in the public sector and Lord Hutton's current proposals for reform would maintain this position. There are around twice as many active members of defined benefit provision in the public sector as in the private sector: approximately 5 million compared to 2.3 million (Pensions Policy Institute figures). Therefore the impact of ending contracting out for defined benefit schemes will have an impact on more employees in the public sector than in the private sector.

14. The ending of contracting out would help to "level the playing field" to the extent that it would remove the scheme design differences (and the perception of differences) between defined benefit and defined contribution schemes, and between public and private sector schemes, that exist today because of contracting out.

15. Contracting out rebates are set based on the principle that a contracted-out pension scheme provides benefits of equivalent actuarial value to the State Second Pension forgone by contracted-out workers (often in addition to the other pension benefits of the scheme). Therefore, if contracting out ends, employees and employers should be in the same financial position as before. National insurance rebates will no longer exist, so individuals and employers will have to pay more in national insurance. But this should be compensated for by needing to pay less into the individual or employer-based pension scheme: the scheme will no longer need to provide what the State Second Pension (or the new single-tier pension) would provide instead.

16. In practice, this theoretical position will be difficult to implement for all schemes. Some schemes are prevented - by restrictions in the amendment power in their scheme rules, and/or (in the case of many schemes in respect of privatised industries) by protective legislation (put in place at the time of privatisation) - from reducing future accrual at all in respect of some or all members.

17. Further, in most contracted-out schemes, it is likely to be the case that the current level of accrual of State Second Pension given up by those who are contracted out varies between members. It may be difficult to identify any change to the benefit formula which would be seen as fair to all the members, and then communicate and negotiate how that change could be made. Some sponsors may see the cessation of defined benefit accrual altogether as the easier option.

18. Therefore, the ending of contracting out may prove to be both a trigger and an excuse for defined benefit schemes in the private sector to cease future benefit accrual. This trend might be expected to continue over time anyway in the absence of reform, but reform may bring a one-off increase in the number of schemes bringing forward such a step.

19. Past experience suggests that closing a defined benefit scheme often means a hybrid or defined contribution scheme is set up at lower value to members. A switch from defined benefit to another scheme design need not be detrimental to members, but any reduction in value would be, as would failure to find ways of explaining to members the uncertainty inherent in defined contribution schemes.

Question 8

If the decision is taken to end contracting out how could the process be best managed so as to minimize any adverse impacts on employers and individuals?

20. In order to avoid confusion and unnecessary administration cost, consideration of ending contracting out in the public sector should be integrated into the current process of developing reform proposals from the independent Public Service Pensions Commission, chaired by Lord Hutton.

21. All employees in contracted-out defined benefit schemes will need to be able to see and understand how the ending of contracting out is cost-neutral for them: in other words what compensating change is being made for their national insurance contributions increasing. This is also true when contracting out ends for defined contribution schemes in 2012. Employees of public sector schemes will have more to understand if public sector scheme reform happens at the same time. **Again, our recommendation is that Government communicate the single-tier reforms in terms that non-expert consumers can understand, with particular attention to contracting out.**

22. Given the need for scheme redesign which the change will bring for some sponsors of contracted-out defined benefit schemes in the private sector, **we urge the Government to engage with industry bodies and large employers to encourage the maintenance of high quality pension provision.** We also urge the Government to understand where there are particular difficulties within specific schemes. **The Institute and Faculty would be happy to help in seeking to resolve problem issues on contracting out in general or in specific cases.**

23. **On balance, despite the difficulties that some schemes will encounter as a result of the end of contracting-out, but recognising that contracting out is declining anyway, the Institute and Faculty believes that the public interest is best served by making the change to the single-tier pension. Finding solutions to manage the ending of contracting out would be preferred to contracting out being a barrier to single-tier reform.**

24. We note that, with the end of contracting out, there would be an immediate increase in Government revenue due to the removal of the national insurance rebate. This would amount to around £7 billion (HMRC Estimated costs of the principal tax expenditure and structural reliefs, Table 1.5, 2009/10). We assume that cost-neutrality means that this money will remain in the pension system. We look forward to reviewing more details in the next phase of policy development.

Chapter 4 – State Pension age

Question 10

What mechanism should be used to determine future increases in State Pension age (SPA)?

Question 11

How should the Government respond to the frequent revisions in life expectancy projections while giving individuals sufficient time to prepare?

25. The Pensions Commission and subsequent legislation accepted the principle that SPA should rise with increasing average lifespans. However, for the policy to be widely accepted, it needs to be well explained that lifespans are increasing and are expected to continue to do so. The Institute and Faculty is keen to play its part in helping the public to understand longevity trends. We publish a six-monthly *Longevity Bulletin* to explain longevity-related issues and highlight recent research in the area; and through the Continuous Mortality Investigation (CMI) and other work, we carry out research into the mortality experience of insurance portfolios and pension schemes in the UK market.

26. We suggest that the key criteria for a mechanism to determine any future increases in SPA should be as follows:

    - **Stability**: A schedule of increases can be planned out for the long-term future with the understanding that it will not be changed unless the evidence on which the decision is based changes significantly.
    - **Sufficient warning**: If a decision is made to change the date of increase from the planned long-term schedule, sufficient notice is given to the individuals affected.
    - **Evidence-based**: the decision is made using all relevant evidence.
    - **Accountability**: the ultimate decision on SPA is made with Ministerial accountability to Parliamentary oversight.

27. We understand the appeal of a formula based on life expectancy that makes increases in SPA automatic. **However, we caution against this approach** for three reasons, as follows.

28. **First, it will not be straightforward to decide on a single formula.** A number of valid formulae using life expectancy could be used, and for each a number of baselines from which the formula could apply. For example, if the decision is to increase state pension age through a formula linked to life expectancy, it would appear to be necessary first to establish a baseline:

    - Is the intention to maintain constant the expected average remaining lifespan from reaching state pension age, or is it the intention to maintain constant the expected proportion of adult life spent over state pension age; and, in considering this,
    - Is the target period or proportion to be taken as equal to that expected for those retiring in the middle of the twentieth century (before the significant and unexpected increase in old age life expectancy) or equal to that expected for those retiring now (boosted by that increase in old age life expectancy)?

29. **Second, no formula is likely to be robust enough to give the required stability in its result**. The main set of projections of future life expectancy used (ONS principal projection) is one possible set, based on one set of assumptions for how mortality rates will change in future. The ONS also publishes a number of different variant projections, based on different assumptions. Even though these variants are rarely referenced, they are critical to understanding the uncertainty of future outcomes. The principal projection is not intended to be 'accurate' in the sense of a prediction or forecast. Different experts take different views on which, if any, of these variant projections is most likely.

30. The projections will change over time. This is not due to forecasting 'mistakes'. It is an inevitable consequence of the inherent uncertainty in future mortality trends. From the 1950s to the 1980s mortality rates were fairly stable and the projections of national statistical agencies turned out to be fairly accurate. The accelerated pace of mortality improvements in the 1980s came as a surprise and projections began to underestimate average lifespans. The future is very uncertain: the recent improvements in mortality rates at older ages are unprecedented and we do not know how they will trend in future. Projections will change: new information on recent mortality becomes available and views change on what assumptions should be used to project future mortality. The change could be in either direction. It is possible that mortality improvements will slow, and projections will turn out to have overestimated average lifespan. Any formula

using a projection of life expectancy on which a decision on SPA is based is therefore likely to give different answers over time, with changes probably too frequent to be able to give satisfactory stability in a future schedule for SPA.

31. We believe some of the appeal of a formula may lie in an implicit but mistaken expectation that it is possible to obtain a single prediction of future life expectancy that will not change. The previous paragraphs explain why this is not possible. Using just one projection for life expectancy in a formula on which so much depends implies certainty when we cannot be certain of future life expectancy trends. **Rather than hoping the projections will be accurate (when it is not likely they will be) in order to be able to use a mechanistic formula, we believe it would be better to manage the uncertainty in future longevity by incorporating a greater degree of judgement into a Review process.**

32. **Third, life expectancy is not the only consideration that should be made in setting SPA.** Life expectancy is a measure of average age at death, but the variation in age at death will also be important, for example by socio-economic or geographic factors. As yet, data exists only on historic life expectancy measures for these subgroups - there are no future projections that can be relied on. Other factors relevant to a decision on SPA that would not be covered by one formula alone (and for which ideal data may not be available) are: profiles of health and ability to work after SPA; healthy life expectancy; practical issues on timing in relation to other reforms or legislative changes that may occur; how open the labour market is for older workers; the general economic circumstances of the country; and what level of pensions expenditure or national insurance contributions is deemed acceptable.

33. **We suggest that a statutory review process, with defined Terms of Reference, can meet the criteria for a mechanism to decide on changes to SPA better than a formula can**. In outline, we see it being a legislative requirement that there is a multi-disciplinary Review held regularly, perhaps every five years, to review evidence and highlight whether the evidence justifies any change from the planned long-term schedule of SPA changes. We see this as meeting the criteria outlined in paragraph 0 above as follows:

    - **Stability**: A planned schedule of increases is set out in legislation. The current plan would be that laid out in the Pensions Act 2007, which set the timetable for increasing State Pension age from 65 to 68, with the timing of the change to age 66 amended by the conclusion of the current debate on the Pensions Bill 2011.
    - **Sufficient warning**: Any decision to change the date of increase from this planned long-term schedule can only be made on the recommendation of a Review and with a minimum warning period for the first cohort affected.
    - **Evidence-based**: the Terms of Reference of the Review require a specified range of evidence to be considered (see below) while allowing scope for the multidisciplinary experts on the Review panel to consider issues they select as important at the time.
    - **Accountability**: while the Review makes a recommendation, any decision will require a legislative change and will therefore be debated in Parliament.

34. There should be a minimum warning period for the first cohort affected by an increase in SPA set in legislation, so that individuals affected are given appropriate time to prepare. However, this needs to be balanced with some flexibility in order to manage Government spending. A warning period of ten years would fit with the majority of responses to the consultation on when SPA should be raised to 66, as reported by the DWP ("A sustainable State Pension: When the State Pension age will increase to 66", November 2010, p. 20).

35. In setting the Terms of Reference for the Review, the Government will have to decide the boundaries of the Review's responsibilities. For example, we assume the Review would not be required to examine the purpose of the state pension (for example is it to provide basic poverty prevention at a very old age, or is it a reward for work that is expected to be received by everyone)? Further, we suggest the Review is not

given any particular direction with regards to an acceptable level of spending on pensions, or to any particular target outcome of a formula such as proportion of adult life to be spent after retirement age. Instead, **the Review should (a) develop a database of relevant demographic and economic evidence and other factors; (b) give explanatory commentary on significant unexpected trends in the data from when the planned schedule of SPA changes was set; and (c) make any recommendation for change to the schedule for SPA increases only on the basis of the Review's findings.**

36. We suggest that the Terms of Reference set out the range of evidence to be considered by the Review, allowing the Review team to be free to incorporate other data they think relevant. The basic evidence to be considered should include:

- the results of a number of different formulae for SPA, using different baselines and different variant assumptions for life expectancy;
- evidence on the variation in lifespans and how it is changing;
- evidence on trends that may affect future life expectancy, such as the prevalence of obesity and patterns in causes of death;
- data on patterns in health before and after SPA, including healthy life expectancy;
- the cost of the state pension under the current SPA schedule and possible changes to it;
- economic circumstances including the labour market situation; and,
- practical issues to be considered if the SPA schedule were to change, including links to other pension policy or market issues.

37. **We believe actuarial expertise would be valuable both as part of this Review process and in developing in more detail how the Review could work. The Institute and Faculty would be happy to contribute further to this and other parts of the Review.**

Yours faithfully,

Ronnie Bowie
President, Institute and Faculty of Actuaries