Institute and Faculty of Actuaries

Intergenerational Fairness

IFoA response to the Work and Pensions Select Committee inquiry

19 February 2016

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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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and Faculty
of Actuaries

Work and Pensions Committee inquiry
on intergenerational fairness
House of Commons
London
SW1A 0AA

19 February 2016

Dear Mr Field

IFoA response to the Work and Pensions Committee's inquiry on intergenerational fairness

1. The Institute and Faculty of Actuaries (IFoA) welcomes the Committee's inquiry on intergenerational fairness and its focus on the long-term sustainability of the UK welfare system. The IFoA's particular area of interest and expertise for this inquiry is the pension framework, which must be sustainable for the State, individuals and employers in the long term to achieve intergenerational fairness.

2. The IFoA is the UK membership body for actuaries, many of whom work in and have a statutory role in the supervision of pension schemes and life companies. As a Royal Chartered professional body, we harness our members' expertise to inform economic and societal challenges in the public interest. We have only commented on those aspects of the inquiry where we have expertise, or have undertaken research or analysis.

Executive summary

3. When assessing long-term trends in pensions and intergenerational fairness it is important to consider all three pillars of the pension framework – State, occupational and private. It is particularly important not to overlook the role of the employer in encouraging levels of saving that will prevent people from falling back on the State, increasing the burden for future generations.

4. Clearly defining the balance of responsibility between Government and individuals for meeting the costs of social care is the key to achieving intergenerational fairness under the current system is. Understanding this responsibility will be crucial if individuals are going to save to meet these future costs. There are an increasing number of people with care needs and if they do not have sufficient savings to meet their care costs they will become reliant on the State, which will have further consequences for intergenerational fairness.

5. Effective communication will play a vital role in creating and delivering a system that is sustainable across generations. It should start from the earliest stages of working life when the impact of saving will have the maximum impact.

Long-term trends in pensions and intergenerational fairness

6. Since the last Pensions Commission, there has been the introduction of a number of fundamental reforms to the pensions framework:
    a. the introduction of the freedom and choice agenda last year
    b. the new State Pension coming in to force this year
    c. the continued staging for auto-enrolment; and
    d. the anticipated Budget announcement on the taxation of pensions.

7. These reforms will have long-term consequences for the pensions system. We welcome the Committee's consideration of what these reforms mean for future, as well as current, retirees.

State provision

8. We welcome the Government's objective of delivering a simpler and fairer State Pension that provides a better foundation for saving, while remaining sustainable for future generations. In scrutinising whether the current system and potential future changes to the system achieve this objective, we suggest a number of factors the Committee could use to assess whether State benefits are sustainable:
    a. The acceptable level of cost to the Treasury in providing a State Pension and age-related benefits such as the winter fuel payment, council tax support, concessionary travel costs and TV license concessions
    b. The comparative level of spending on age-related benefits relative to other welfare benefits and the relationship with non-benefit policies such as the Living Wage
    c. Whether State benefits should be universal, or subject to some elements of means testing. We note the risk that means testing for age related benefits could discourage saving by those who want to ensure eligibility for those benefits. Where benefits are paid tax free, is this always appropriate and necessary to achieve the relevant objectives
    d. Other conditionality of State benefits, for example, non-increasing pension for those retiring abroad
    e. How the amount of State Pension and other age-related benefits are derived, for example, in relation to earnings or the minimum income required to avoid poverty
    f. How State Pension Age is set, both in terms of linking State Pension Age to life expectancy and the rational for the current assumption that one third of adult life should be spent in retirement
    g. The conditions to qualify for the State Pension
    h. The current and projected future levels of occupational and private pension provision[i]

9. To achieve intergenerational fairness, it is important that the Government considers how to fund any reforms to the system and the resulting impact on taxation for current and future generations. In considering intergenerational fairness, we agree with the Committee's focus on the triple lock, as the Office for Budget Responsibility's analysis shows that based on current economic trends the triple lock will increase expenditure on the State Pension as a share of GDP over the long term.[ii] The triple lock was perhaps important as a temporary measure after the link of State Pension to earnings was restored, as a route to getting the State Pension to a level that is reasonable in relation to wages. However, if the level of the new State Pension has been set at the appropriate level relative to earnings, it should mean the triple lock is no longer needed. Maintaining the triple lock would only mean that retirement income increases relative to the earnings of the working age population.

10. As has already been seen by the work of the WASPI campaign, any increase in State Pension Age will create a discontinuity between those who reach State Pension Age just before and just after any change. This is perhaps inevitable, although a more gradual transition over a longer period (such as a rolling increase of one month after every 4 months) may be seen as less discriminatory than a rapid increase over a short period (such as an increase of 1 year phased in over just 2 years). However, the impact on those whose State Pension Age is delayed can be minimised by clear communication of the expected increase in State Pension Age as far ahead as possible. We suggest consideration is given to setting out (if not legislating for) the long term expected path for State Pension Age, even if this is subject to future fine tuning. The current approach of just setting out and legislating for next expected change inevitably creates false expectations as to when people will qualify for their state pension.

Occupational pensions

11. With traditional Defined Benefit (DB) plans continuing to lose their dominance in occupational pensions and a shift towards Defined Contribution (DC) pension arrangements, inflation, market and longevity risk is transferring from employers to individuals. This could mean that a person's retirement income may be subject to greater variability than before. While earlier cohorts of retirees, and many of those in the more immediate approach to retirement, will have some DB pension and protection from these risks, it is important that protections are put in place in the new environment to, as far as possible, prevent future retirees being detrimentally impacted by the transfer of risks. If individuals run out of savings before the end of their retirement without protection it is likely that they will fall back on the State, increasing the burden for future generations of the working age population..

12. This transfer of risk from the employer to the individual does not diminish the importance of the role of the employer. The tax incentives available to employers are likely to play an important role in increasing levels of saving. A reduction in incentives to employers could reduce the amount employers are willing to pay into schemes where they are currently paying above the minimum automatic enrolment contribution rate. This would reduce the incentive for individuals to save into a pension and as a result could increase the opt-out rate. If current savers do not save enough to support their retirement income needs this again could result in them falling back on the State.

13. We welcome that the Committee is also conducting an inquiry on automatic enrolment (AE), and in particular that the inquiry covers the interaction between AE and other pension reforms. It is important that the Committee gains a holistic perspective of what the current pension policy environment means for current and future retirees. AE has been successful in getting more people saving into an occupational pension scheme, but this only addresses part of the broader challenge of promoting individual responsibility for their retirement income.

14. The tension between the behaviours promoted by the AE reforms and the behaviours likely to arise from the freedom and choice agenda needs continued focus. Whilst for AE inertia has had a positive impact on savings, inertia can lead to poor retirement outcomes where the path of least resistance is unlikely to be optimal in helping people to fund their future retirement income needs. To prevent retirees running out of funds in the latest stages of their retirement and becoming reliant on State benefits we recommend that the Government seeks to nudge individuals during the decumulation phase towards actions that are more likely to prevent them from running down their funds. The form that this might take is beyond the scope of this response, but consideration could be given to requiring schemes and providers to put in place an appropriate default decumulation vehicle, analogous with AE requirements. The IFoA is

completing research on both nudges and default pathways and we would welcome the opportunity to discuss these with the Committee.

Private pensions

15. An important part of creating a sustainable pension framework will be encouraging individuals to take some level of personal responsibility for their retirement income and increasing saving levels. The incentive to save should be the most important aspect of any changes to the taxation of pensions. Without an incentive, alternative forms of investment with no restrictions on fund access will appear more attractive and this could increase the likelihood that assets are depleted. This could have a consequence for State expenditure on age-related benefits. The constant change to the taxation of pensions is likely to be a disincentive to savers. If Government could obtain political consensus on the taxation of pensions for a sustained period, there would be greater possibility of building on the success of automatic enrolment – a consensus-led initiative – to incentivise saving. A lack of trust arising from uncertainty of potential future political change is likely to have a negative impact on the desire of individuals to save into a pension.

16. In addition, we ask the Committee to consider the potential implications of moving from an exempt, exempt, taxed 'EET' to a 'TEE' taxed, exempt, exempt taxation of pensions system. As this would effectively bring forward tax revenues from future generations, who will likely face the largest bills for pensions and health and social care. Future generations would benefit from as broad a tax base as possible to meet these costs as taxation helps to fund State provision for current retirees.

Long term trends in health & social care and intergenerational fairness

17. Over the previous decade, life expectancy in England increased at a relatively constant rate, however, trends in healthy life expectancy - how long a population might live for without health needs - are much less consistent. In the IFoA's Longevity Bulletin: Longer life in better health, we illustrate that whilst life expectancy is increasing, a lower percentage of the individual's overall life was spent in good health. [iii] Already more than two-fifths of national health spending is on individuals over 65, if increases in the proportion of life spent in ill health continue, this proportion may continue to increase. [iv]

18. In addition, the number of people with social care needs in later life is rising. The Department of Health estimates that by 2018 there will be over 1 million more people with three or more long-term conditions in England than there were in 2008. [v] Despite this increase in the number of people with care needs, between 2009 and 2014, local authority spending on social care for older people fell in real terms by 17%.[vi]

19. As the number of people with care needs is rising, yet State funding is decreasing. Striking the right balance between State and self-funding will be important in creating a system that is sustainable over the long term. To encourage people to save for any potential social care costs in later life the Government can play a key role in helping people to prepare by:
    - clearly defining the sharing of responsibility for the costs of care needs between Government and individuals;
    - informing people of the cost of care needs; and
    - transforming social care provision to deal with the increasing demand.

20. If the Government is looking to individuals to meet more of their care costs, it is vital they are encouraged to save sufficiently as the expenses associated with care needs could

unexpectedly exhaust an individual's funds in retirement even if they made prudent plans for retirement. This will leave them reliant on State benefits. With the increasing number of people likely to have care needs this cost could fall on those of working age.[vii]

21. The issue of long term care funding highlights the wider issue that the costs of an ageing population has to be met, whether that is found through the current generation of workers, for example through taxation, or by the savings of those that have the need at that time. In addition to looking at individuals, we could also consider the role of government 'saving' i.e. not spending more tax than they receive, in anticipation of meeting the additional costs a particular generation might create as it ages.

Encouraging saving for a more sustainable system

22. We suggest current barriers to sufficient saving include:
    - Retirement seems too far away to begin planning for unless the benefits of saving are tangible, especially where there are other more immediate financial pressures
    - A lack of understanding around how much people will need to save in order to have adequacy of income throughout retirement, including their potential care needs
    - Whilst acknowledging the forthcoming simplification of the State Pension, the pensions framework remains complex and arguably in the short term the transitional provisions will make the system even more complicated
    - The tax framework for pensions has changed frequently in the past, and these changes have not always been easy to understand, and therefore, may not have been fully appreciated
    - A lack of stability in pensions provision (State, occupational and private) has created a lack of trust that the benefits available for current retirees will be available for future generations
    - Owing to the tax privileges afforded to pension savings, there is a perhaps inevitable restriction on when people can access their savings, meaning that pensions are relatively inflexible compared to savings vehicles such as ISAs[viii]

23. To achieve intergenerational fairness we recommend four key priorities that policymakers need to consider to overcome these barriers. The IFoA has set these out in our 'Saving for Retirement' policy briefing:
    Priority 1: The pensions and social care framework must be sustainable for the State, individuals and employers in the long-term
    Priority 2: There must be clarity on the role of the State
    Priority 3: Individuals need to understand how long they might live in retirement (not just their life expectancy, but also the likelihood of living to much older ages)
    Priority 4: Individuals need to understand what level of savings they will need to meet their retirement income needs, including potential care costs and be encouraged to save to meet them, for example through tax relief or behavioural nudges[ix]

24. Effective communication is crucial in creating and delivering a system that is sustainable across generations. Effective communication can increase transparency in the system and ensure individuals understand the benefits of saving, both financial (employer contributions and tax relief) and quality of life (not running out of funds in the later stages of retirement and having control over quality of care if required). It can also help to avoid distrust in the system, as evidenced by for example the recent WASPI campaign. Effective communication should start from the earliest stages of working life when the impact of starting to save could have the highest impact.

25. Whilst we have focused on those areas relevant to the actuarial profession, we urge the Committee to consider our comments regarding pensions and social care within the context of the significant financial burdens facing the current generation of workers. Those entering the working age population are likely to face rising student debts, changes in working patterns (for example zero hour contracts and increases in the number of self-employed workers) and the increase of house prices as a multiple of income. Whilst it is vital to encourage saving, this cannot be done without consideration of whether younger generations are likely to have sufficient wealth to meet their immediate needs. To achieve intergenerational fairness it is important that the same generation is not unnecessarily burdened with funding State benefits that will likely be lower in the future. It seems reasonable that those benefitting from a longer life expectancy also contribute to the increasing cost.

Should you wish to discuss any of the points raised in further detail please contact Rebecca Deegan, Policy Analyst (rebecca.deegan@actuaries.org.uk / 02076322125) in the first instance.

Yours sincerely

Colin Wilson
President-elect, Institute and Faculty of Actuaries

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[i] IFoA (2015) *Considerations on State Pension Age in the UK*
[ii] Office for Budget Responsibility (2015) *Welfare trends report*
[iii] IFoA (2014) *Longevity Bulletin 04 – Longer life in better health?*
[iv] Estimates from the Nuffield Trust [Data produced for The Guardian. Available online: http://www.theguardian.com/society/2016/feb/01/ageing-britain-two-fifths-nhs-budget-spent-over-65s. Accessed 18 February 2016]
[v] Department of Health (2012) *Long Term Conditions Compendium of Information: Third Edition*
[vi] The Kings Fund (2015) *How serious are the pressures in social care* [Online] Available from: http://www.kingsfund.org.uk/projects/verdict/how-serious-are-pressures-social-care
[vii] IFoA (2015) *How financial products can work along side the Care Act to help people pay for care*
[viii] IFoA (2015) *Policy Briefing: Saving for Retirement*
[ix] *ibid*