Institute and Faculty of Actuaries

Strengthening the incentive to save: a consultation on pensions tax relief

IFoA response to HM Treasury

30 September 2015

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.

Pensions Consultation 2015
Pensions and Savings Team
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

30 September 2015

Dear Sirs

HM Treasury - Strengthening the incentive to save: a consultation on pensions tax relief

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to this important consultation. We also welcome the Government's willingness to consult on all possible measures, rather than consult on only a limited range of possible changes.

2. As well as responding to the questions asked in the consultation, we have set out some objectives in the General Comments section that we consider should sit alongside the principles suggested in the consultation paper. While our responses to the questions asked contain a lot of detail, we have included as an appendix a summary of the advantages and disadvantages of specific changes to the tax framework.

General Comments

3. The IFoA considers the **incentive to save** as being the most important aspect of any changes to the tax relief framework. Membership of a pension scheme requires a strong incentive to save, otherwise the requirement to lock funds away until the later stages of life will deter pension saving. Without that incentive, alternative forms of investment with no restrictions on fund access will appear more attractive and there will be a strong possibility that assets will be depleted before retirement. This could have a consequence for welfare expenditure in the form of higher payments to older people, for example.

4. The impact on **employers** will be very significant. The membership of pension schemes is more attractive to employees if employers make a major contribution to the scheme. Healthy employer support will also encourage employees to remain in schemes. Any changes to the tax relief framework that discourage employers from sponsoring pension arrangements should be avoided.

5. Changes should be measured against clear and, preferably, quantitative principles. The IFoA welcomes the inclusion of principles in the consultation paper that will form the foundation for any changes. However, without further detail, most changes could be justified against the principles set out. The IFoA would welcome further clarity about the application of the principles in the following two ways:
   a) We would welcome analysis of the impact of changes for different cohorts of the population, both working and retired; and
   b) If any changes were to lead to a conflict between the aims of government policy, the principles should be given a relative priority.

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6. **Sustainability** should be measured in political terms and not only financial terms. Actuaries are aware of the impact of changes over the medium to longer term that mean previous long term assumptions are no longer valid. If the Government could obtain political consensus to implementing changes for a sustained period, there would be a greater possibility of building on the early success of another consensus led initiative - Automatic Enrolment (AE). Uncertainty arising from potential future political change could have a negative impact on the desire of individuals to save for retirement by means of pension schemes.

7. **Transitional issues** represent an additional cost for employers, providers and ultimately scheme members. We would urge the Government to consider carefully the cost of implementing change, particularly in respect of Defined Benefit (DB) provision.

Q.1 To what extent does the complexity of the current system undermine the incentive for individuals to save into a pension?

8. In summary, the IFoA considers the current system to operate in a simple way for most pension scheme members. While there are some complexities, we would encourage the Government to take this opportunity to remove them, while maintaining a system that works well for the majority. The IFoA considers that the current framework would enable changes to meet the principles in full.

9. The question suggests that the current system is too complex, although it was introduced under the label of 'simplification' in 2006. Even raising the matter of complexity should act as a note of caution to policymakers that good intentions do not always result in good outcomes, or even a simple and transparent system.

10. If scheme members consider pensions tax as too complicated, the challenge may be that either tax is too complicated, or pensions are too complicated. Some may view Income Tax and National Insurance as complex and, indeed, more complex than the resulting pensions tax arrangement. Alternatively, others may view the locking away of significant funds for many years as too complex, leading to a disengagement with pensions, rather than expressing concerns about the tax arrangements.

11. The IFoA recognises that successive governments have taken steps to change the general view of pensions; however, the challenge remains that it is very difficult to engage individuals fully in saving for an event that may be many decades in the future without some form of incentive. This challenge is increased when saving for retirement is not regarded as important due to higher priorities at any point in time, or when income is too low to enable individuals to save.

12. For a large majority of pension scheme members, the system is not complex, particularly in relation to paying contributions to pension schemes. The complexity within the system arises around the limits on benefits within the system and the practical application of those limits. Our understanding of the simplicity is best considered by looking at different segments of all pension scheme members.

10\. Paying contributions to a scheme directly from salary does not cause any complexity greater than any other deduction from gross salary. There is no indication that any payroll deductions are particularly complex. The payment of a deduction from gross salary to a pension scheme is the most straightforward payment method. It should be noted that the nudge approach of the immediate payroll deduction has been one factor in the success to date of AE.

11\. Scheme members who pay contributions from net salary do experience a slightly more complex arrangement. However, for basic rate taxpayers, payment of contributions from net salary does not create any administrative burden. As basic rate tax is reclaimed by the firm receiving the contributions, the administrative action lies with that firm.

12. We would note that higher rate taxpayers who pay contributions from net earnings would have to reclaim tax relief through their annual self-assessment. This would not appear to be any more complex in relation to any other aspect of self-assessment.

13. We have already referred to the success of AE to date. It would appear that the current tax regime has not been a barrier to participation in saving for retirement. Although it may be best to reserve judgment until micro-employers enrol their employees, if employees remain as scheme members under the current framework, it would be challenging to argue that the complexity of the current system undermines pension scheme membership. If the consultation were to result in a reduction to net pay, members who have become accustomed to regular pension contributions may view the change as a disincentive to save.

14. Complexity is introduced when individuals start approaching the Annual (AA) and Lifetime Allowances (LTA). It should be noted that those scheme members affected by both allowances are currently more likely to be higher paid. Such members are more likely to afford and take up detailed financial advice in order to avoid breaching the allowances, although the gradual reduction in the AA and LTA limits would gradually change this position. We would also note that such members are also more likely to be in a position to use other tax-efficient savings vehicles. Although changes to the pensions tax framework may lead to a reduction in total pensions tax relief, the impact of such a change could be offset by greater demand for other long-term savings products offering higher rate tax relief.

15. While the tax relief framework is designed to cover both defined benefit (DB) and defined contribution (DC) schemes, it is clear that the AA and LTA do not fit comfortably with both types of benefit provision.

16. The AA sits very comfortably with DC schemes, where individuals are aware of the maximum contribution that could be made to a scheme in any one year. However, for DB schemes, the AA is much more complex and can create a range of unanticipated outcomes from a member perspective, where individuals can breach the allowance unwittingly. This would appear to be in contradiction to the principles of transparency and personal responsibility. We would also note that if Government were to move to either a "TEE" regime or a system where the rate of relief is not at an individual's marginal rate (i.e. a single rate of relief), the broad brush calculation methodology used to determine the AA for DB members is, in our view, unsuitable and a more refined approach would be required.

17. Conversely, the operation of the LTA is consistent with limiting members from accumulating excessive funds under DB schemes. It is easier to understand and to recognise circumstances that may require members to take preventative action.

18. The tax position at retirement may also affect the general view of the tax framework. However, given the delay between making contributions and receiving benefits, it would appear unlikely that the tax treatment of benefits would be a major consideration for many scheme members.

19. Any government can change the structure and rates of pensions tax and relief. The current system offers the Government an opportunity to change the balance of tax reliefs granted between cohorts of taxpayers. Most obviously, changes to the rate of tax relief and the availability, or otherwise, of tax free lump sums at retirement would affect the amount of relief granted and who would receive it.

Q.2 Do respondents believe that a simpler system is likely to result in greater engagement with pension saving? If so, how could the system be simplified to strengthen the incentive for individuals to save into a pension?

21. As noted previously, the success of AE to date does not indicate that the tax framework has been a barrier to member participation. However, we would again note that the completion of the AE roll-out will provide a better indicator of success.

22. We are aware that others have commented that an ISA regime is simpler than pensions. The ISA tax regime is not necessarily simpler than the pensions tax regime for the vast majority of pension scheme members. However, the limits on contributions for the ISA regime are simpler.

23. If ISA simplicity is seen as an ideal, this is a different point to changing the tax regime. Rather it would be the application a fixed monetary limit to the tax relief available. This would fit more easily within a DC regime. The implications for those with continuing DB provision would be hugely significant, as DB provision is not consistent with an ISA type limit. Any change at this level would be enormously disruptive.

24. The biggest challenge in encouraging saving for retirement is more likely to be associated with inaccessible funds until a minimum age. Better communication may be one tool towards the education of scheme members, or more importantly, potential scheme members, of the tax incentives provided as the balance to inaccessible funds. It would appear disproportionate to implement major changes while the impact of AE for smaller employers and the benefits of improved communications remain unknown.

25. The IFoA would welcome the Government's view of how incentives to save would work and the extent to which they succeed. In particular, the success of AE could be used as an example of how individuals have reacted to more information. There could be lessons to learn from other savings vehicles that are successful in attracting funds. The Government may wish to consider how those vehicles could sit alongside pensions to supplement longer-term saving for retirement.

26. Similarly, we would welcome any clarification about how the current pension incentives are perceived as unsuccessful in encouraging people to save for retirement.

27. It should also be borne in mind that many decisions about retirement saving are not taken by individuals. Such decisions sit with employers and, to some extent, remove personal responsibility from members. Any changes to the tax relief system should be sympathetic to the needs of the employers, or at a minimum, consider the potential actions of employers that may adversely affect the total saving for retirement.

28. The IFoA would also welcome clarification from the Government about the incentive to save for the self-employed. The numbers of the self-employed are increasing, but there is no automatic incentive to save. Any changes to the current system should reflect the importance of that growing sector which does not benefit from AE.

Q.3 Would an alternative system allow individuals to take greater personal responsibility for saving an adequate amount for retirement, particularly in the context of the shift to defined contribution pensions?

29. The consequences of the shift to DC has been the transfer of some responsibility to individuals. As a consequence, members of DC schemes have taken on the major risks: investment, longevity, inflation and interest rates. In contrast, the risks faced by members of

DB schemes are the continuing ability of the sponsor to pay for benefits and changes to future benefit design.

30. It is not entirely clear that any changes to tax relief would make a significant difference to individual responsibility. Members of DC schemes will face a decision to accept the need to contribute to schemes during their working lives to provide retirement benefits; to have retirement income available from other sources, or to live only with State benefits. The general reluctance of members to take personal responsibility for retirement planning was a core reason for the introduction of AE.

31. If the Government aims to increase personal responsibility, learning from the success of the initial introduction of AE may be more beneficial than making further changes to the structure of pension provision.

32. We have already noted that retirement saving will be a priority for different people at different points in their lives. That ever-changing priority is very likely to determine the amount of contributions paid to a scheme rather than a consideration of what tax reliefs would be available. The Government could offer greater incentives to the lower paid to defer income and to save more. We would emphasise that such encouragement could be undertaken within the current system. This is one possible change that would benefit from detailed analysis.

33. One possible change could be the application of a single rate of tax relief to pension contributions. This could target tax relief towards those who have least disposable income by offering relief at a rate greater than basic rate. Such a change could be fiscally neutral based on the current relief granted on contributions, or the rate could be set at a level that reduced the relief granted from the current level. We note that such an approach could be liable to future change that reduced the incentive to save by reducing the rate of relief.

34. It is also worth repeating that understanding the impact of current limits to saving (the AA and LTA) would be beneficial. If most DC members remain unaffected by both allowances, it may suggest that there would be flexibility to reduce further the total limits to provide greater incentive for contributions.

35. However, while reductions in the AA and LTA would appear attractive as a means of targeting relief at the lower paid, the Government should be aware of potential consequences for DB schemes. The current limits are starting to impact those who could not be regarded as the highest paid, but rather have long service in DB schemes. Any changes in this area should be considered very carefully.

36. We would encourage the Government to consider changes to the pensions tax system that would increase the focus on retirement income. Increasing longevity and the increasing time spent with care needs in later life require larger accumulated funds at retirement if individuals are not to depend totally on welfare provision. The current system allows the tax framework to act as a natural brake on removals of cash at retirement for DC members. Moving to a system that allows unlimited, untaxed withdrawals at retirement would suggest that provision of income in the latter stages of life would not be a priority. We would caution against such a change.

37. We would welcome any framework that allows individuals to use retirement funds to provide income in the most appropriate manner during retirement. An individual will have different needs during retirement, so there should be flexibility in the system that enables individuals to meet those needs.

38. We would emphasise again the need to consider how the self-employed could benefit from strengthening the incentive to save. Changes to the tax relief for pensions should reflect the requirements of the self-employed.

Q.4 Would an alternative system allow individuals to plan better for how they use their savings in retirement?

39. There have been significant changes to pensions legislation over the last decade. As AE has resulted in more people participating in pension saving than before, the IFoA would strongly encourage limited changes in the short-term. It is important that the new pensions framework has sufficient time to bed-in before any more significant changes are considered. The biggest factor in helping individuals to plan for retirement would be stability. Consequently, we would support modest changes to the tax framework being undertaken within the current system rather than more radical changes.

40. As noted previously, we would suggest that increasing participation in long-term saving should be the greater priority rather than developing a new tax system.

41. The biggest concern the IFoA would have about a new system would be the potential removal of a brake on individuals accessing funds at retirement. The current tax approach encourages income as a priority rather than complete capital withdrawals. We would urge the Government to fully consider the possible impact of such changes on the broader welfare system.

42. An alternative system would also require the introduction of transitional arrangements. Such arrangements would be complex and would not add any simplicity to the current system. In particular, transitional arrangements for DB schemes would cause a big increase in administrative costs. Such costs may not be beneficial to the employers that continue to allow accrual.

43. We would also encourage the Government to consider the impact of the 2014 Budget pension reforms. While it is too soon to reach conclusions about the use of the new freedoms, we would welcome any analysis of income and capital withdrawals that would allow a complete understanding of the benefits and risks of those reforms.

Q.5 Should the government consider differential treatment for defined benefit and defined contribution pensions? If so, how should each be treated?

44. The current system allows flexibility for the Government to make ‘evolutionary’ improvements to the existing pensions tax framework to achieve its objectives. This would allow continued consistent treatment of DB and DC pension provision.

45. However, if Government were to implement more radical change to pensions taxation, the wider consequences would need careful consideration.

46. The nature of DB schemes would cause challenges in designing a fair, transparent and practical TEE regime, therefore, the Government should not under-estimate the impact of transitional arrangements and the associated costs. Given the declining importance of DB arrangements, we are unsure the additional cost would be beneficial.

47. There would also be a number of challenges in applying a single rate of relief to DB pensions.

48. Although the current AA system places a value on DB pension accrual, it limits the overall amount of accrual in a very broad, approximate fashion. If there is a requirement to

determine the actual tax liability for every member of a DB scheme, we would suggest that a more robust methodology would be essential.

49. A TEE regime, or a single rate of relief, would be easier to apply to DC schemes, but operating different systems for DB and DC would bring its own complexity and would not appear to meet the transparency principle. In addition, there would be transitional issues to consider.

50. It is unclear whether changes to the pension tax framework would be retrospective, or prospective. Again, careful analysis of the options would be needed to investigate the complexity of operating dual systems and the impact of amending accrued rights, or funds.

51. One possible simplification would be to remove the AA from DB schemes and the LTA from DC schemes, although certain circumstances would require careful consideration (eg DB to DC transfers). As we noted previously, both allowances do not sit comfortably with both types of scheme; therefore, adapting the current system may make the allowances work more simply.

52. Alongside such a change, the Government could consider the impact of changing the allowances. We would encourage any such change to incorporate regular fixed reviews that provide some certainty to scheme members, but that would also provide future governments with the flexibility to keep a sustainable system.

53. Whichever way the limits are set, it is likely that arbitrage situations will arise between DB and DC members and fairness between different types of member will be a key consideration.

54. The Government should also consider the potential impact on AE given that most AE membership is by means of DC schemes. Changing the tax regime may change the member's net pay and projected benefits, resulting in reduced confidence in AE just as it is gaining momentum among small employers.

55. The Government should also be aware of the perception that public sector employees benefit significantly from DB provision. If different tax regimes existed for DB and DC schemes, DC scheme members may view the protection of a tax system that offers specific benefits to DB members as unfair.

Q.6 What administrative barriers exist to reforming the system of pensions tax, particularly in the context of automatic enrolment? How could these best be overcome?

56. The IFoA considers that the existing tax system provides sufficient flexibility for Government to adjust current reliefs to achieve its intended outcome. Amending the current system would introduce additional administrative complexity and cost for employers, trustees and members. The Government should not underestimate these costs.

57. Removing tax relief on contributions would likely increase AE opt-outs, as well as having implications for employers' contribution systems and communication to employees. Given one of the principles is to build on the success of AE, we would caution against changes that would hinder the greater participation of employees in pension saving. In addition, the step changes to contributions for AE have not yet been implemented, so employees must become accustomed to increased saving.

58. Ring-fencing of pension funds in relation to contributions made under the current pensions tax framework would introduce administrative complexity. In particular DB schemes would face major costs, which given the limited extent of future accrual, would appear disproportionate.

Q.7 How should employer pension contributions be treated under any reform of pensions tax relief?

59. We would emphasise the points made in our opening comments that the impact of changes on employers is very important. Employers provide a high level of encouragement to their employees to join schemes. The IFoA would have concerns that any additional costs for employers would deter them from encouraging employees to join pension schemes. Any measure that prompted employers to reduce their total contributions to schemes would have a serious impact on national pension provision. We would encourage the Government to consider the views of employers and their representative bodies specifically in relation to this question.

60. While the IFoA will not specify any policy proposals, we would encourage the Government to have regard to the interaction of Income Tax and National Insurance. We note that there has been speculation of changes to both by many commentators. If the Government were to consider such changes, we would welcome consideration of changes to employer pension contributions as part of that review.

61. The IFoA would also highlight that a significant proportion of employer contributions are in respect of deficit payments for DB schemes. Any analysis of change to the tax treatment of employer contributions should reflect that those contributions are in respect of past accrual.

62. The extent to which the Government wishes to balance the granting of reliefs between employers and employees is a policy question. The IFoA has no view on that balance provided both employers and employees retain an incentive to save for retirement.

Q.8 How can the government make sure that any reform of pensions tax relief is sustainable for the future?

63. Sustainability should consider financial and political measures. If the Government can develop consensus for the future pensions framework, including tax, that framework will have greater stability. Greater stability in the framework can give confidence to all participants in pension provision that long-term saving is viable and beneficial. Financial stability will mean setting tax relief in a way that does not create a cashflow problem for any government, while recognising that there will not be a future call on post-retirement welfare payments.

64. We would support any analysis the Government might undertake to recognise the benefits of tax relief across different cohorts. Scenario testing and population projections for those cohorts should provide a useful estimation of future reliefs granted.

65. The IFoA recognises that this consultation will provide many possible solutions. We would welcome the opportunity to discuss our response with officials, particularly the way in which our general comments could be used as an objective assessment of any future proposals. If you wished to have such a meeting, please contact Philip Doggart, Technical Policy Manager at the IFoA, on 0131 2401319 or at Philip.Doggart@actuaries.org.uk.

Yours sincerely

Fiona Morrison
President, Institute and Faculty of Actuaries

Appendix **Headline Advantages and Disadvantages of Possible Changes**

Change	Advantages	Disadvantages
Remove higher rate tax relief	• Reduces cost to HM Treasury • Relatively simple • Will impact middle income earners harder	• The rate of tax relief could be lower than the eventual tax paid • Highest paid may access other tax efficient vehicles • Greater complexity for higher rate taxpayers in DB schemes
Introduce higher single rate tax relief	• Targets the lower paid increasing the incentive to those who need it most	• The rate of tax relief could be lower than the eventual tax paid • Highest paid may access other tax efficient vehicles • Greater complexity for all members of DB schemes • External factors may be a greater deterrent to paying pension contributions than the availability of tax relief
Move to a TEE system	• Simple to understand	• Transitional arrangements are complex, particularly for DB schemes • No brake on capital withdrawals after retirement • Removes incentive to save for the long-term • Tax treatment of occupational pensions would be out of line with taxation of the State Pension
Remove NI benefit for employers	• Can target relief to employees	• Disincentive for pension provision