



OCTOBER 2010 PENSIONS BRIEFER

INTRODUCTION

The election and the run up to it saw little in the way of developments in the world of pensions as “purdah” reigned in the corridors of Whitehall. The arrival of the coalition government has sparked a veritable tsunami of changes, many of which will have major implications for the way we save for retirement. Not a day goes by without new consultations or significant pieces of research being published and it has frankly been impossible to keep up. However, decisions have been taken in the last week which make now a good time to take stock. The announcement of the coalition’s intention to work towards a decent, universal, basic state pension, and to abolish means-tested retirement income benefits is one, and the publication of the auto-enrolment review with its conclusions another. Both have material impacts on the future of retirement and upon policy directions such as the abolition of the requirement to annuities at age 75, for example. This Briefer will look at a canter at some of the developments and their implications.

AUTO-ENROLMENT

There has long been policy consensus around the decision to auto-enrol employees into pension saving commencing in 2012, but the new government established a review team to consider how it might work and, specifically, whether the National Employment Savings Trust (NEST) would actually need to be built. Could the existing industry do the “heavy lifting” instead? What changes to the parameters of auto-enrolment might be advisable? The summer saw extensive consultation by the review team and a number of options were considered, such as exempting companies with fewer than 5 employees from the new “duties”, minimum salary levels for auto-enrolment and others which had the effect of getting very close to the existing “stakeholder” pension regime. Even at this, however, stakeholder providers signalled in August that they were just not interested in stepping up to the plate, and at that point the decision to press ahead with the NEST build was made. This also relieved any pressure there might have been to make major parameter changes to auto-enrolment, although the changes there have been are welcome. These include the ability to defer auto-enrolment by up to 3 months and the prospective ability of existing employer pension schemes to self-certify compliance with the minimum standards. All good, common sense - “Day 1” auto-enrolment always looked an administration nightmare to me.

So now we proceed to the first tranche of auto-enrolled employees in 2012, with the first “pilot” employers scheduled to go live in 2011. The publicity has raised awareness rapidly amongst employers, and especially small employers, of an impending 3% addition to their salary roll. This is the level at which compulsory “super” contributions by employers started in Australia in 1992. Mighty was the grumbling amongst employer groups ahead of it going in at the time, but within a year everyone had got used to it. If the Cooper Review in Oz has its way, the employer contribution next year will be no less than 12% of salary, up from 9% now. This puts a future 3% contribution from UK employers in context, and even this will be phased in.

Will auto-enrolment work?

My best guess is “sort of”. There are two issues out there which may militate against it being the success it needs to be. The first is that those on modest incomes tend to have immediate needs which account for every pound of income they generate, so an (eventual) 4% cut in their income is going to be very noticed. In Australia, the pension saving obligation was always on the EMPLOYER – employee contributions are encouraged, but are voluntary. The second is the high personal debts many households carry, whose servicing costs often preclude much in the way of saving, although the Savings Gateway experiment gave cause to hope that even those on the most modest incomes could save a bit, if given the right incentives. Perhaps a third is the damaged brand of pension saving, and it’s interesting to note the way that NEST has set out to avoid the “p” word in its prototype literature. I’ll stick my neck out and estimate 45% to 50% opt-outs, though I hope I’m wrong. I don’t think the policy objective will be deemed to have been achieved at that, and that compulsion on the employer, rather than the employee, will be required.

TOWARDS A DECENT, UNIVERSAL, BASIC STATE PENSION FOR ALL

The announcement, the day before the release of the auto-enrolment report, of the publication of a Green Paper on this topic before the end of the year, is one of the most welcome developments I have seen in pensions in all my time working with them. Probably intended to forestall any newspaper headlines about it being “unsafe to save” in pensions (which it did), it will also have far-reaching consequences for wider pension reform. It is envisaged that the current means-tested retirement income benefits (Guarantee Credit and Savings Credit) will be abolished and that the current State Second Pension (S2P)

will be rolled in to the new pension, to provide an income of around £140 per week for a single pensioner. This compares with a Basic State Pension of just over £97 today. If enacted, the aim is to introduce the new regime from 2015. Why is this so important? We have argued for this move for some time now, believing the current arcanelly complex morass of different retirement benefits to be impenetrable to the very people supposed to use, with means-testing acting as a barrier to private saving, resulting in poor outcomes for retirees. Under this proposed regime, radical simplification will take place and people will have a very clear idea of what they will get from the state in retirement, providing the clearest possible incentive for further saving and ensuring that every pound saved will directly benefit the saver. Reform of the state retirement benefit architecture will also make meaningful reform elsewhere possible. For example, the current move to abolish the requirement to buy an annuity at age 75 contains a requirement to provide a “minimum income” to lift the pensioner clear of means-tested retirement benefits. If these no longer exist, why do we need to this? Why not allow income drawdown direct from the pension throughout retirement, using the entire pension fund? If pensioners DO run out of money, at least they will have the state pension, as an entitlement, to fall back on. For many, an annuity will still be the right choice of retirement income vehicle, although annuities, when “understood” by consumers, tend to get a negative reaction, even though they remove investment and longevity risk. And, if we now have very clear incentives to save, then auto-enrolment into saving will be more acceptable, countering to some extent the forces I referred to above. Note that I used the word “saving” advisedly, because this development may well pave the way for reform of the impenetrable architecture we currently understand as a “pension”.....

However, on a note of caution, this IS just a Green Paper, just the start of a process, and there WILL be opposition from those who will lose out on S2P benefits, for example. However, my view is that there will be far more winners than losers here, and that the prize is worth driving very hard indeed to get. More power to the Pensions Minister, Steve Webb!

RAISING THE STATE RETIREMENT AGE

An early move on the part of the coalition government was to signal its intention to raise the state retirement age sooner and further than the current proposals, which would see the retirement age raised to 68 in 2046. This always looked too weak to me, but we can see from experience in Germany and France that steep, short term, increases in retirement age can cause problems. The former is putting retirement age up from 65 to 67 soon and this has caused grumbling amongst older workers in its largely manufacturing based economy. The French, of course, have taken to the streets and manned the barricades to defeat a reform which, despite the headlines here, is about a similar jump in retirement age to 67 for most. The UK looks likely to go to 66 for men and women in 2020 – but this surely must be just the start of a rapid move towards 70. The savings are startling, with over £5bn per annum saved in state pension costs alone, with extra tax and national insurance receipts estimated at £3.5bn. In fact, it is arguable that the state retirement age is already 70 here. A little-known scheme exists whereby if state pension is deferred up to that age, a hugely increased pension becomes payable together with a lump sum, if desired. The figures make it a “no brainer” for those able to carry on in work.

RESTRICTING PENSIONS TAX RELIEF

One of the earliest possible moves on the part of the new government was to signal its intention to abandon the approach taken by the previous administration to this issue and to work on the basis of restricting the Annual Allowance instead. Again, this is an approach we had long argued for. It's not perfect, throwing up issues for the Defined Benefit community in particular, but a new, pragmatic, approach has been shown by Ministers and Officials at HM Treasury which is refreshing to see. At least the new regime will be operable by the industry and comprehensible to consumers, neither of which could be said of the previous approach. The reduced Annual Allowance will be £50000, better than some thought, and relief will be allowed at the tax payer's highest marginal rate, preserving an important and long-established principle.

SCHEME DATA – THE PENSIONS REGULATOR

Just published, this data is composed from the annual or triennial returns that Trust-based occupational Defined Contribution (DC) schemes are required to submit to the Pensions Regulator, and they capture the decline of such schemes in the private sector. Although not focussed on Defined Benefit (DB) schemes, the figure of just 1,140 open DB schemes left in the private sector charts their nosedive towards extinction. This compares with 34,610 open DC schemes. Even these have fallen in number to be just 25% of the total in 1997, showing the rapid retreat from occupational scheme provision in favour of contract-based arrangements – or none at all. Interestingly, NEST is structured as a Trust – based occupational pension scheme, bucking the trend for a range of operational and regulatory reasons. Most worrying of all, though, is the average combined contribution rate to these schemes, which is around 9.3% of salary, not far above the combined 8% which will eventually go into auto-enrolment and which compares unfavourably with Australia, which is now the best-pensioned country, per capita, on the planet. Unless we can get 15% of salary roll going into pension saving, year in, year out, we stand little chance of building pension “pots” sufficient to make much impact in terms of retirement income.

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