UK Pension Provision - Cutting the Gordian Knot

Charles Cowling, a senior actuary and pension consultant within JLT Employee Benefits, a division of the JLT Group, has written a paper for the think tank, Politeia, on pension reform in the UK.

The views expressed in Charles's paper are his personal views on reform of the pension system in the UK and do not represent a JLT "house view". But JLT Employee Benefits does believe that pension reform in the UK is needed at this difficult time for our economy and for pension schemes. Moreover, JLT Employee Benefits welcomes new and innovative contributions to this vitally important debate and hopes that Charles's paper will spark some much needed new thinking and discussion.

In his Politeia paper, Charles Cowling highlights a number of problems affecting pensions in the UK :

- People are all living longer - a lot longer
- Pensions have become much more expensive
- Tax incentives for pension saving have been eroded
- The private sector is weighed down by legacy pension debts
- The public sector has a mountain of unfunded pension debt
- Regulators are demanding increased protection for pensions
- Employment practices are changing
- Defined Benefit (DB) Pension Schemes are rapidly disappearing in the private sector
- We are not saving enough for our retirement
- Current pension provision is a complicated mixture of State and Private
- The National Employment Savings Trust (NEST) is complicated and will provide only minimal benefits
- Politicians do not seem prepared to introduce major pension reform

Charles recognises that there is no unique solution to the many and difficult pension problems which the UK faces. But any "solution" to our pension difficulties must be a "big picture" solution. It must tackle all the different elements of this fiendishly difficult issue. Steve Webb, the recently appointed Pensions Minister, has spoken of the "curse of incrementalism" whereby time and again we have tinkered with our pension system in the UK without introducing the fundamental and holistic change that is needed. Charles suggests one possible way forward in his paper which can be summarised as follows:

1. Overhaul of State benefits
State pension provision should be simplified and made more affordable with an increase in the State Pension Age (SPA). In particular, reform needs to increase SPA to age 70 or 75 as soon as possible.

The State Second Pension (S2P) should be abolished and a new enhanced flat rate Basic State Pension payable from the new State Pension Age should be introduced. If at all possible, the level of the Basic State Pension should be high enough to take most people out of the means tested Pensions Credit.

The decision on restoring the earnings link for the Basic State Pension should be linked to possible further increases in SPA for increasing longevity, i.e. if the earnings link is restored then there should continue to be further increases in SPA to reflect increasing longevity (and initially this should mean increasing SPA to age 75).

If, however, it is desired that there should be no further increases to State Pension Age beyond age 70 then the Basic State Pension should continue to be linked to prices in order to accommodate the cost of increasing longevity.

2. Introduction of a Standard Transfer Value basis
The adoption of a standard and consistent way of placing a value on a pension is recommended and a proposed Standard Transfer Value basis is outlined in the paper.

3. Creation of new low risk Default Investment Funds
Default Investment Funds (DIFs) should be created to allow people to manage better the risks associated with DC pension schemes. The key characteristics of DIFs would be:

- The capital value of the invested funds is guaranteed not to reduce
- Interest is added to invested funds (net of all charges) equal to at least the rate of increase in the RPI or CPI
- Provided the above criteria are met, DIFs can be designed to whatever additional investment profile NEST and / or the capital markets can create and support
- The Government is allowed to create unfunded DIFs which pay notional interest at the rate of the increase in the RPI (or CPI) + the yield on index-linked gilts

4. Simplification and enhancement of NEST

The following changes to NEST are proposed:

- Auto-enrolment to apply to all employees within 6 months of starting employment with no opting-out. There will be no 'contracting-out' by employers of this minimum second tier pension, although existing DC schemes could, where required, be converted to qualify as a NEST equivalent scheme. For those whose total earnings are less than 2x the Lower Earnings Limit, NEST pension provision would not be compulsory and would be by application rather than auto-enrolment.
- The minimum total contributions should be increased to 12% of the greater of basic salary and 'band earnings' (i.e. earnings between the Lower Earnings Limit and the Upper Earnings Limit). Employer contributions should be set at a minimum of 6 per cent. This increase in cost will be partly offset by lower National Insurance contributions with the abolition of S2P.

All accrued second tier State pensions should be converted into capital sums (calculated on the Standard Transfer Value basis) and then these entitlements transferred to an unfunded Government Default Investment Fund.

The concept of a Target Second Pension should be introduced, possibly equal to the enhanced Basic State Pension. The first tranche of pension savings must then be invested in the new low risk DIFs until the total funds so invested reach 15x the Target Second Pension. Once the pension savings have grown so that the total invested funds (including unfunded DIFs) exceed 15x Target Second Pension then all additional pension savings can be invested with greater freedom. Funds could be transferred out of DIFs into other pension investment funds provided at least 15x Target Second Pension is maintained in DIFs.

On retirement the accumulated funds must first be used to buy an annuity up to the amount of the Target Second Pension. Retirement should be allowed from age 55, provided the accumulated funds are sufficient to secure the Target Second Pension. Up to one quarter of all pension funds in excess of the amount required to secure the Target Second Pension can be taken as tax free cash at retirement.

The private sector should be allowed full and fair competition with NEST. So pension providers should be allowed to create DIFs and pension schemes equivalent to NEST.

5. Restore simple 'EET' tax system for pensions

All existing tax rules / limits on pension contributions should be removed. Full tax relief on pension contributions should be unlimited up to 25 per cent of the greater of basic salary and 'band earnings' but tax relief on employer contributions should be granted only where such contributions are the same (as a percentage) for all employees. All pension savings should be allowed to roll up free of income and capital gains tax.

Thus a simple 'EET' system is restored, i.e. pension savings are exempt from tax at the point of deduction from salary, are exempt from tax before retirement, but are taxed as income in retirement.

However, a maximum limit of £100,000 is suggested for tax free cash. It should be possible to take the tax free cash in more than one installment. But the total tax free cash would still be limited to £100,000. If there is a desire to restrict high earner tax relief further this is better (and more simply) done by further reducing the maximum limit for tax free cash, possibly down to £50,000.

If a new simple universal DC based system with compulsory minimum contributions is to be introduced for all, then a sad but necessary victim of the proposals is the end of DB pension schemes. So no tax relief on new accrual in DB schemes. Any new DB accrual (including salary linkage or enhanced early retirement) should be taxed as a benefit in kind (calculated as the increase in the accrued benefit valued on the Standard Transfer Value basis). Any transfer value paid from a DB scheme which is in excess of the Standard Transfer Value should be taxed as a benefit in kind on the excess payment.

Full and immediate tax relief should be granted on contributions aimed at removing DB pension scheme deficits.

Provided someone has earned a Target Second Pension, then there should be no further requirement to buy an annuity at retirement or any age thereafter. An annuity could be purchased at any time, but if an annuity is not purchased, the member could draw up to 5% per annum of their pension fund (subject to normal income tax rules) at any time from age 55 onwards.

The above (much simplified) framework would then replace all existing tax rules on pensions.

6. Reform of public sector pensions

Public sector pensions should be treated in the same way as private sector pensions, but with future change driven through the tax system. There would therefore be no attempt to cut back accrued benefits of public sector workers. This is a debt that the Government must manage over the next 40 or more years.

For future pension accrual, the public sector should be subject to the same rules as the private sector, as outlined above. The public sector could retain existing DB schemes, but the expectation is that the taxing of all DB accrual as a benefit in kind and the required introduction of mandatory NEST schemes would see a very significant rationalisation of DB schemes.

The public sector could still continue to provide generous pension schemes through enhanced NEST schemes (using unfunded Government DIFs), but there would be much greater transparency on their cost.

7. Help employers manage DB legacy liabilities

The cost of insurance company buy-outs for deferred pensioners is high and the risk of ongoing management of legacy liabilities is also high. It is not practicable or even possible to take away the layers of extra costs and guarantees that have been heaped on legacy pension liabilities in the UK over many years. But it is possible to provide assistance to employers to help them settle these liabilities.

So, the Standard Transfer Value basis should be introduced for all pension schemes. Trustees could choose to set transfer values as a percentage of the Standard Transfer Value. Trustees could pay less than the Standard Transfer Value if so advised by Scheme Actuary, but trustees must disclose to members the calculation of transfer values as a percentage of the Standard Transfer Value.

Any pension scheme paying transfer values equal to the full Standard Transfer Value could, at the request of the employer, compulsorily transfer any deferred pensioner under the age of 55 into an appropriate DIF. Pension schemes would thus be able to reduce legacy DB liabilities at a reasonable cost.

8. Change approach to employment / retirement

Greater use of part-time employment between age 55 and SPA needs to be encouraged. One possible approach might be:

- Remove references to 'retirement' from employment contracts and 'employment law, whilst retaining the power for employers to 'retire' employees if through ill-health or infirmity they are unable to do their job and there is no suitable alternative job.
- Introduce requirements for training and retraining older employees
- Introduce legislation which would allow employers (indeed drafted in such a way so that it would be normal practice unless both the employer and employee agreed otherwise) to reduce workers hours progressively between the age of 60 and State Pension Age.

The full paper is available at www.politeia.co.uk