



Turner's work of art? The second report of the Pensions Commission

The long-awaited, extensively leaked but highly comprehensive second report of the Pensions Commission has been published. Running to nearly 800 pages (including appendices), it is a major assessment of the uncertain future facing pension provision in the UK if current laws remain unchanged, and suggests a blueprint for reform. As we have come to expect of the Commission's work, it is painstakingly researched and based upon an impressive bank of knowledge, much of it gathered by the Commission itself, in the absence of suitable, reliable information from any other source. Not surprisingly, given the line taken in the Commission's interim report last year (reported in Issue 94) there is no 'magic solution' offered. Instead, reform is recommended on several fronts, as a balanced package, so that no single change becomes too onerous in itself. As such, the recommendations should be looked at as a package. The balance between different items may not be right yet, but to 'cherry-pick' some items and ignore others would destroy any chance of the balanced solution that the Commission is trying hard to achieve.

The recommendations – a package deal

So, what are the specific recommendations? They fall under two main headings: reform of the State pension arrangements, and encouraging private provision.

Reform of State arrangements

The Commission's view is that present State arrangements are too complicated, wrongly targeted, and insufficient for the nation's long-term needs. They are also designed to underpin a thriving and expanding private retirement savings system – but instead, private saving is contracting, leaving an increasing potential shortfall. The system of means-tested pension credits has done a good job in recent years to alleviate the worst effects of pensioner poverty, but they are at best a temporary measure, and their relationship with a Basic State Pension that increases only in line with price inflation is set over time to put the majority of pensioners onto means testing for their basic entitlement from the State. The Commission recognises that any changes here imply increased costs, but it has sought to minimise those by the balance it has struck.

Consequently, it recommends that:

- the Basic State Pension should become more generous, increased in line with increases in National Average Earnings from 2010 or 2011, when the public expenditure benefit of the rise in women's State Pension Age begins to flow through the system; simultaneously, the real value of the means-tested pensions credit should be capped, so that the current trend of increasing numbers falling within the means-tested system is reversed over time
- qualification should become less dependent upon work history, and more on residency, to improve the coverage of people such as carers, who have not had the opportunity to earn rights due to an understandable inability to engage in paid employment; it should be a universal benefit for those aged over 75

- the current two-tier system, although unnecessarily complex and undesirable, is too ingrained in the pensions system for it to be abandoned; S2P should therefore be retained, but as a flat-rate benefit as it was originally intended to become; in any case, the Commission believes that retention of the two-tier system will facilitate the transition and to abolish it would accelerate the decline of defined benefit provision
- the age from which State pensions are normally payable should increase broadly in proportion to the increase in life expectancy, possibly to 66 by 2030, to 67 by 2040 and to 68 by 2050; a differential between the Basic State Pension and S2P could be justified, to protect those in the lower socio-economic groups who have lower life expectancy; consideration should also be given to allowing partial drawing of either or both benefits, to encourage retirement/employment flexibility, thereby hopefully reducing costs and keeping more individuals active in the workforce for longer
- after 2050, any further increases in the State Pension Age should continue to be related to improvements in average life expectancy, to maintain the proportion of working life to retirement
- contracting-out of S2P, although undesirable, should be maintained for defined benefit arrangements until possibly 2030; however, contracting out for all DC arrangements should be abolished.

Encouraging private provision

The Commission clearly wants to see a significant increase in private provision on top of a (still fairly basic – providing perhaps about 30% of average earnings on average) State pension. It is concerned that membership of good private schemes is still only taken up by a lucky minority – usually those with higher disposable incomes anyway. Noting that where a good employer-sponsored scheme is not available, the costs associated with existing private pensions savings vehicles are not competitive, the Commission wishes to see the creation of a new low-cost savings vehicle – the National Pension Savings Scheme (NPSS).

It stops short of recommending full compulsion, which many had called for. It effectively regards this as too blunt an instrument, since it would not take account of individual circumstances such as accrued student debt, the need to take out a mortgage, or the high levels of debt that many individuals currently hold – and which ideally should be cleared before paying contributions to fund pensions.

However, the alternative recommended by the Commission is the closest it could get to compulsion without actually introducing it. Every employer who does not provide access to an occupational scheme at least as generous as the NPSS would have to participate in the NPSS, unless the *employee* chose to opt out (a decision which is intended to be revocable if desired by the employee). Suggested contributions would be 4% from the employee, 3% from the employer, and 1% from the State, on earnings between the primary threshold and the upper earnings limit. Of course, many people are self-employed, and they would be *encouraged* to join, on similar terms.

In order to keep costs low, there would be a national contributions collection and records service, and the contributions would be passed on to selected private sector fund managers. Choice of investments would include a number of very low-cost funds bulk-bought from the fund management industry, with a default option incorporating 'lifestyling' principles. In this way, the Commission believes that annual costs for the new arrangements can be contained to around 0.2% - 0.3% of fund value – comparable to those currently enjoyed by the larger occupational schemes.

Although the Commission believes this system will do much to alleviate the projected decline in future private pension coverage, it wishes to see people making even greater provision – after all, the contribution levels are modest compared to those currently made by good occupational schemes, and the suggested improvements to State pensions will still leave many with lower expectations than are currently enjoyed by many members of occupational schemes. Additional voluntary contributions to the NSPP (up to a certain limit) would therefore be allowed. Furthermore, the Commission wants to see good conventional schemes continue, and so do not suggest any reduction to the levels of tax concession presently available. In addition, it wants to encourage further provision by members, and recognises that this will require a concentrated education effort, targeted at those currently in employment, to match that starting to occur in schools.

Further measures

This is a comprehensive report, looking across a wide area of interrelated issues. It recognises the importance of encouraging longer working, with an environment that makes it easier to remain actively at work, perhaps balancing work and retirement and, as part of that, the need to promote good and healthy working environments and processes. This is considered particularly important in respect of the lower socio-economic groups, whose members appear to be disproportionately vulnerable to serious illness and death from earlier ages, and therefore liable to be more adversely affected by an increase in the State Pension Age.

Finally, the Commission recognises that things never stand still. Any new system will need to be kept under regular review, to ensure it continues to be properly targeted; it is therefore recommended that a successor body be established, charged with presenting a report, every three to four years, to Parliament and Government on the continued relevance of the system.

First reactions

So what do we make of it all? First, it is worth remembering that this report is written to address *future* issues; as such, it was never intended to address the problems that so many employers with occupational schemes are currently grappling with, such as funding deficits and excessive regulation. There is therefore no need for an urgent consideration of these recommendations by employers, who are busy enough dealing with current problems and struggling to prepare for the changes that next April will bring.

However, it would be wrong for employers to believe that these proposals have no relevance. Most scheme designs are affected to some extent by the State arrangements, even if it is only through a recognition of the aggregate amount of retirement benefit that an employee can expect to receive. Many more schemes actively integrate, either through a recognition of the State benefit in their own benefit formula, or through being contracted out. Any changes to State benefit will therefore need to be considered when reviewing existing scheme design.

In the course of such a review, some employers' thoughts will undoubtedly turn to considering whether they wish to provide anything more generous than the 'compulsory' contributions

to the NPSS (for in essence they are compulsory). It is often said that one reason why there is such a poor level of employee saving for retirement is that individuals neither understand nor trust the system to deliver on its 'promises'. If that is true, it also applies to many employers, who feel that they are treated as 'cash cows' to be milked whenever the government of the day considers it needs money for further public expenditure, or for funding its latest act of largesse towards employees. Consequently, without clear signals that the goalposts will at last stand still for a while, employers may decide that they cannot continue to run businesses with the uncertainties and cost volatilities that they have been exposed to in the past from pensions, and retreat to satisfying only the legal minimum requirements.

We have specific concerns about the continued complexity of the system, with the two-tier State benefit continuing, and contracting-out continuing, even in its reduced form. That said, we give the Commission's report a cautious welcome. It attempts to give a comprehensive package of recommendations, striking a balance between several difficult and potentially unpalatable options. Such a report will never please everyone; each recommendation will have its supporters and its opponents. But any solution will provoke such responses; what is important is that we have a package of reforms that fit together as an integrated whole. As long as the package as a *whole* addresses the issues, its shape is almost immaterial, *provided it is not constantly changed*; if businesses know what their liabilities are, they can and will plan to deal with them. For this reason, we are particularly pleased to see the recommendation of a successor to the Commission, which should at least deter politicians from making changes without understanding the likely consequences – although we would like to see the body given some decision-making responsibility.

The report was to the Government. The Secretary of State for Work and Pensions has welcomed it as "an important milestone towards a lasting pension settlement" and promised wide debate over the next few months, and we are promised a detailed response with policy proposals in the spring. We await this crucial development with interest.

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