



Our response to the First Report of the Pensions Commission

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Mellon

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1. Introduction and overview

The Human Resources & Investor Solutions division of Mellon is pleased to have the opportunity to comment on the First Report of the Pensions Commission. Overall, we welcome the tone of the report and its concentration on first establishing key facts and data on which to base a mature and wide-ranging debate. That the debate needs to be wide-ranging is beyond doubt. It is not, and never has been, appropriate to look at pensions in a vacuum. Planning for retirement is a long-term issue, whether provision is to be made by the State, or by private means. Nor is this principle changed by whether the pension is funded or not. The provision of an income for someone who is no longer actively contributing to the nation's wealth requires advance planning, and can only be afforded if the cost is effectively spread over a number of years.

Combating “short-termism”

In our view, one of the key problems of pensions legislation over the past two decades has been its focus on short-term “fixes” to address symptoms that cause problems in the short-term, without appropriate thought being given to the longer-term effects on pensions or other areas, or even whether those problems being addressed are actually of long-term significance at all.

Whilst it is certainly true that election cycles and the understandable short-term perspective of the politician have been factors in this trend, these factors could have been controlled if there had been a single point of control over policy, able to take an expert and long-term view of the need for, and effects of, new legislation and other rules. Arguably this should have been done at Cabinet level, but with politicians having seemingly ever-shorter periods in government office, the necessary consistency rarely exists within a particular government, let alone when governments change colour. When one adds to this the huge amount of legislation that is now processed through Parliament each year, it is not surprising that the resulting time constraints prevent thorough debate and consideration of proposed new legislation – resulting in inappropriate and often counter-productive measures.

It is with this in mind that we have for some years now recommended the creation of a permanent, independent Pensions Authority, staffed by individuals with pensions and other relevant expertise and experience, and charged with taking appropriate pensions decisions. The creation of such a body would address the barriers to understanding amongst policymakers caused by the complexity of the UK's pensions system (although one would hope and expect that such a body would urgently seek ways to reduce such complexities) and would also provide the required long-term focus for policies. Aspects of our proposals have received widespread support over the past few months, and have been widely reported. However, we would be happy to expand on the details if it would assist the Commission.

Over-regulation

As the value of the liabilities to be funded grows, so the interest of regulators grows, and this is manifested in the growth of bureaucratic controls over trustees. The most recent of these has been the publication by the Treasury in late 2004 of proposals for new requirements for trustees under the Myners Code. The cumulative effect of all these additional requirements is that progressively fewer “lay” people are willing to volunteer to be a trustee. This is threatening to undermine the whole trust system for occupational pensions. The driver for this push to “professionalise” trustee boards seems to be largely the size of assets controlled by pension scheme trustees as a whole. Given concerns about that size (and the fact that, as a result of recent developments in accounting, scheme funding and expected investment returns, it is likely to get considerably larger over the next few years) it is understandable that any perceived “disconnection” between trustees and, for example, overt control in corporate governance areas will become more important.

The funding obsession

There appears to be an assumption that the best way to “guarantee” that pensions expectations will be delivered is to put money aside in a separately-owned fund. Simplistically, and in an ideal world perhaps, this would be the case.

However, as recent events have graphically demonstrated, an obsession with “full funding” (however that may be defined) has not necessarily made members’ accrued pensions safe and in a growing number of cases recently has led to strains on providers (especially employers sponsoring defined benefit schemes) that can either lead to a reduction in benefit promises or in extreme cases can push the company into insolvency. This is already causing significant problems for trustee boards (particularly for trustees whose expertise lies other than with pensions or financial matters) that find themselves having to balance the statutory funding requirements with the effect on the employer, and this can only continue. In many cases, the “problem” is essentially a short-term one, which could be appropriately addressed if a longer perspective were to be taken. Even clearly solvent employers with a strong financial base suffer, as accounting rules seek to value the long-term financial obligations of the pensions promises as a snapshot of today’s position.

Strong anecdotal evidence is emerging that these factors are starting to hold back the economic performance of companies. As the Commission’s First Report clearly shows, the strain on the national economy from the expected increase in the dependency ratio over the next 30 years will be significant, requiring the economy to be as strong and flexible as possible to help to meet the additional strain. It would be ironic if the necessary growth were to be seriously hampered by the imposition of straightjackets on companies through provisions aimed at meeting funding levels on a short-term perspective.

The creation of the Pensions Protection Fund does not address the fundamental security issue *overall* – it merely spreads it around a slightly different constituency, making problems for other employers. The PPF board itself, through its acceptance that it will not hold sufficient assets to meet all its long-term liabilities, judged from a short-term perspective, has tacitly acknowledged this. However, it is apparently comfortable with that situation (even without guaranteed government underwriting), because it is taking a long-term view. This is precisely what should be allowed to happen (within clearly-defined parameters) in other arrangements.

The ownership of assets to fund a future pensions promise is only part of the debate on the provision of benefits. In order to maintain (and hopefully increase) value, the assets held must actively participate in the economic process. On a proper long-term perspective they must deliver a given return. What therefore, in essence, is the difference between those assets being owned by a separate fund with their value today being directly compared to a future liability, and their value being retained in the wider economy, with the knowledge that at some time a financial liability will need to be paid for by them? In both cases, the liability will have to be settled by a call on the value of those assets or others of equal value. In the meantime, we will have broken the obsessive and damaging link between employers' future liabilities and current assets held in schemes against those liabilities.

Of course, it is true that holding assets specifically against a future liability does give some comfort and given the entrenched nature of the current UK approach, a wholesale movement away from funding in private sector arrangements would rightly be viewed as a step too far. However, given the problems currently afflicting the UK's funded pensions system and its effects on sponsoring employers who (for the moment at least) make provision for their employees voluntarily, it seems sensible to take an in-depth look at the principles behind funding and to separate out and address the more onerous, short-term problems. We do not know what the outcome of such a review would – or should – be; only that this type of fundamental and to some extent ideological review needs to be undertaken. It would need to be conducted, or at the very least directed, by a group of experts who have a strong mandate and long-term, wide-ranging focus, and its results implemented by a body capable of translating those results into sensible policies – in short, the proposed Pensions Authority.

2. Responses to the Commission's identified issues for consultation

First, in response to the Commission's three specific areas for comment:

1. Factual accuracy

We are not aware of any areas where the First Report is factually wrong, or where the Commission has failed to take relevant information into account.

2. Key variables

Assumptions have to be made and there can be no certainty of outcome of many of the variables. Generally the assumptions are within a reasonable anticipated range of outcomes. However, the equity real return of 6% per annum would appear to be at the high end of the range. Of more significance than the assumed return is the volatility of any such return.

3. The role of government in pensions

We believe that the role of the State in pension provision should be limited to the provision of a basic benefit available on a universal basis, set and maintained at a level that would be just sufficient to keep the recipient out of poverty if it were their only retirement benefit. The definition of "poverty" for this purpose would need political and economic input, taking into account such factors as overall affordability and the willingness of taxpayers generally to meet the bill. Any provision above that level should be the responsibility of the individual, and effective encouragement should be given to employers and others to help with that provision.

We have already pointed out that making provision for funded pensions is a long-term process. A suitable plan for determining an appropriate level of pension needs to start with a target based upon an assessment of the cost of securing a given lifestyle. It follows therefore that, in order to determine the amount of that target to be provided by private arrangements, it will be necessary to know what the State will provide. Therefore the State's element must be largely stable and predictable, which means that it must be set at a level that will largely be maintained for many decades at least. That in turn means that it must not be changed in reaction solely to short-term occurrences, which suggests that there would not be a day-to-day role for government after the initial level and parameters for change have been set.

We accept that there are sectors of society that are poorly placed to make their own provision. However, as long as the State pension has universal coverage and is at a level that ensures that all citizens are kept above the official poverty level, personal provision on top becomes an entirely separate issue, which can be addressed in terms of encouraging and helping people

to save. We accept that this is an area where government (or its appropriate delegate, such as a Pensions Authority) has a useful role to play.

We also recognise that the principle of compulsory savings within a private sector environment is, superficially at least, an attractive proposition. However, apart from the inequity of the principle of requiring some people (we are not sure how to spread such a requirement equitably across the whole population) to apply a proportion of their income in a way dictated by the State, we believe that such a requirement would generate resentment and hostility towards those who introduced it.

It may also result in a *reduction* in overall savings. This could occur because, in many cases, savings currently being made in other forms would be diverted to meet this requirement, and many people and employers would regard it as appropriate only to satisfy the minimum compulsory requirements and cease to provide anything further. This is likely still to be so even following government and industry advice to the contrary. This is to some extent a result of human nature, and the introduction of a transparent compulsory element above that required by the State through taxation would encourage that. This implies a need for incentives to save above the minimum compulsory level. Given the fact that, politically, any requirement for compulsory savings would have to be at a modest level, the overall savings rate would reduce. On top of all this, there would have to be a new bureaucratic regime, with its attendant costs (both direct and indirect) introduced to police it.

There is also an issue over the way in which such compulsory contributions would be invested. There is a fundamental difference between compelling contributions to a State scheme through taxation and compelling them into assets run by the private sector. The latter involves issues of choice, and the need to ensure a system of guaranteeing the security of those investments – and yet more bureaucracy and cost.

However, we also recognise that if a voluntary process cannot be made to work (enabling pension provision above the “poverty” level) it may be necessary for further State intervention, possibly with compulsion. The above concerns with compulsion would need addressing thoroughly and robustly to avoid the potential pitfalls. It is difficult to see how compulsion can work without government guarantees on returns, which in effect brings one back full circle to enhanced State provision (albeit partially on a funded basis). First of all though, voluntarism should be given a chance to work, in a long-term stable environment that would test whether it is a viable approach, given favourable and encouraging circumstances.

3. Other specific issues raised by the Commission for comment

As an employee benefits consultancy, advising clients wishing to make provision for their employees, we intend to concentrate in our response on issues that are of importance to our clients. However, we do have a background observation to make that influences the way in which we see the role of employers in respect of pension provision.

Since we do not regard it as the State's role to *ensure* that all their citizens are necessarily *financially comfortable* (as opposed to ensuring that they do not fall below a defined poverty level) in retirement, there is no need for government to impose requirements on employers to contribute to their employees' retirement benefits in excess of the level of taxation necessary to fund an equitable share of the cost of the universal basic State pension.

Furthermore, given the large number of individuals who are not in the paid employment of another, it is difficult to see how equivalent compulsion could be introduced to give these individuals comparable benefits. The logical implication of this is that a considerable amount of additional State interference with the economy as a whole and with the freedom of employers to get on and generate wealth, would be needed. We do not regard this as an attractive prospect.

However, we do agree that it is socially and morally desirable, if possible, that people should not be subject to financial concerns in their declining years. With this in mind, there is a role for government to *encourage* private retirement benefit provision, through such means as education, information, ensuring security where possible, and possibly the provision of appropriately-focused tax incentives – but with one proviso: none of these forms of encouragement should act as a disproportionate burden on employers. Any policies formulated in regard to this role should take account of the availability of other assets in the round, and the incentives and encouragement given in respect of them.

This forms the basis of our responses to a number of the questions raised in the First Report and answers those questions that relate to the role to be played by government.

In view of our position that the market should effectively determine the level of non-State provision, we have no specific comments on what constitutes an “adequate” level of income replacement.

We agree that the conclusions of Chapter 5 are reasonable. It is agreed that, if current trends continue, non-pension assets will play a non-trivial but modest role in pension provision. This position could change if a stronger savings culture were to emerge, combined with a significant increase in free net assets. However, at the moment there seems little possibility of the latter occurrence, given the increasing burden of university fees together with increasing needs for private care for the growing number and average longevity of the elderly.

We agree that housing wealth could play a significant role overall, but its effect in individual cases is restricted both because of the pattern of distribution of house ownership, and the ability or inclination of some to extract sufficient value from it to increase their retirement income.

Our opinions on the issue of compulsion are set out above. We agree that the voluntarist approach will not be able to ensure the provision of additional benefits, above those provided by the State, for all – and particularly not in the case of those on lower incomes during their working lives. However, as long as the universal State pension will keep those individuals out of poverty, the State should feel content to restrict its involvement to encouraging additional private provision by the means identified above.

Nevertheless, it is certainly true that the present means-tested State pension constitutes a serious impediment to any efforts in this respect. It is human nature that, if there is thought to be a strong probability of the State providing additional benefit in the event that the individual does not, particularly at the levels currently provided, and in respect of those on low incomes, then there will be a strong disincentive to save. That is undoubtedly what is happening now. In addition, the system is stifling the encouragement of private provision by the low paid, because providers cannot be sure that the arrangement they sell will not disqualify the individual from future means-tested benefit.

There is another problem. What we are describing here is, of course, the position that will apply on retirement in the future, but based upon today's rules. However, there is no guarantee that the current means-tested system will still be in place when today's workers come to retire. The Government has accepted views that the current system, at the current levels, is unsustainable in the long term. So, it is likely that those who would most benefit from saving regularly now are currently discouraged from doing so, but by the time that they realise that they should have been saving, it will be too late for them to make up the lost opportunity. This is a clear example of the need, referred to earlier, for pensions policies to be long-term, to ensure consistency for planning.

We agree with the analysis in Chapter 8 of the First Report of the position of women pensioners and of how it is likely to evolve. It follows that we accept the principle that we need to aim for a system in which all individuals, men and women, accrue pensions in their own right. Our recommendation above in respect of the State benefit will enable parity on at least this level to be achieved between men and women. As far as additional provision is concerned, the changes to the Inland Revenue rules for tax-approved arrangements due to come into effect from 6 April 2006 will help, since they will allow more freedom over who may contribute and when, in principle enabling provision to be made even while an individual is not receiving income.

4. About Mellon

The Human Resources & Investor Solutions division of Mellon is an employee benefit and actuarial consultancy operating through 74 offices around the world. In the UK we have over 30 years' experience, advising on all aspects of the provision and implementation of employee benefits for staff in corporations, local government departments and non-profit making institutions.

We employ consultants of the highest calibre. They are innovative business professionals who specialise in the key areas in which we operate, namely retirement planning, pension scheme administration, investment, employee communications, health & welfare, rewards and HR advice.

Our ability to understand our clients' needs, concerns and aspirations has enabled us to successfully provide creative solutions to the challenges they face.

Founded in 1916, we changed our name from Buck Consultants and Buck Healthcare in October 2003, and are a leading provider of HR consulting and outsourcing services in the world.

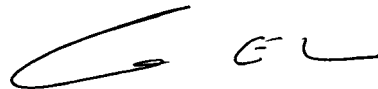
As the legislation affecting individuals and employers becomes increasingly complex, our international presence provides multinationals with the reassurance that we can advise on benefits and remuneration policies for staff anywhere in the world. With headquarters in Pittsburgh, USA, our international network spans offices across North America, South America, Asia Pacific and Europe.

As a member of the Mellon Financial Corporation, we draw upon extensive resources through our internal expertise and through our extensive corporate partnerships. With more than 5,000 professionals to serve our clients, we help employers provide for the health, welfare and financial security of an estimated 15 million men and women worldwide.



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