NAPF

Security in retirement: *towards a new pensions system*

NAPF response

September 2006

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2. However, given the importance of the changes proposed and the size of the challenge ahead, the Government must take the time to get the new policy framework right. The consequences of not doing so could be highly damaging to new and existing pension savers.

3. To help future generations plan for old age, the current wave of pensions reforms must lead to a lasting and effective settlement. To ensure their success – not just now but also in the future – we propose that a small, highly focused, Pensions Monitoring Board be established to monitor the adequacy and sustainability of the pension system, the take-up of Personal Accounts, and their impact on existing workplace pensions and savings levels.

Designing Personal Accounts

4. The NAPF supports the development of Personal Accounts, but how they are delivered will be critical. If designed poorly, they may not work in the best interests of consumers and could result in lower pensions for those already saving for retirement. It is essential that Personal Accounts are properly targeted and do not displace better schemes. This should be reflected in the evaluation criteria used to assess which of the options for Personal Accounts set out in the White Paper is selected by the Government.

5. Both the NPSS and Industry Model fail to achieve the best solution with regard to simplicity and choice; trust and confidence; and competition harnessed in consumers' interests. In particular, consumers are likely to find the types of choice confusing and may be less likely to remain in Personal Accounts as a result. And consumers are less likely to have confidence in the new regime as the most trusted party in today's world of pensions – the employer – will no longer be playing a central role.

6. However, if Government is minded to proceed with one or other of the two models then, on balance, NPSS appears to be the preferable option *provided:*

- it includes effective governance arrangements;
- it is maintained as a strictly targeted intervention;
- it is designed explicitly to limit the damage to existing provision; and
- it allows a diverse market of workplace pensions to thrive alongside it.

A Five Point Plan for Better Pensions

7. Personal Accounts will be a significant intervention and they will inevitably have an impact on existing schemes, especially as the Government has proposed that all employers must auto-enrol, and provide at least a 3% contribution, for all their employees – whether they are in Personal Accounts or in a workplace pension.

8. While many of these effects will be positive, some will be negative. For many employers with good schemes, auto-enrolment will result in contributions being paid to more employees. There is a risk that, in order to contain pension costs, some companies could level down their contribution rates towards the Personal Accounts minimum. We estimate that auto-enrolment could add around £2 billion to pensions bill for employers that already contribute 3% or more.

9. But the NAPF believes it should be possible to reduce the risk of levelling down and maintain the best of today's pension provision if the Government adopts the NAPF's 5 Point Plan for Better Pensions. We propose:

   1. A ***Good Workplace Pension Quality Mark*** for employers offering schemes above the Personal Accounts minimum and who meet set criteria.

   2. ***Financial incentives*** for employers that make contributions of at least 5% of gross earnings.

   3. ***Ring-fencing Personal Accounts*** from existing provision by prohibiting transfers in or out.

   4. ***A simple, flexible "suitable alternative scheme test"*** that takes account of contributions, costs and charges and scheme waiting periods.

   5. ***Transitional measures*** on contribution ceilings and waiting periods to help employers adjust to the additional costs of auto-enrolment (to be reviewed after 10 years)

Super Trusts – operating alongside Personal Accounts

10. The UK DC market is relatively immature. Unless serious consideration is given to the implications of the DC shift, there is a risk that future generations will retire on less than adequate incomes. The NAPF believes Super Trusts – large, multi-employer schemes with high standards of governance working solely in members' interests – provide a way to deliver the features necessary for a strong DC system.

11. Super Trusts will prove attractive to employers for a number of reasons: some may have reservations about the design of Personal Accounts or about placing their employees in a Government-run arrangement; others may want to do more than they can within the Personal Accounts structure but not wish to administer their own scheme; and a third group may wish to transfer existing DC pension arrangements into a Super Trust.

12. The Government has invited the NAPF to explore how Super Trusts could function alongside Personal Accounts. We look forward to developing this initiative with the Government over the coming months.

Strengthening occupational pensions – a flexible approach

13. The NAPF warmly welcomes the Government's proposal for a rolling deregulatory review of pensions legislation aimed at providing much-needed support to existing workplace pensions.

14. Occupational pensions – both DB and DC – play an important role in the pension planning of many millions of people and will continue to do so for many decades to come. They typically provide higher pensions than could be expected under Personal Accounts. Support for existing schemes depends not only on ensuring that Personal Accounts remain a "targeted intervention" but also on paring back successive layers of costly regulations applied over recent decades.

15. The NAPF has identified five areas on which the deregulatory review should focus as a priority:
    1. changes to scheme Normal Pension Ages;
    2. easing restrictions on changes to accrued rights (section 67, Pensions Act 1995);
    3. modification of the debt on employer regulations (section 75, Pensions Act 2004);
    4. changes to mandatory increases to pensions in payment; and
    5. changes to revaluation of deferred pensions.

16. We recognise the need to balance the interests of scheme members and scheme sponsors, but by reducing the running costs of defined benefit occupational pensions schemes, there is a greater chance that these schemes will stay open to future accruals and new members in the longer term.

Providing a foundation for private saving

17. The NAPF supports the broad thrust of the State Pension reforms. But the system will remain highly complex. A single, simple, State Pension would allow people to plan more easily for retirement and it should remain a goal for policymakers. We recommend that ten years after the introduction of these State Pension reforms there should be a review aimed at deciding whether the two flat-rate state pension systems should be merged into a single-tier.

18. Reforms to the State Pension must not harm, or increase the costs of, workplace pension schemes. The White Paper will accelerate the evolution of the State Second Pension (S2P) into a flat-rate benefit which will be complete by around 2030. In contracted-out defined benefit schemes, a single formula is used both to replace the S2P rights that members have given up and to provide additional benefits. Unless such schemes modify their rules, this reform will transfer resources from employers with DB schemes to the Exchequer. The Government estimates that its gains could total £0.4 billion in 2015, £1.1 billion in 2020, and £2.7 billion in 2030. We suggest that the Government should take account of this development when considering the NAPF's 5 Point Plan proposal for additional fiscal incentives for employers offering high pension contributions.

1. Introduction

Summary

- The **NAPF supports the framework for pension reform** set out in the Pensions White Paper, in particular the use of auto-enrolment and employer contributions. The reforms have the potential to benefit millions of working people and reverse the long-term decline in UK pension savings.
- Given the importance of the changes proposed, and the size of the challenge ahead, the **Government should take the time to get the new policy framework right** – the consequences of not doing so will be highly damaging to new and existing pension savers.
- It is important that the reforms lead to a lasting settlement on which current and future generations can plan for old age. To ensure stability, the Government should establish a small, highly focused, **Pensions Monitoring Board**. This should be charged with monitoring the adequacy and sustainability of the pension system. Its remit should include assessing the impact of Personal Accounts on existing workplace pensions and saving levels.

1. The NAPF welcomes the opportunity to respond to the White Paper *Security in retirement – towards a new pensions system.* The NAPF is the leading voice of workplace pensions in the UK. Some 10 million people are currently building up pensions through NAPF member schemes, and a further 5 million pensioners are receiving valuable retirement incomes from such schemes. NAPF members hold assets of over £800 billion, and account for around one fifth of investment in the UK stock market.

2. We share the Government's view that the current pensions system is failing too many of our citizens. There are a number of reasons why this situation has arisen:
    - Successive cut-backs have left the UK State Pension system "one of the least generous in the developed world".[1]
    - Escalating layers of regulation, combined with improvements in longevity, have increased the costs of providing pensions. Together, these have acted as a powerful deterrent to employers wishing to run pensions on a risk-sharing basis. The result has been a move away from defined benefit (DB) pensions to defined contribution (DC) pensions, often with lower contributions and consequently lower retirement incomes.

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1 *Pensions: challenges and choices – the first report of the Pensions Commission, 2004, p58*

- The interaction of means-tested benefits with private saving means that, on current projections, over 70% of today's population will be in receipt of means-tested benefits by 2050. This acts as a disincentive to save.

3. The NAPF therefore welcomes the framework for reform set out in the White Paper. Unlike previous attempts at pensions reform, which have adopted a piecemeal approach by looking across the pensions system as a whole, it presents an excellent opportunity to develop a framework that is genuinely fit for purpose – now and for future generations of savers.

4. The results of the White Paper are intended to last for decades and will affect the lives of millions of UK citizens – both those already members of pension schemes and those newly introduced to pensions saving through Personal Accounts. If the full potential of the White Paper is to be met, it is essential that the Government takes time to fully develop its proposals and assesses all the options, even if this means a slight delay in implementation. Failure to do so could have adverse consequences for Personal Account savers and the millions who currently belong to good quality occupational schemes whose pensions prospects would be damaged by a system which is poorly designed. Working in co-operation with all the major stakeholders, the Government must undertake a proper analysis of the risks to both government and consumers of the proposed new system to ensure that its design does not undermine the policy objectives sought by both the Government and the NAPF.

Recommendation 1: the Government should take time to develop fully its proposals and assess all the options. It must not rush into decisions, the effects of which will last for decades.

5. If properly implemented, the White Paper has the potential to create a step change in pensions savings. In particular, we welcome:
   - the Government's commitment to reform State and private sector pensions in tandem;
   - the recognition of the need to deliver value-for-money pension products to those not currently saving, building on the principles of auto-enrolment and mandatory contributions;
   - the commitment to support existing pension provision; and
   - the desire to build a lasting pensions consensus.

6. The NAPF is eager to play its part in building that consensus, and it is in this spirit that the comments and recommendations set out in this response are made.

7. In making our recommendations to strengthen the proposed framework for reform, we have been guided by five key tests:

    1. Will the new framework increase not just the numbers saving in pensions, but also add to, rather than replace, existing pension saving?
    2. Does it support existing pension provision by limiting inadvertent damage through levelling down and by creating a lighter touch regulatory regime?
    3. Does it create a genuinely simpler pensions system that will help promote understanding and take up?
    4. Will it increase consumer trust and confidence in pensions?
    5. Does it create a long-term stable and sustainable system around which there is consensus from the major stakeholders and political parties?

8. To meet the last of these tests, and the Government's own assertion that its reforms are a "new structure for the UK pensions system for the long term"[2], an independent mechanism is needed to ensure the conditions are present for the consensus to remain in place, thereby guaranteeing stability in pensions policy.

9. In its Second Report, the Pensions Commission recommended the creation of a permanent Pensions Advisory Commission to provide periodic reports to Parliament on key trends in demography, pension provision, and employment and retirement patterns. It also recommended that it should highlight the implications of this data for a wide range of government policy, including such issues as the State Pension Age, the adequacy of saving in both the National Pension Savings Scheme and private provision, and whether compulsion is needed in place of auto-enrolment. This recommendation received support from a wide range of stakeholders, including the NAPF[3].

10. The Government's response was to say that it would periodically undertake reviews, drawing on a range of advice in light of demographic developments. We appreciate that the Government may have reservations about setting up a new institution in the area of pensions, given that several new bodies have been created over recent years. We also understand that the Government may feel that the creation of another major pension institution at this time may not help promote the stability needed to help people plan for retirement.

11. But we believe there is a middle way: the creation of a small, highly focussed body – the Pensions Monitoring Board (PMB) – which would monitor the adequacy and sustainability of the pension system and provide a triennial report

2 Secretary of State's Foreword to the Pensions White Paper.

3 Others who supported the creation of a permanent pensions commission included Which?, Help the Aged, Age Concern and the Pensions Policy Institute.

to Government on developments, and any implications for pensions policy. This would not be a policy-making body – this role rests with government. Rather its remit would be to help government ensure that the pensions system remains on the course set by the reforms.

12. Much of the PMB's work would be to compile and analyse existing data, but it would also commission additional research on topics not covered by the available data or requiring closer study. A model for this body is the Low Pay Commission which operates to clearly defined objectives and has only 10 employees.

13. The Government has said that it will undertake a review of the institutional landscape for pensions later this year. The creation of a Pensions Monitoring Board should form part of that review.

Box 1: Pensions Monitoring Board: proposed Terms of Reference

Remit: to monitor the adequacy and sustainability of the pension system.

- **Adequacy:** monitoring the adequacy of retirement provision in both the state and private sectors against government-set benchmarks. The analysis would also take account of non-pension sources of retirement income such as housing wealth, welfare payments and inheritances.

- **Sustainability:** monitoring the sustainability of the pension system, especially with regard to life expectancy, affordability for public finances and the success or otherwise of private pensions saving. This would include an early warning of any adverse trends (eg levelling-down of existing pension provision, poor take-up of pensions among the self-employed, high auto-enrolment opt-out rates) and an ongoing review of the need for adjustments in the State Pension Age in light of demographic change.

Outputs: a triennial report on developments, including any implications for pensions policy, to the Secretary of State for Work and Pensions, laid and debated in the House of Commons.

Structure: a Board comprising a small number of expert appointees supported by a small secretariat.

Accountability: to Parliament.

Recommendation 2: As part of its review of the institutional landscape, Government should create a small, focused, Pensions Monitoring Board to monitor the adequacy and sustainability of the pensions system.

2. Designing Personal Accounts

Summary

- The **NAPF supports the development of Personal Accounts**. They have the potential to help millions of people save for retirement in value for money products. But how they are delivered will be of critical importance.
- Personal Accounts should be designed to be a **targeted intervention** – at their introduction and over the long term. They will, therefore, need to be very carefully designed, and the **interface with existing pension provision** needs careful consideration if widespread levelling down is to be avoided.
- **Both models put forward for consideration have significant drawbacks** – they require complex decisions to be made by unsophisticated consumers and a significant new IT infrastructure. These features pose risks to consumers and government and could undermine the objectives of Personal Accounts.
- However, it appears likely that the Government will opt for one or other of the models set out in the White Paper. **On balance the NPSS is the preferable of the two options**

14. The NAPF fully supports the thinking behind Personal Accounts – it is right that the millions of people who do not have access to a pension arrangement through their job should be given access to a low cost pension scheme built around auto-enrolment and mandatory employer and employee contributions.

15. So the question is not *whether* Personal Accounts should exist, but *how* they are designed and delivered, as this will determine the numbers saving in them and their impact on existing schemes and pensions savers.

Personal Accounts design

16. One of the factors that has led to a decline in pension provision has been a collapse in confidence in pensions (and, more generally, financial services providers). This results from a series of issues, including personal pensions mis-selling, Maxwell, Equitable Life and, more recently, the high- profile collapse of company pension schemes. Whilst these issues have affected only a minority of schemes, and the vast majority continue to be well run, they have nonetheless had a damaging effect on consumers' perceptions of pensions. It is therefore essential that Personal Accounts command the trust and confidence of consumers. Failure to do so will result in large numbers of people opting out of Personal Accounts.

17. Regardless of the delivery model, the NAPF believes the success of Personal Accounts depends on:
    - **consumer trust and confidence** – delivered by building a simple framework with appropriate choices to the target market, maintaining employer involvement, and achieving value for money; and
    - **operational effectiveness –** delivered through an effective and error-free infrastructure which is well governed in consumers' interests and which harnesses market forces to drive down costs and drive up standards for retirement savers.

Trust and confidence

Simplicity: choice, adequacy and personal responsibility

18. The Government has said it wants individuals to take personal responsibility for their income in retirement and that this should be reflected in the system's design. We agree. Individuals should, where possible, take responsibility for ensuring they have an adequate income in addition to the State Pension. But we disagree that personal responsibility for pensions saving is instilled by requiring individuals to take complex decisions that they neither want, nor are capable of exercising.

19. Rather, personal responsibility comes from individuals choosing to remain auto-enrolled into their pension arrangement and opting to save above and beyond the statutory minimum where they can afford this. Once the new system is established, additional layers of choice could be added (as happened in Australia some ten years after compulsory superannuation started). This is a much more logical starting point given the UK's current chronic problems of undersaving and low financial awareness.

20. Personal Accounts are intended for people who do not have access to a pension with an employer contribution via their workplace. In the main, these will be lower income individuals working for smaller employers. Many will be first-time savers. As such, Personal Accounts must be built around the needs of these consumers by offering appropriate levels of choice and not around the more sophisticated savings tastes of some policymakers and commentators.

21. Requiring Personal Accounts savers to make complex decisions is likely to have one of a number of effects:
    - baffled by the choices, people will choose not to save; and/or
    - consumers may make poor decisions so their retirement expectations will not be met. In this case they are likely to look to government for redress: it will simply not be credible for the Government to say to these consumers that they could have made different or better choices.

22. The Pensions Commission recognised this danger, commenting in respect of fund choice, "…the consequences of poor decisions and poor timing are very large…"[4]. Lord Turner went as far as to say that "people exercise choice in a way that harms them"[5]. It is important, therefore, that the Government resists the temptation to "over engineer" Personal Accounts by offering too much choice. Rather it must focus on the job in hand – turning millions of non-pension savers into pension savers. Achieving a high take up of the new system would be a significant political achievement on the part of the Government.

23. The Government has yet to produce a strong evidence base to show that consumers want choice in Personal Accounts and, if given it, would make active and informed use of the choices available to them. By contrast, there is considerable evidence – much of it government sponsored – pointing to the very low levels of consumer financial literacy in the UK and the risks this poses to consumers when faced with complex financial decisions. For example:
    - around half the UK adult population does not have the numeracy skills expected of an 11 year old[6]; and
    - 40% of people who own an equity ISA did not know that the cash value of their investment is directly affected by stock market performance, while 15% of people who own cash ISAs believed that the value of their investment fluctuates according to stock market performance[7].

24. This low level of financial literacy is reflected in the poor quality and inappropriate decisions often taken by consumers:
    - NAPF research indicates that significant numbers would be likely to make unsuitable investment choices. 55% of people said they would want the largest proportion of their savings to be invested in "accounts paying a low rate of interest but where you are guaranteed not to loose your money". This is despite the fact that such funds are not considered suitable for long-term investments. The figure rose to 61% for those aged between 18-34 – the age group for whom low-risk, low-return investments are generally considered most unsuitable[8];
    - one-fifth of Child Trust Fund accounts are invested in cash, and around 30% of accounts remain unopened (20 February 2006[9]); and

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4 A New Pension Settlement for the 21st Century, Pension Commission Second Report, p195. (Hereafter Second Report)

5 Remarks at Which? roundtable discussion, Portcullis House, 1 March 2005.

6 Leitch Review of Skills, Skills in the UK: the long-term challenge, Interim Report, December 2005.

7 Financial Capability in the UK: Establishing a Baseline, FSA, March 2006

8 Populus Poll for the NAPF. Populus interviewed a representative sample of 1,002 adults aged 18+ by telephone between 17-19 February 2006.

9 CTF – transitional vouchers issued and numbers converted into accounts, Feb 2006, HMRC.

- over 4 million consumers bought their most complex financial product without considering any other options at all[10].

25. Where people are offered investment choices in DC pensions, most prefer not to exercise that choice. NAPF members who offer default lifestyle funds report that, on average, 83% of scheme members remain in the default fund[11]. Nearly 75% of DC schemes offer unused fund choices[12]. This is not just a UK phenomenon. In Sweden, 91% of newly enrolled individuals invest in the default fund[13]. Of these, it is estimated that three times as many passively accepted the default fund as actively selected it.

26. Neither do consumers feel capable of exercising choice without recourse to the kind of financial advice that is unlikely to be available in Personal Accounts. In research conducted for the NAPF, people were told that if they joined a Personal Account they could be asked to choose how their money was invested. Few felt confident about taking the decision themselves without advice[14]:
    - just 15% thought: "I would be confident in choosing how to invest the money in my pension fund by myself with no professional advice";
    - 42% thought: "I would be happy to decide how to invest the money in my pension fund but I would pay an independent financial adviser to help me";
    - 41% thought: "I would prefer to rely on the expertise of the people managing my pension fund to decide how best to invest my money".

27. It is therefore reasonable to expect that, for the vast majority, choice will be a theoretical possibility rather than something they will actively exercise. Furthermore, it is likely to add unnecessary complexity, risk to consumers who are poorly placed to make informed decisions and additional cost.

Recommendation 3: The Government should only provide choice in Personal Accounts where it will add to savers' trust and confidence. Choice should be focused on whether, and how much, to save rather than complex decisions about "brand" and investment.

10 Financial Capability in the UK: Establishing a Baseline, FSA, March 2006

11 NAPF Annual Survey 2005

12 DC Link, March 2006, www.lcpdclink.co.uk

13 Second Report, p200

14 Populus Poll for the NAPF. Populus interviewed a representative sample of 1,002 adults aged 18+ by telephone between 17-19 February 2006.

Trusted guides: the role of employers

28. Despite the general collapse in consumer confidence in pensions, working people still tend to trust their employer when it comes to pensions, significantly more so than either government or pension providers: net trust in government on private pensions matters stands at -52, whilst trust in employers stands at +31, according to a recent ABI poll[15].

29. Whilst recognising and supporting the need to minimise burdens on employers within the Personal Accounts system, it seems counterintuitive that both the NPSS and the Government's version of the Industry Model relegate the role of employers to that of payment agents. Effective employer involvement is proven to generate higher levels of scheme take-up and offer low cost, value for money pensions. Without employer involvement there is a significant risk that Personal Accounts will fail to reach their full potential.

Recommendation 4: The Government should promote employer engagement in pensions as their involvement encourages confidence in pension saving.

Consumer confidence – value for money

30. Costs and charges will not be the only factor that affects the value of an individual's pension 'pot', investment returns are also important, as the Pensions Policy Institute has explained[16]. But as the Pensions Commission made clear[17], the importance of low costs and charges cannot be ignored, particularly for those in the Personal Accounts target market. NAPF agrees that more of an individual's savings should work for them and should not be eroded in costs and charges.

31. The final charge under Personal Accounts remains unknown. Table 1 shows the impact of doubling the AMC and the importance of keeping costs low.

Table 1: Impact of charges in Personal Accounts[18]

	Pension Pot After 40 years of saving	Annual Income in retirement
30 basis points	£160,100	£7,610
50 basis points	£153,400	£7,280
100 basis points	£138,200	£6,560

15 State of the Nations' Saving, ABI, 2005

16 How important are low charges in Personal Accounts? PPI Briefing Note 33, August 2006

17 Second Report, p 39

18 *All figures in 2006/07 prices. Calculations are for a median earner on £23,000 whose salary grows by 2% in real terms each year. The individual saves 8% of banded earnings continuously for 40 years. Investment returns are 3.5% in real terms each year. After this, the whole pension pot is used to buy an annuity (ie we do not take account of any lump sum that may be taken). Annuities have been calculated using the best rates available at 6 September 2006 for a male non-smoker retiring at 65, as shown on FSA comparative tables. Annuities are single life, rise with RPI and have no guarantee.*

Recommendation 5: The Government should hold firm to its objectives of developing a Personal Accounts regime which delivers low pension charges.

Operational effectiveness

Infrastructure design

32. Both models for Personal Accounts proposed in the White Paper require the development of a sizeable new infrastructure to carry out significant administrative functions including: collecting and reconciling contributions; creating and retaining records; defaulting individuals who do not (or cannot) select a fund and/or provider; recording the right amount of contributions and benefits; investing contributions accurately and in a timely fashion; and paying out benefits accurately and on time.

33. Successive governments have a poor record of delivering large scale IT projects, on time, to budget and without technical flaws. Many of the biggest failures have been in the area of benefit payment and contribution collection. Examples include the failure of the £485 million computer system at the Child Support Agency; NIRS 1 & 2 which led to underpayment of SERPS pensions; and A Day implementation, where the IT had a thirty-fold over-run[19]. Failures have occurred even where IT support functions have been outsourced to the private sector.

34. With some good reason then, many consumers lack confidence in a large, new and untested system to run their pensions. They believe that it would be prone to errors and would not collect or record the amounts they had saved accurately. When asked about their confidence in a new pensions computer system to run Personal Accounts:
    - 53% were not confident it would record the amounts they had saved accurately (15% were confident);
    - 47% were not confident it would ensure they were paid what they were entitled to (just 23% confident);
    - 41% were not confident that they would receive their pension when they were supposed to (33% confident); and
    - 56% were not confident that the system would be secure from glitches, viruses or people trying fraudulently to access pension details (19% confident)[20].

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19 See Super Trusts – a better alternative to NPSS, NAPF, 2006 for sources and further examples

20 Populus poll for NAPF. 1,002 adults surveyed between 17-19 February 2006. Results shown are for adults aged under 65.

Good governance

35. Good governance will be an essential part of the ongoing operational effectiveness of Personal Accounts. In today's well run occupational pensions schemes it is clear how this works: on a periodic basis the trustees select service providers, such as fund managers, from across the market and make appointments based on cost and quality. Trustees have a fiduciary duty to operate in the best interests of scheme members and beneficiaries. It is less clear how good governance would be delivered in the two Personal Accounts models.

36. For the NPSS, it is proposed that a Non-Departmental Public Body (NDPB) of Government appointees would provide the governance function. Whilst this provides the opportunity to appoint experts, the NAPF sees three shortcomings with this approach:
    - the NPSS Board would be very remote from the individual consumer;
    - unless specified in legislation, there would no explicit fiduciary duty on the NDPB members to operate in the interests of members and beneficiaries in the same way as there is under a trust-based arrangement; and
    - an NDPB could be vulnerable to political interference and so unable to operate independently.

37. Under the Industry Model based around competing financial services brands, there is no independent governance overlay and therefore no independent body that could ensure that consumers' best interests were served on an ongoing basis. This is a particular risk given that there is no purchaser-provider separation.

Recommendation 6: The Government should incorporate good governance, with independent experts acting for consumers, in Personal Accounts design.

Harnessing market forces for consumers' benefit

38. Personal Accounts must deliver high quality services at low charges to consumers not just at the point of implementation, but on an ongoing basis. This requires the presence of appropriate levels of competition between participating commercial entities working in the interests of consumers. Neither model for Personal Accounts put forward in the White Paper meets this test.

39. The NPSS suffers because it is a single scheme. Even with multiple providers and scheme administrators, a single scheme cannot provide the contestability and competition needed to drive down costs over time and provide consumers with continuing high levels of service. A single scheme would not have the opportunity to learn from its competitors and improve its services to members. The Government has recognised this point. As former Pensions Minister Stephen

Timms has said, NPSS would have nothing against which it could benchmark itself to ensure that its costs and charges were set at the right level[21].

40. A second drawback of a single NPSS is its potential size. If successful, the NPSS could become very large, very quickly. And whilst a large scheme has the potential to benefit from economies of scale, if allowed to develop unfettered, it has the potential to be market distorting with large amounts of funds under management controlled by a single body.

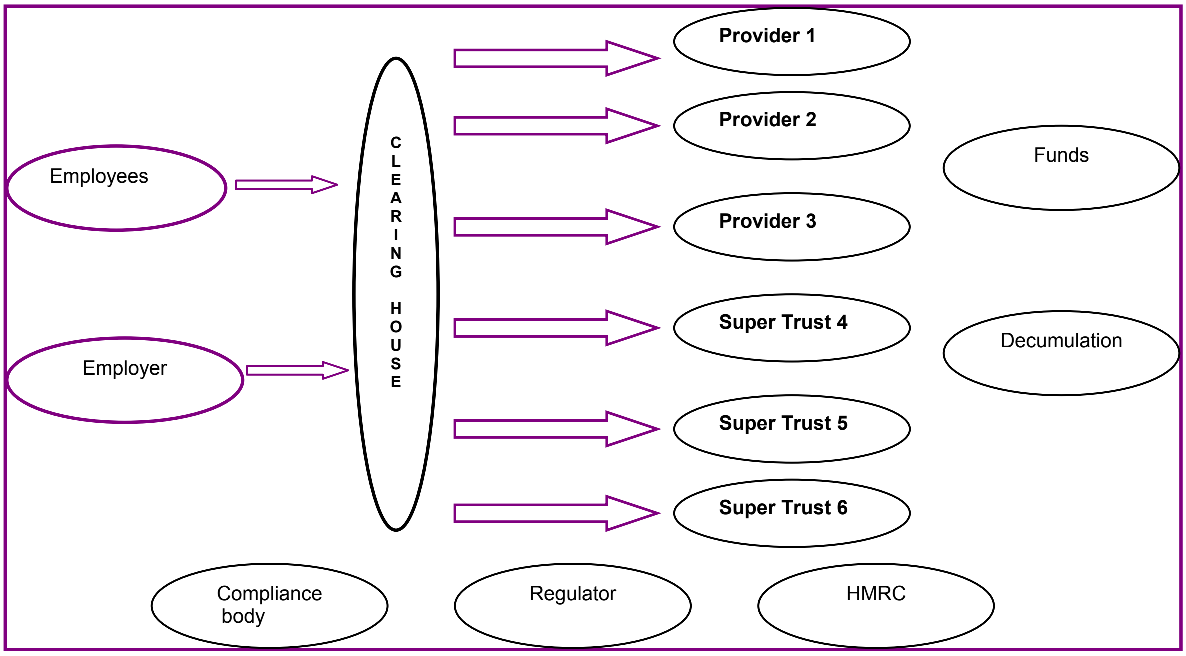
41. The Industry Model proposed in the White Paper is centred around brands of commercial pension providers competing for retirement savers' business. This is likely to lead to higher costs and expensive brand-based marketing campaigns.

42. More fundamentally, there is no purchaser-provider split which would require those running the scheme to seek out the best services from the whole market based on quality of service and cost to consumers. The Industry Model envisages that 'Brand A' could provide the scheme administration, give the investment business to Brand A's fund management arm and the decumulation business to its decumulation business. Such concentration is unlikely to deliver best value to consumers in the long run. Rather, the interests of the Brands would prevail.

43. Competition could be made to work more effectively in the Industry Model if there was a diverse range of providers participating in the market. Fig 1 illustrates a hybrid Industry Model where a limited number of participating "brands" are not confined to insurance companies, but also include not-for-profit trust-based providers such as Super Trusts which are likely to operate on lower costs. By having a more diverse range of providers, consumers are more likely to get a better deal over the long term.

21 Speaking at the DWP Industry Summit on NPSS alternatives, 28 February 2006

Fig 1: Hybrid Industry Model schematic



44. In a low charge environment, providers in Personal Accounts will require a number of years to recoup their return on capital. Experience from stakeholder pensions suggests this could be around 10-15 years. Therefore any contracts awarded to run Personal Accounts (eg awarded by the NPSS for scheme administration or licences awarded by the Government to participate as a branded provider in the Industry Model) would need to be issued for a lengthy period. During this time, the Government would be susceptible to pressure from providers for increases the price cap: there would be no guarantee there would not be a repeat of the stakeholder experience when, a few months after their launch, insurers lobbied for an increase in the price cap.

Minimising risks to Government of Personal Accounts

45. Any failures of Personal Accounts – whether arising from a failure of the infrastructure, the failure of a commercial provider operating within Personal Accounts, or poor decision making and low take up by consumers – carry significant political and reputational risks for the Government. Regardless of whether the new infrastructure was run directly by the Government, through a public-private partnership, or wholly by a private sector body the risk will ultimately rest with the Government. And it will be to the Government that consumers turn for redress if the Personal Accounts administration fails.

Table 2: Risks to the Government of Personal Accounts

Time horizon	Risk
Short term	New infrastructure cannot carry out the necessary functions and/or is not delivered to time or budget. Potential higher charges for consumers (and/or taxpayers foot the bill). Reputational risk for the Government.
Short & medium term	Low take up due to lack of consumer trust in providers and possible failures in the Clearing House/NPSS.
Medium term	Government licences a provider which fails or cannot operate within the price cap. Government bears the reputational risk and the likelihood of having to compensate consumers.
Medium term	Providers demand a higher price for operating in the Personal Accounts market (as per stakeholder pensions).
Long term	The consequences of consumers' poor decision making are realised. Ultimately, consumers will look to the Government to take responsibility and compensate poor choices.
Long term	Poor take up has not generated a "step change" in pensions savings behaviour.

The Industry Model and NPSS – strengths and weaknesses

46. Against the features described above, the NPSS and Industry Model as set out in the White Paper have many weaknesses.

NPSS

- **Simplicity:** Not simple as members will have to choose between 6-10 funds.
- **Role for employer:** None. Employers are reduced to being "payment agents". They do not act as members' "trusted guides".
- **Consumer confidence – value for money:** costs are unknown.
- **Infrastructure design:** New and untested infrastructure required. This poses risks for government and consumers alike.
- **Governance:** Weak governance and close to government, so risks political interference.
- **Harnessing market forces:** A single NPSS has nothing against which it can benchmark itself.
- **No purchaser-provider split** to get the best services for scheme members.

Industry Model

- **Simplicity:** Very complex as members will have to choose between a range of branded providers *and* a range of investment options.
- **Role for employer:** None. Employers are reduced to being "payment agents". They do not act as members' "trusted guides".
- **Consumer confidence – value for money:** competition between participating brands will increases costs. Modelling shows Industry Model starts from a higher cost base (c70 bpts).
- **Infrastructure design:** New and untested infrastructure required due to presence of a Clearing House. This poses risks for government and consumers alike.
- **Governance:** No independent governance mechanism.
- **Harnessing market forces:** No purchaser-provider split to get the best services for scheme members.

Super Trusts

47. As set out in Chapter 4, NAPF remains of the view that Super Trusts are well placed to provide the delivery model for Personal Accounts. Super Trusts, which build on the already tried, tested and successful model of large-scale multi-employer schemes currently providing pensions to over a million people, could achieve:
    - **high levels of coverage** though auto-enrolment and employer contributions;
    - **low costs** (of around 40 bpts) through scale economies;
    - **consumer protection** through the presence of expert trustees;
    - **simplicity for employers and scheme members** by providing a carousel system for employers that do not want to select a Super Trust and by placing investment decisions in the hands of expert trustees, not inexpert consumers; and
    - **lower risks to government** through the absence of a new IT infrastructure, separation from government and the Pensions Regulator supervising Super Trusts.

48. Given the weaknesses in the NPSS and Industry Model, we believe the Government was too hasty in rejecting Super Trusts as the model for Personal Accounts. However, we welcome the Government's recognition that Super Trusts have a role to play in DC pension provision and that it is keen to work with us to explore "whether Super Trusts could work alongside Personal Accounts to offer

more choice in pension provision"[22]. We look forward to working with the Government over the coming months. Chapter 4 sets out our initial thoughts.

Personal Accounts – evaluation and success criteria

49. Before any final decision is made on the delivery model for Personal Accounts we agree with Government there must be a thorough evaluation of all the issues and options. This will help achieve clarity over the policy objectives, define success criteria and help prevent inadvertent damage to existing pensions arrangements.

50. The evaluation criteria for Personal Accounts proposed in the White Paper are set at a very high level and need further development in order for them to be sufficiently clear and transparent. The evaluation exercise should not just examine the merits (or otherwise) of the key design elements of Personal Accounts, but also the overall policy objective – achieving a significant increase in pension saving amongst the target audience and not damaging good workplace schemes.

51. Box 2 sets out the evaluation criteria which the NAPF believes the Government should use to assess Personal Accounts. These offer a greater degree of granularity than those in the White Paper and take as their starting point the need to generate higher levels of new pensions saving, whilst at the same time not diminishing that already in place. Given its importance the Government should publish the results of the evaluation before any decision is made to proceed with a particular Personal Accounts model. In particular, the Government should be explicit about how it has applied the criteria against which it has chosen its preferred model and on which there will be further consultation in the Autumn. In view of the importance of the decisions to be made and the level of uncertainty surrounding the two models, if it not possible to undertake a full and open evaluation, we recommend that the Government publishes a Green, and not a White Paper on Personal Accounts this Autumn.

Recommendation 7: New, more granular evaluation criteria for Personal Accounts should be developed which take as their starting point the need to increase the numbers of savers and overall levels of saving.

22 Pensions White Paper, page 47

Box 2: Evaluation criteria for Personal Accounts

Personal Accounts

1. High level of uptake (participation and saving levels) by employees working for employers with no current pension provision.

2. Minimal risk of the new system adversely impacting on existing provision and leading to levelling down.

3. Provision of good value pensions savings, and income streams in retirement, for the unpensioned as a result of good governance, appropriate levels of consumer protection, a well designed and managed 'default fund', low costs and charges, and facilitation of the annuitisation process.

4. Mechanisms to mitigate the risks for government, for employers and for individual consumers.

5. Competitive market forces harnessed to achieve the most cost-effective outcome over time.

6. Appropriate levels of choice and responsibility for consumers, bearing in mind the skills and experience of the target market.

7. Minimal burdens on employers commensurate with the need to encourage uptake.

8. Implementation costs, risks and timescales kept to acceptable levels.

9. Minimal risk that consumers are disappointed by the outcome of the system.

Model preference

52. For the reasons explained above, the NAPF remains of the view that both models put forward in the White Paper (and the many hybrid variants that have emerged subsequently, for example from commercial pension providers) are imperfect: they are unlikely to work in the best interests of consumers and pose high degrees of risk to the Government.

53. However, if the Government is minded to proceed with one or other of the models set out in the White Paper, on balance, NPSS appears to be the preferable of the two because:

- **NPSS is simpler than the Industry Model so savers are less likely to opt-out:** as consumers only have to choose a fund, rather than also having to choose a provider, they are less likely to be confused and are therefore more likely to stay opted in.

- **NPSS is likely to be cheaper than the Industry Model:** as the NPSS does not involve providers competing for business, there is less risk that pension charges will rise as a result of marketing and advertising expenditure.

- **NPSS could be more easily designed to incorporate higher governance standards than the Industry Model:** a governance body would act as an informed purchaser, buying services on the basis of cost and quality in the interests of scheme members and keeping costs low. But to be effective, it would need to operate on the same side of the buy/ sell divide as the consumer. The Industry Model, where there would be nothing operating on the buy side other than the consumer, would not be well suited to the incorporation of this form of governance. NPSS, however, could be designed to include such a body. Provided it is genuinely independent, it could act in a similar way to the Board of a Super Trust. Indeed Adair Turner has likened the NPSS to a single Super Trust.

- **NPSS could more easily adapt to innovations in investment management resulting in higher expected pensions than in the Industry Model:** whilst keeping costs and charges low is an important feature of Personal Accounts, the final value of the consumer's pension will also depend on investment returns. Because of its size and scale and the independent governance overlay, the NPSS could more easily adapt to innovations in investment management aimed at increasing expected investment returns for members. In contrast, the smaller scale and cost constraints likely to apply under the Industry Model would probably provide less scope for such practices.

- **NPSS could more easily be designed than the Industry Model to avoid unintended consequences such as levelling down and market distortion:** As the Pensions Commission identified, Personal Accounts could potentially become very large, very quickly. This is likely to have unintended consequences, such as a general levelling down of existing pension provision to Personal Account levels and market distortion if the system becomes too large. However, such risks can be minimised if Personal Accounts are designed from the outset as a strictly targeted intervention – for example, by limiting transfers and contributions. NPSS is more likely to be able to operate effectively as a targeted intervention than the Industry Model.

54. The NAPF would, therefore, be willing in principle to help further develop an NPSS-based delivery model for Personal Accounts *provided that* it is:
    - effectively governed;
    - maintained as a strictly targeted intervention;
    - designed explicitly to limit damage to existing provision; and
    - allows a diverse market of workplace pensions to thrive on top.

Recommendation 8: Provided NPSS can be maintained as a well governed, targeted intervention that does not harm existing pension provision it should, subject to further consultation, be developed further.

3. A Five Point Plan for Better Pensions

Summary

- **Personal Accounts will be a significant intervention in pension provision and they will inevitably have an impact on existing workplace pensions**, especially as the Government has proposed that all employers must auto-enrol, and provide a 3% contribution for, all their employees – whether they are in Personal Accounts or a workplace pension.
- **While many of these effects will be positive, some will be negative** – in particular, the risk that average employer contributions to existing pensions will decline to the Personal Accounts minimum.
- In light of this it is important that Personal Accounts remain a "targeted intervention" as the Government has proposed.
- **By adopting our Five Point Plan for Better Pensions, the Government can reduce the risk of levelling down** and maintain the best of today's pension provision:
    1. **A *Good Workplace Pension Quality Mark*** for employers offering schemes above the Personal Accounts minimum and who meet set criteria.
    2. ***Financial incentives*** for employers that make contributions of at least 5% of gross earnings.
    3. ***Ring-fencing Personal Accounts*** from existing provision by prohibiting transfers in or out.
    4. ***A simple, flexible "suitable alternative scheme test"*** that takes account of contributions, costs and charges and scheme waiting periods.
    5. ***Transitional measures*** on contribution ceilings and waiting periods to help employers adjust to the additional costs of auto-enrolment (that would be reviewed after 10 years)

The position of Personal Accounts – a targeted intervention

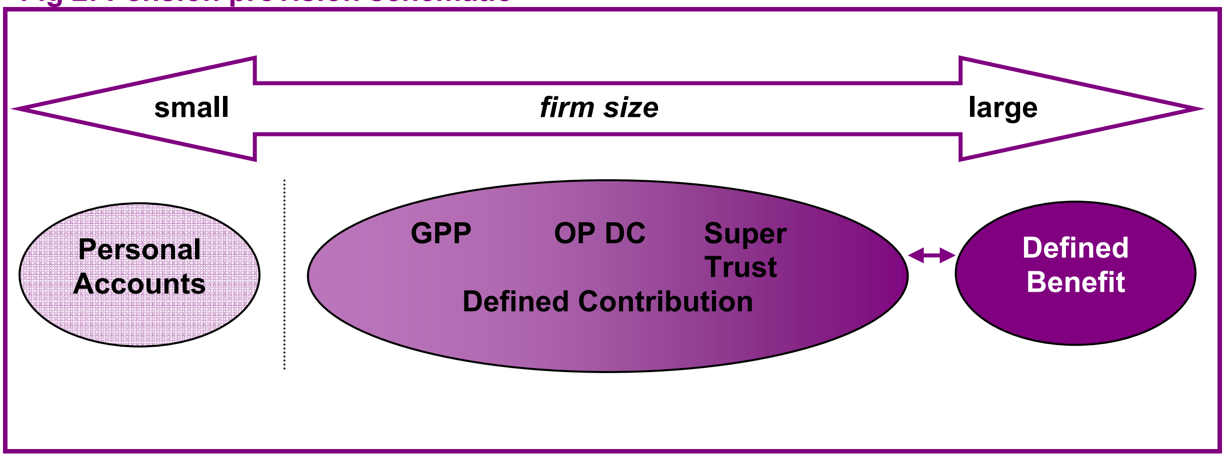
55. Personal Accounts will be a significant intervention in pension provision and their creation will inevitably have an impact on existing workplace pensions. While many of these effects will be positive, some will be negative. The challenge for Government is to capture the benefits of Personal Accounts without placing existing workplace pension provision in jeopardy. In our view, this can be best achieved by getting the right interface between Personal Accounts and existing schemes and by maintaining them as two separate, though complementary,

systems. This is essential if our first test – creating more savings and more pensions savers – is to be met.

56. We therefore agree with the Government that Personal Accounts should be a "targeted intervention" for those who do not have access to a good employer pension arrangement. As James Purnell, Minister for Pension Reform, said at the Pensions Summit in July 2006, "It is aimed at people who aren't saving at the moment, people on low and medium incomes, and we will design it around the target market". The target group are most likely to be people working for smaller enterprises. Like the Government, we believe that the majority of working people should continue to build up pensions as now, through employer-led pensions. As the former Pensions Minister Stephen Timms said, "it is impossible to envisage a future for the pensions system that does not have a central role for employers at its heart"[23]. For workers in the public sector and some large private sector corporations this may continue to be a form of DB pensions. But for the majority, pensions will become DC of varying types, from GPPs to Super Trusts.

57. For this goal to be realised, Personal Accounts must remain a targeted intervention, not just at the point of implementation but also over the longer term. There must therefore be a clear dividing line between the Personal Accounts minimum and superior existing pension arrangements that prevents Personal Accounts from becoming the pensions "norm", replacing good quality existing pension arrangements and reducing the pension benefits of millions of working people in the process.

Fig 2: Pension provision schematic



58. Achieving this outcome will require careful design and some very finely balanced decisions that will affect not just Personal Accounts but also their interaction with existing provision. These include arriving at a simple definition of a "suitable"

23 Speaking at the NAPF Autumn Conference, 17 November 2005

existing scheme that will exempt employers from having to provide access to Personal Accounts and careful consideration of the contribution limits and transfer arrangements that should apply to Personal Accounts.

59. If Personal Accounts are not maintained as a "targeted intervention" there is a significant risk of levelling down – employers placing new (or even existing) staff in Personal Accounts at the minimum level or otherwise reducing their superior pension arrangements.

60. To limit the extent of levelling down, the NAPF is proposing a Five Point Plan that will provide encouragement to employers offering better pensions than Personal Accounts and, through a range of transitional measures, minimises the cost to employers of the new regime.

Recommendation 9: To meet its goal of creating more savers and more saving, Government must maintain Personal Accounts as a targeted intervention to help those who do not have access to a workplace pension and employer contribution.

Why levelling down matters

61. Whilst Personal Accounts have a number of advantages, today's workplace pensions are better in several ways:

- The vast majority of workplace provision has higher employer contribution rates than the minimum level to be required under Personal Accounts. For example, almost 90% of the 1 million active members of DC occupational schemes and over 95% of the 3.66 million active members of DB occupational schemes receive employer contributions of over 3% of earnings. Moreover, about two-thirds (around 750,000) of the employees currently in DC occupational pensions benefit from an average employer contribution of 6% of gross earnings – more than double default employer contributions proposed for Personal Accounts. And employer contributions to DB schemes are many times higher still, with 95% of active members (3.44 million) receiving a 6% employer contribution or above and 85% (3.11 million) receiving a 10% employer contribution or above[24].

24 Occupational Pension Schemes 2005, Government Actuary's Department p27, p97, p99 for contribution rates; ASHE for number of members.

- Employers offering a pension generally help their employees understand the value of pension saving and, in almost half of cases, also meet the cost of pension charges.

62. Personal Accounts pose a threat to today's workplace pensions because the Government has proposed that employers may only be exempted from providing a Personal Account pension to their employees if they automatically enrol all employees into a "suitable alternative scheme". As, currently, only between 40% and 60% of employees choose to join their company pension, the automatic enrolment of all employees would add very significantly to the employer's pension costs unless employers choose to reduce their contributions[25]. We estimate that this could add over £2 billion to the pension costs of employers that currently provide pensions. This is far more than the £0.6 billion estimated by DWP sponsored research[26] because in practice levelling down means reducing contribution rates for new joiners, and not just for existing scheme members as the DWP defines it. And with the effects of labour market mobility, the impact of levelling down will be profound.

63. Faced with this rise in pension costs, we believe that all employers will review their current pension arrangements and ask probing questions about the value of offering pension contributions above and beyond the minimum 3% of band earnings levels set for Personal Accounts. Our discussions with pension scheme managers and pension providers suggest that employers are likely to adopt a range of "coping strategies" that will result in the levelling down of pension provision:

    - **Accept cost increase:** they may accept the increase in costs, e.g. by restraint in future pay awards, and pay their current high level of pension contributions to all employees.

    - **Level down for all:** they may spread their current pension contributions more thinly over a greater number of employees – as a result many who are currently saving in pensions will face a reduction in the value of their employer contribution (which for most is the largest element of their pension contribution).

25 Quantity vs Quality? NAPF, June 2006, pp11-14

26 The DWP's Regulatory Impact Assessment says the White Paper reforms will add around £600 million to annual labour costs for employers who already contribute 3% or more (p70). Crucially, this calculation assumes that contribution rates are levelled down to the legal minimum for people joining as a result of auto-enrolment. The NAPF estimates that the cost to these employees could be around £2 billion if they instead auto-enrol people into the good schemes they currently offer.

- **Level down for new members:** they may maintain their current pension arrangements for current members but place those that have not already chosen to join the scheme and new employees into a Personal Account pension at the minimum contribution level.

- **Cut pensions to minimum level:** they may close their existing schemes and, in future, place all employees in a Personal Account at the minimum level.

64. The effects of levelling down are likely to be felt hardest by those on moderate incomes who are currently accruing adequate, but by no means generous pensions – but pensions which nonetheless are more generous than those which will be available from Personal Accounts. The precise effects would be different for each individual and will depend on factors such as investment returns and annuity rates which are difficult to predict. Box 3 sets out a few examples. These indicate how much better off moderate earners could be if employers with good schemes can be persuaded to keep these open rather than levelling down in favour of Personal Accounts.

Box 3: The impact of levelling down on moderate earners

Bob earns £23,000. Each year, his salary rises in line with average earnings. He will save for 40 years continuously.

Without levelling down, his employers would all offer DC schemes with a 6% employer contribution and a 3% employee contribution based on gross earnings. This would produce a pension pot worth £221,000 at retirement. Of this, £147,300 would derive from employer contributions. Bob can convert this money into an annuity worth £10,370 a year, of which £6,910 derives from employer contributions.

If Bob's employers level down, he will only have access to Personal Accounts with the minimum rate of employer contributions. Although his own contributions will be higher (at 5% of banded earnings), his final pension pot will be £153,400 – 30% less than he would have got without levelling down. Of this, £57,500 comes from employer contributions. Bob can convert this money into an annual income of £7,280, of which £2,730 derives from employer contributions.

So, despite saving more himself, Bob's pension will be worth 30% less if his employers level down. This will leave him around £3,000 a year poorer.

Kate earns £20,000. Each year, her salary rises in line with average earnings. She is 20 years from retirement and is about to start saving for the first time.

Without levelling down, Sally's employers would provide a contracted-in final salary scheme. This would provide 1/80th of her final pensionable earnings for each year of service. (Most final salary schemes offer a higher accrual rate, but also involve giving up S2P rights.) The scheme defines pensionable pay as excluding the first £5,000, increasing this with price inflation each year. After 20 years' service, Kate would qualify for annual pension payments of £6,030.

If Kate's employer levels down to the minimum level of contributions in Personal Accounts, she will retire with a pension pot of £38,900, of which £14,600 derives from employer contributions. She can convert this into an annual income of £1,640, of which £620 derives from employer contributions.

So if Kate's employer levels down, her pension will be worth 70% less. This will leave her £4,390 a year poorer.

All figures are in today's prices. Earnings are assumed to rise by 2% in real terms each year. This causes DC contributions to rise and DB pensions to become more valuable. For simplicity, it is assumed that pension reform is introduced immediately (this is equivalent to ignoring earnings growth between now and 2012). In all cases, DC pensions are assumed to produce a 3.5% real rate of return each year. Annuity rates are those available to 65 year-old non-smokers retiring today. All annuities are single life, indexed to RPI and have no guarantee. Except where stated, AMCs in both Personal Accounts and existing DC schemes are assumed to by 0.5%. Numbers have been rounded.

65. The coping strategy employed is likely to depend on the size and profitability of the firm, the value of pension offered by other employers in the same sector, the degree to which the Government overtly supports – financially or promotionally – existing pension provision which is superior to Personal Accounts, and the economic conditions prevailing at the time the new pension arrangements are introduced.

66. We believe that the risk of levelling down can be greatly reduced if the Government stands by its stated objective of making Personal Accounts a targeted intervention – both at the time they are introduced and over the longer term – and keeps in mind that the pension reform will have failed if it only results in more savers but not more saving.

A Five Point Plan for Better Pensions

67. To help minimise the risk of levelling down and to maintain the best of existing pension provision, we recommend a Five Point Plan is implemented comprising:

- **Good Workplace Pension Quality Mark:** to bolster the best of existing pension provision by promoting a Good Workplace Pension Quality Mark for any employer that offers an employer contribution at twice the level of Personal Accounts (the Quality Mark would also be made available to employers offering Personal Accounts).

- **Extra support for high employer contributions:** to provide additional financial support to employers providing pension contributions at twice the level of Personal Accounts.

- **Ring-fencing Personal Accounts:** to design the system of Personal Accounts in a way that will tend to maintain existing pension provision, in particular, by prohibiting transfers from existing pension provision into or out of Personal Accounts.

- **A Simple "Suitable Alternative Scheme" test:** to minimise the administrative burden of the exemption process for those already offering suitable alternative pensions by adopting a simple scheme level test and by allowing a waiting period for enrolment of 3 months (rather than the 1 month proposed for Personal Accounts).

- **Transitional measures – waiting periods and contribution ceilings:** for the first 10 years of Personal Accounts:
    - employers providing a pension contribution at twice the Personal Account level should be allowed to apply a waiting period of 12 months to reduce the cost impact of the new regime; and
    - as recommended by the Pensions Commission, a cap should be placed on contributions to Personal Accounts of £3,000 a year to reduce the likelihood of employers switching to Personal Accounts.

A Good Workplace Pension Quality Mark

68. The establishment of a minimum level of employer contributions at 3% of band earnings for Personal Accounts will create a new benchmark for pension provision. There is a real risk that many employers – who already provide pensions at levels well above the new minimum level – will conclude that the Personal Accounts minimum is the "Government approved" level of provision. Given that these employers, due to the introduction of automatic enrolment, will be facing a substantial increase in pension costs, and that few employees appear to appreciate the value of their pension (only 29% of companies believe their

employees place a high value on them[27]), many employers may feel that it is reasonable to cut their level of employer contributions to the minimum.

69. But the Government could discourage such levelling down – and even encourage higher pension provision – if it sends a powerful signal that good employers do much more than provide the minimum level. We propose that a "Good Workplace Pension Quality Mark" similar to the "Investors in People" award should be established for those employers that provide significantly higher levels of contributions than the minimum. The Quality Mark could also be made dependent on qualitative aspects of the pension such as good member information and investment performance. It could be awarded by an independent accreditation body set up for the purpose. Employers could display the Quality Mark in recruitment literature and in communications with employees. The NAPF would be pleased to develop proposals for the Quality Mark, in conjunction with the Government and other key stakeholders.

70. We suggest that an employer contribution of double the minimum level set for Personal Accounts (ie around 5% of gross earnings) would be the appropriate level to underpin existing good pension provision. Currently, the average employer contribution in DC occupational pensions is around 6% of gross earnings. 49% of members are in schemes where the employer contribution is between 4% and 8% of gross earnings, 30% above this level, and only 24% below this level. As for defined benefit schemes, the average employer contribution is around 16% of gross earnings. 82% of members are in schemes where employer contributions are over 8% of gross earnings, a further 5% in schemes where employer contributions are between 4% and 8% of gross earnings, and only 8% of members are in schemes where the employer contributes less than 4% of gross earnings[28].

71. Clearly, setting the Good Workplace Pension Quality Mark at twice the level of Personal Accounts would not be without costs for some scheme sponsors, but for the vast majority the level would be in line with, or below, current contribution levels. Though they would still be faced by cost pressures resulting from automatic enrolment of all staff into their pension scheme.

72. The creation of a Quality Mark would also help employees understand the pension benefits being offered and this, in turn, would help employers justify to themselves the expense of offering a pension above the minimum level of Personal Accounts. The Quality Mark should be available to all employers,

27 The Employer Task Force Report on Pensions, December 2004, p 18

28 Occupational Pension Schemes 2005, Government Actuary's Department, 2005, p 94, p 97, p 99 whatever type of pension they offer, be it an occupational pension scheme, a Group Personal Pension, or a Personal Account.

Extra support for high employer contributions

73. Government could also encourage employers to contribute well above the minimum by providing additional financial support. We recognise that the public funds face many competing demands. But the abolition of contracting-out for DC pensions will save the Exchequer £4 billion per year[29]. We urge Government to use this sum of money to support funded pension provision. We welcome Secretary of State, John Hutton's, statement on this matter: "I think it legitimate and sensible to use the savings that are generated from the DC rebate to support the introduction of the Personal Accounts system"[30].

74. We propose that some of the £4 billion should be used to provide a financial incentive to employers to provide pension contributions at a level substantially above the Personal Account minimum. In our view, if the Government were to provide the incentives for pension contributions at or above the level eligible for the Good Workplace Pension award – an employer contribution of twice the Personal Account minimum – it would reinforce the signal to employers that the Personal Account minimum is not enough to generate an adequate income in retirement. Although this proposal requires further development, we suggest that the incentive might take the form of a tax credit on the employer's NI contributions. It could either be paid as a lump sum to all employers achieving the Good Workplace Pension Quality Mark or be structured to provide additional incentives for employer contributions above the Quality Mark level.

75. In this way, employers offering a contribution at twice the minimum level – 6% of band earnings (around 5% of gross earnings) – would have an incentive from both the demand and the supply side. On the demand side, employers in receipt of the Good Workplace Pension Award will be better able to attract good employees as the standard will help prospective employees understand the value of the pension benefits being offered. And the supply side will be helped as the existence of a financial incentive will make higher contributions more affordable.

76. The need for continued financial incentives could be reviewed after, say, 10 years. If the Quality Mark works as intended and provides customer appreciation of the value of good pensions then the need for additional incentives is likely to reduce over time.

29 Hansard, 11 July 2006, col 1754W

30 Evidence to the Work and Pensions Select Committee, 7 June 2006

Ring-fencing Personal Accounts: transfers

77. If individuals can take their fund out of Personal Accounts and place it in existing workplace pension provision, or trustees have the option of switching some or all of their fund (eg that relating to deferred members) into Personal Accounts, it would create harmful instability for both the Personal Accounts provider and existing pension provision. Moreover, if transfers are possible, it is likely that this might facilitate any tendency by employers to level down from good existing provision to lower contribution Personal Account provision. In light of this we suggest that it would be better to maintain a clear separation between the two forms of pension by prohibiting transfers between the two.

Simple "suitable alternative scheme" test

78. Given that the minimum employer contribution under Personal Accounts is less than half that of existing DC pension provision and around a sixth of DB provision, the additional costs arising from auto-enrolment could provide powerful incentives for employers to abandon existing pension provision[31]. It is important, therefore, that the process by which employers may continue to provide their existing scheme and be exempted from Personal Accounts should be as light touch as possible.

79. In addition to broadly matching the key elements of Personal Accounts, the suitable alternative scheme test should aim to:
    - **avoid** discouraging employers from continuing to offer good workplace pensions;
    - **avoid** levelling down (both for existing and new members);
    - **avoid** forcing schemes to undertake substantial changes to the scheme rules and scheme design; and
    - **avoid** imposing a substantial administrative burden on employers.

80. There is a number of ways in which a suitable alternative scheme test could be defined. For example, in the case of DB schemes, it could be based around the reference scheme test for contracted out schemes or on a minimum accrual rate. However it is defined, it will be important that the Test is not abused and it may be that there is a role for the Pensions Regulator in guarding against this risk. The NAPF's initial proposals for a suitable alternative scheme test for both DB and DC pensions are set out below. In essence, they aim to make the test simple to apply by making it applicable at scheme level and self-certifiable. The employer would be able to make the comparison with Personal Accounts by

31 Occupational Pension Schemes 2005, Government Actuary's Department, 2005, p97, p99 using standard Government-produced comparative tables. We look forward to discussion this important policy area with the DWP over the coming months.

Defined benefit scheme test

81. In the case of DB schemes, the employer would compare the capital value, calculated on a prescribed basis, at retirement necessary to buy a benefit at the accrual rate of the scheme against the value of the Personal Account fund that would accrue for different levels of earnings/savings and different periods of scheme membership.

Box 4: Suitable Alternative Scheme Test for defined benefit schemes

Any employer offering a defined benefit scheme is exempted from providing Personal Accounts if the scheme self-certifies that it:

- provides a benefit which would requires a capital value at the point of retirement that is the same or higher than that available from saving in a Personal Account for the same period; and

- overall, the employer has provided at least 3/8ths of the contributions; and

- automatically enrols all employees after either:
  - a waiting period of 3 months or;
  - after a waiting period of 12 months in the case of schemes where the average benefit level is twice the minimum level to be expected under a Personal Account pension*; and

- has a minimum entry age of 22 years or below.

To facilitate the comparison between the benefit level expected from the scheme at retirement and the fund to be accumulated under a Personal Account pension, the Government should provide comparative tables that demonstrate the value of Personal Account saving after charges for a range of incomes and durations of saving, making prudent investment return assumptions. The scheme can then apply the tables to the scheme as a whole (not to each individual). In order to account for fluctuations of earnings due to overtime and bonuses, it should be correct for 90% of members, 90% of the time.

*this option is a transitional measure and will be reviewed 10 years after the introduction of Personal Accounts.

Defined contribution scheme test

82. In the case of DC schemes, the employer would compare the annual employer contributions net of charges of the company scheme to the value of employer contributions net of charges of Personal Accounts. Given that many company pension schemes calculate contributions on the basis of gross earnings or a range of other commonly used bases, and the Personal Accounts regime will calculate contributions on the basis of band earnings, the Government should provide comparative tables to simplify this process.

Box 5: Suitable Alternative Scheme Test for defined contribution schemes

Any employer offering a defined contribution scheme will be exempt from providing Personal Accounts if the scheme self-certifies that it:

- requires a total minimum contribution net of charges equivalent to, or greater than, the total minimum contributions from Personal Account pensions net of charges; and
- includes an employer contribution equivalent to, or greater than, the minimum employer contribution required for a Personal Account pension; and
- automatically enrols all employees either:
  - after a waiting period of 3 months or;
  - after a waiting period of 12 months in the case of schemes providing an employer contribution twice the minimum level required under Personal Accounts*; and
- has a minimum age of 22 years or below.

NB. To facilitate comparison of contributions between the scheme and Personal Accounts, the Government should provide comparative tables for the equivalence between contributions based on the band of earnings used for Personal Accounts and a range of bases commonly used by schemes, eg gross earnings.

*this option is a transitional measure and will be reviewed 10 years after the introduction of Personal Accounts.

83. In addition, to reduce the administrative burden of employers on enrolling all employees, even those that may not pass their probationary period, we propose that the waiting period for all schemes deemed eligible for exemption from Personal Accounts should be allowed to operate a waiting period of 3 months. This is slightly longer than the 1 month period which, in effect, would apply in the

case of Personal Accounts, but much shorter than the waiting periods that appear to apply in existing provision where automatic enrolment is used. For example, Tesco automatically enrols staff once they have been with the company for more than a year (and are over 25 years of age) and the BBC does so after 2 years of employment[32]. This would not affect the entry age for Personal Accounts, which would remain as 22 years of age as proposed in the White Paper.

84. In order to reduce the immediate cost of the new regime on employers already providing good pension schemes, we suggest that employers providing contributions at twice the minimum level should be allowed to operate a longer waiting period for an initial 10 year period, which would then to be subject to review. This proposal is described in more detail in the next section.

Transitional measures: waiting periods and contribution ceilings

85. There are many uncertainties as to how employers will react to the introduction of Personal Accounts. But these uncertainties may be reduced if Personal Accounts are designed not only to serve the target market but also to maintain good existing pension provision. Two measures in particular would help to achieve this:
    - allowing employers that provide contributions in existing provision at twice the minimum level to apply a transitional waiting period of 12 months – this would reduce the cost impact of automatically enrolling all employees into the scheme; and
    - placing a ceiling on contributions to Personal Accounts in order to ensure the new system is effectively targeted.

86. Whilst the application of a 12 month waiting period for schemes that offer high levels of contributions could mean that some short term employees could miss out on pension saving, in practice this effect would be limited:
    - only 1 in 5 employees stay in their job for less than a year and, on balance, they will only have such short term employment when young – as employees become older, they tend to stay longer in each employment[33];
    - in practice, existing schemes are rarely offered in industries with high numbers of short term employees so the numbers affected would be much less than 1 in 5;
    - we are proposing that 12 month waiting periods be applied only on a transitional basis and that their impact should be reviewed after 10 years once their impact can be assessed.

32 Quantity vs Quality? NAPF, June 2006, p14, p16

33 Labour Turnover Survey Report, Chartered Institute of personnel and Development, October 2001, p2; The Flexible Labour Market: Implications for Pension Provision, NAPF, May 1999, p9

Overall this proposal would give a better pensions ‘deal’ to more employees including those who only stay 2 or 3 years in a job. This is because the 1 year waiting period would only apply to schemes with employer contributions of around double the Personal Accounts level and so employees would recoup the lost employer contribution after only 21 months of employment.

87. Placing a ceiling on contribution levels is not, in itself, desirable. Many might say that it seems only fair that someone saving in a Personal Account has the opportunity to use it as a pension saving vehicle up to the levels permitted in other pension arrangements. However Personal Accounts are intended as a targeted intervention focussed on helping those on low to moderate incomes and working for small employers to have access to a low-cost pension. With this group in mind, the Pensions Commission’s proposal that all savers be subject to a £3,000 per annum contribution ceiling makes sense. For example, someone on median earnings saving the maximum £3,000 a year would have a projected combined state and Personal Account pension of around 60% of their former earnings. For those on lower earnings, the replacement rate would be even higher.

88. If Personal Accounts become widely used by those on higher earnings, then they could find the £3,000 ceiling to be less adequate. However, higher earners tend to be served by better existing market provision. The Government should focus its priority on extending provision to current non-pension savers in implementing Personal Accounts.

89. We recognise that this is a difficult issue and that an argument can be put forward on either side. Therefore, we suggest that the Government should start by setting a contribution ceiling of £3,000 per annum and then review the position after 10 years. In this way, it will be possible to see whether savers are calling for higher contribution ceilings and to allow time to see how employers offering existing pensions have reacted to the introduction of Personal Accounts.

Recommendation 10: the Government should adopt a Five Point Plan to help support good pension provision and prevent levelling down. This should comprise a Good Workplace Quality Mark; extra financial support for those employers paying contributions in excess of Personal Accounts minima; placing restrictions on transfers to and from Personal Accounts; devising a simple “suitable alternative scheme test”; and a package of transitional measures.

4. Super Trusts – a modern DC solution

Summary

- We are pleased that the Government wishes to work with the NAPF to examine how **Super Trusts could operate alongside Personal Accounts**.
- **Super Trusts should prove attractive to employers for a number of reasons**. Some may have reservations about the design of Personal Accounts and lack the confidence in putting their employees in what is viewed as a government-run arrangement. Others may want to do more than the legal minimum outside of the Personal Accounts structure without the responsibility of administering their own scheme. Others may wish to transfer existing DC pension arrangements into a Super Trust.
- **Super Trusts offer Government and regulators the significant prize of simplifying the pensions landscape** while improving governance standards in existing DC schemes and making them easier to regulate.
- The NAPF has started discussions with the DWP and people who may be interested in running Super Trusts. **We look forward to working with Government and others over the coming months to develop Super Trusts**.

The new DC world

90. The pensions savings market in the UK is moving, inexorably, from a predominantly defined benefit pattern of provision to one which is predominantly defined contribution. This will bring the UK more in line with funded pension systems in most other countries around the world. But we will remain distinctive in that we appear set to remain a country with relatively low levels of state pension provision. So there will be an even more pressing need to ensure the future DC pension system is effective, operates in the interests of consumers, and does not shift too much risk onto the shoulders of those who are ill equipped to carry it.

91. The UK has not yet had a generation of consumers come to retire with DC pensions. Instead, our DC experience has been largely limited to 'top-up' pensions in the form of AVCs, for example. But this is set to change, and we need to anticipate and plan for a future DC world that doesn't disappoint consumers. This is particularly important if auto-enrolment is to be introduced. Unless a strong DC system is developed, then there could be political risk for future governments as generations of voters come to retire on much lower pensions than they had expected.

92. The NAPF believes the key features necessary for a strong DC system are:

- **Large scale schemes** that can operate at low cost, with effective governance and appropriate expertise. These would need to be institutions operating on the buy side of the market, with expertise in investment, administration and communications/customer service.
- **Collective provision** so there can be some risk sharing between a large pool of members. This would help deliver better balance of risk and return for members and be more cost effective.
- **Auto-enrolment of members into a single diversified investment fund**. This would avoid the hazards of individual consumers being required to make asset allocation decisions, or the need for a low risk default fund. Individuals who wanted investment choice could opt out into a limited range of sub-funds;
- **Provision of help with the transition from accumulation to decumulation**. This could range from generic advice provision, management of an open market annuity purchase facility, or bulk annuity purchase and distribution to members, through to in-house provision of a decumulation fund and transitioning of members from accumulation to decumulation subject to their means and lifestyle preferences.
- **High quality administration systems** to ensure accurate record keeping and timely investment of funds.
- **Full transferability**, so an individual accumulates a single pot. This helps promote understanding, reduces costs, and eases the accumulation/ decumulation process.

93. Many large trust based DC schemes demonstrate many or most of the desirable features set out above. But other DC provision still has costs and charges that are too high, lacks effective governance, is too small in scale to be efficient, or presents consumers with bewildering or inappropriate investment choices. Very little focus has been given to developing effective approaches to managing the accumulation/decumulation transition. This will become a key issue as DC saving matures in the UK.

94. Over the coming months, the NAPF will develop its thinking around the new world of DC pension provision, and we will share the product of our work with the DWP and HM Treasury. We believe, however, that Super Trusts provide a good way of delivering the features necessary for a strong DC system.

What are Super Trusts?

95. The NAPF developed its proposals for Super Trusts in response to the Government's challenge to the pensions industry to propose alternatives to the National Pension Savings Scheme recommended by the Pensions

Commission[34]. We remain of the view that the Government has missed an opportunity to maximise the full potential of Personal Accounts by opting for a delivery model not based on Super Trusts. Nonetheless, we are pleased that the Government has recognised the potential for Super Trusts and has said Government is "interested in looking at whether Super Trusts could work alongside Personal Accounts to offer more choice in pension provision"[35]. The NAPF is committed to working with the Government on this initiative.

96. Super Trusts have many features in common with large occupational schemes which already have very low costs and charges. However, they would be new financial institutions, occupying the space between retail pensions and occupational pensions as they exist today. They would be run on a not-for-profit basis, governed by a board of 'trustees' with a legal duty to put members' interests before those of commercial providers. Super Trusts would incorporate the best of the tried and tested practices from large occupational and multi-employer schemes currently serving thousands of employers and over a million working people today. The unique selling points of Super Trusts are:

- **Cost** – Super Trusts would be low cost pensions arrangements due to their efficiency and scale. But unlike other market-based solutions, they have the potential to remain low cost through the buying power of the Super Trust acting on the 'buy' side on behalf of members to pursue good deals and value for money. Their buying power would ensure that costs were driven down over time whilst service standards were driven up.

- **Coverage** – Super Trusts would achieve the same universal coverage as NPSS due to the presence of auto-enrolment. But because employers have a more clearly defined role within the Super Trust framework, and because members would not be faced with complex (and off-putting) investment decisions, levels of opt-outs are likely to be low.

- **Consumer protection** – uniquely, Super Trusts are centred around good scheme governance which puts members, not commercial pension providers, first. This is not the case when members are locked into a single NPSS or a branded Industry Model where there is no purchaser-provider split.

- **Lower investment risk** – by adopting a pooled approach to scheme investment, members share in a fund (and its returns) that is invested in a basket of assets for growth and security. The Super Trust provides up-side opportunities and manages down-side risk by applying its investment

34 Rt Hon Stephen Timms MP, speech at the ABI Saver Summit, 5 December 2005

35 White Paper p47

expertise to asset allocation and investment strategy. Mass market consumers do not have such expertise.

- **Competition** – Super Trusts would offer some diversity in the market place and a managed choice for employers to choose the appropriate Super Trust for their workforce. And there is the scope for keen competition between commercial providers wishing to provide services to Super Trusts.

97. Further information about Super Trusts is set out in *Super Trusts – putting members first* at www.napf.co.uk .

Why there is a role for Super Trusts

98. There are four important benefits of Super Trusts in the post-2012 pensions landscape following the introduction of Personal Accounts.

Personal Accounts alternative

99. Super Trusts could provide an alternative to Personal Accounts for employers who do not currently provide pension contributions but who prefer not to use Personal Accounts.

100. Whilst many employers that currently do not offer a pension arrangement (or an employer contribution) will participate in Personal Accounts after 2012, some might not, and might seek to provide pensions in other ways. This could be because they are concerned that the design of Personal Accounts could have adverse consequences for their employees. For example, their decisions might be coloured by a general scepticism about large IT projects commissioned by the public sector, or they may fear becoming embroiled in disputes if the Clearing House passes an employee contribution to the wrong provider under the Industry Model.

101. Moreover, as Super Trusts do not require the creation of a new centralised infrastructure to collect contributions and administer accounts, they could be established in advance of the introduction of Personal Accounts. This would mean that employees could have the option of starting to save in low cost pensions before 2012.

Suitable alternative scheme

102. Depending on how the suitable alternative scheme test is structured, some employers may favour a contribution schedule that is better for most of their employees than a 3% contribution on band earnings, but which would not be permitted within the Personal Account system (eg a higher contribution level

combined with a short waiting period). If exemptions are permitted in such circumstances, employers who would rather offer this sort of arrangement without administering their own scheme could provide pensions through a Super Trust.

103. The Pensions Commission argued that if a single NPSS is to avoid becoming so large as to distort the market it will be necessary to cap the contributions that any individual can make to the scheme in any one year. The NAPF agrees with this analysis and supports the Commission's recommendation that contributions be capped at twice the default contribution for the median earner (around £3,000 a year). Some employers may wish to ensure that the higher earners amongst their employees will not be constrained by this cap. Super Trusts would offer a solution for these employers.

Greater efficiencies and economies of scale

104. The size of Super Trusts and their purchasing power and expertise could bring benefits to those employers already running much smaller occupational DC pensions schemes who might want to consolidate existing DC schemes. Accrued occupational DC benefits stand at around £190 billion[36].

105. By transferring accrued DC rights into much larger Super Trusts employers would be able to put their schemes on a more efficient footing and to realise economies of scale. In turn, these efficiencies would be passed on to scheme members in the form of better value and potentially larger pension 'pots' and better member communications.

Regulatory dividend

106. Out of 44,700 private section DC schemes that are still open to new members, only 2,900 have 12 or more members. Fewer than 800 of these schemes have 100 or more members[37]. Fewer, larger, better run schemes would be easier to regulate and could lead to a more rational, lighter-touch regulatory framework for funded pensions. As the Pensions Regulator has noted, "larger schemes are better governed than smaller schemes"[38].

107. We envisage a new, light touch regime for Super Trusts with a central role for the Pensions Regulator which would be charged with authorising Super Trusts on the basis of their business plans and governance arrangements.

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36 Pension Fund Indicators 2006, UBS, p69

37 Occupational Pension Schemes 2005, Government Actuary's Department, p22

38 TPR press release, 5 September 2006

108. Because many of the building blocks for Super Trusts are already in place, any new legislation for Super Trusts (such as new powers for the regulator regarding the authorisation of Super Trusts) would be easy to achieve.

Who would establish Super Trusts?

109. In our discussions on the development of Super Trusts, we have given considerable consideration to the question of who would run a Super Trust in this new environment.

110. Super Trusts could be set up by a range of entities. These could include financial services companies or new market entrants. One obvious group from which Super Trusts may develop is existing multi-employer schemes. These cover a range of different industries and have diverse membership bases and the expertise to run large, multi-employer arrangements. A number of schemes have already signalled that they would be willing to expand their remits to establish Super Trusts if the right operating environment and was enacted by the Government and there was serious commitment from Government for Super Trusts.

Recommendation 11: Government should work with the NAPF, the Pensions Regulator and potential Super Trust providers to develop a regulatory framework that enables the establishment of Super Trusts.

5. Strengthening occupational pensions – a flexible approach

Summary

- To increase the likelihood of schemes remaining open to future accruals and, where possible, to new members in the longer term the **deregulatory review must result in a genuinely simpler regulatory environment and ensure that good schemes are more affordable.**
- Sponsors should be permitted to increase **Normal Pension Age** in line with future increases in longevity for the whole of a member's period of scheme membership.
- Schemes should be permitted to amend **accrued rights** provided that the effect is not to reduce the actuarial value of any member's benefits by more than 5% *and* that overall liabilities did not fall in value.
- In all cases *except where a solvent employer is entering wind up* the benchmark for the **debt on the employer** should be s179 and not s75. This will aid corporate activity and, in turn, help secure members' employment and job prospects.
- DB schemes should be permitted greater flexibility in respect of **increases to pensions in payment** for example by awarding indexation for future accruals on a discretionary basis as the scheme's funding position permits.
- **Revaluation of deferred pensions** should be on the same basis as currently required of pensions in payment – namely 2.5% a year.
- Proposals for a **Pensions Law Re-write** should be deferred in favour of a concerted effort to reduce the regulatory and cost burden faced by schemes.
- Government should work with the pensions industry to develop a simpler way for those **contracted-out DB schemes** that wish to contract back in to do so.
- Schemes that wish to do so should be permitted to **convert GMPs into scheme benefits**. But the decision should remain with the scheme sponsor and trustees to decide when they convert and for which classes of member.

111. Today, almost 8 million private sector workers are saving for their old age through a pension that comes with their job. And in most cases, the level of contributions being paid is as good as, or greater than, that which would be paid into Personal Accounts:

  - In April 2005, 3.6 million were saving in private sector DB schemes – this is almost as many as were in DC schemes (around 4 million)[39].

39 Annual Survey of Hours and Earnings, 2005

- 302,000 people joined private sector DB schemes in the year to April 2005, half as many again as joined occupational DC schemes[40];
- on average, employer contributions to DB schemes stand at 16% of pensionable pay. Joint employer and employee contributions to occupational DC stand at 9% and almost 10% to GPPs[41]; and
- typically, a DB pension will deliver an annual income to a median earner of around £8,300 or a 36% replacement rate. A typical DC occupational scheme will deliver a median earner around £4,896 a year (or a replacement rate of 21.3%) compared to the projected income of £3,384 (or a 14.7% replacement rate) for the same individual whose pension is provided via a Personal Account[42].

112. Workplace pensions – whether defined benefit or defined contribution – retain an important role in the future well-being of many millions of working people, and will do so for decades to come. So in addition to introducing millions of new savers to pensions via Personal Accounts, the Government must also take steps to ensure that existing workplace schemes continue to stay open to future accruals and, where possible, to new members in the longer term by actively supporting high quality pension provision. The NAPF therefore welcomes the Government's commitment to "continue to support …existing provision"[43] and its undertaking to work with the pensions industry to develop a simpler, lighter touch, regulatory framework to ease cost pressures on employers.

113. Support for existing schemes hinges on:

- getting the interface between Personal Accounts and existing workplace pension schemes right so that Personal Accounts remain a targeted intervention for those who genuinely do not have access to a pension arrangement through their job;
- crafting the right definition of a "suitable scheme" in such a way that it does not lead employers to level down their existing pension provision;
- more effective incentives for employers that provide pensions in excess of the Personal Accounts minimum, eg for those that meet the Good Workplace Pension Quality Mark; and

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40 Occupational Pension Schemes 2005, Government Actuary's Department

41 Occupational Pension Schemes 2005, Government Actuary's Department, p 94; Pension Commission Second Report p 55

42 All figures are in today's earnings terms, and assume saving for 40 years. In all cases, a real rate of return of 3.5% a year is assumed, along with an Annual Management Charge of 0.5%. The full value of the pension pot is assumed to be converted into an annuity at retirement. Annuities have been calculated using rates currently available for male non-smokers purchasing single-life RPI-indexed annuities with no guarantee at age 65. Replacement rates are for the first year of retirement only. As annuity payments are linked to prices rather than earnings, these will fall (in today's earnings terms) over time. DB calculation based on a 1/60th scheme where the first £5k of earnings are not pensionable. Retirement benefits exclude that part replacing S2P.

43 White Paper, p 85.

- paring back the successive layers of regulations that have been imposed on schemes over recent decades, which have added significantly to the costs of running occupational pension schemes.

114. The NAPF has put forward proposals on the first three of these issues in the previous chapter of this response. This chapter deals with the last issue – ensuring the continuing viability of good quality existing pension schemes to the benefit of scheme members by reducing excessive and costly regulation.

115. The recognition by the Government of the pressures private sector scheme sponsors are now under is welcome. Approximately 57% of private sector DB schemes are now closed to new entrants and more are set to follow suit[44]. Pension scheme liabilities for FTSE 350 companies alone are now around £500bn[45] and are growing still further as life expectancy improves by, on average, an extra year each decade. Changes to life expectancy forecasts in the past year have added £20bn to companies' pension liabilities[46]. For the majority of schemes, the real cost pressures come from meeting the costs of benefits already accrued in respect of former employees. There are currently around 3 pensioners or deferred scheme members to every active member[47], and as private sector DB schemes continue to close to new members so too the ratio of active to non-active members will continue to decline. The Pensions Commission estimated that active membership of DB schemes will "ultimately fall by 60% from 2000 levels" if current trends continue[48].

116. The increasing cost of supporting defined benefit pensions is also having a knock-on effect on UK competitiveness: older companies with large pension liabilities are competing with younger companies with lower (or no) pension liabilities; and UK companies are competing with international companies that have managed to off-load their pension liabilities altogether. This point has been recognised by the Treasury Committee which said *"The growth of business investment has been modest in recent times compared with previous periods of economic recovery. The need for companies to devote additional resources to pension funds may have been a factor in this".*[49] More recent survey evidence from consultants Aon led them to conclude that *"One third of companies say rising pension costs are hurting their share price"*[50].

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44 NAPF Annual Survey, 2005

45 Watson Wyatt Pension Deficit Index

46 KPMG press release, 24 May 2006 – data for UK quoted companies

47 GAD Survey of Occupational Pension Schemes 2005, Government Actuary's Department, 2005

48 Pensions: Challenges and Choices – first report of the Pensions Commission, 2004, p85

49 Treasury Committee, January 2006

50 AON, May 2006

Deregulatory Review

117. The Government's overall drive towards Better Regulation, leading to a risk-based approach that is proportionate and does not impose burdens on business, is to be welcomed. As part of this overarching policy agenda, we particularly welcome proposals for a rolling deregulatory review of pensions legislation aimed at providing much-needed support to workplace pensions. But if the deregulatory review is to support scheme sponsors and extend the longevity of occupational schemes for current and future workers it cannot simply tinker around the edges. It must focus on those issues that will have the biggest impact on simplifying the pensions framework, giving schemes some flexibility and reducing schemes' running costs. To this end we are encouraged by the Secretary of State's statement to the 2006 NAPF Annual Conference and Exhibition that "nothing is ruled out and nothing is ruled in [of the deregulatory review]" and that issues listed in the White Paper are the minimum that the Government is prepared to consider.

118. The NAPF has identified five areas on which the deregulatory review should focus as a priority:

1. changes to scheme Normal Pension Ages;
2. easing restrictions on changes to accrued rights (section 67, Pensions Act 1995);
3. modification of the debt on employer regulations (section 75, Pensions Act 2004);
4. mandatory increases to pensions in payment; and
5. revaluation of deferred pensions.

119. Additional areas for deregulation, which should be tackled in the second phase of the deregulatory review, are set out in at the end of this chapter.

Recommendation 12: The deregulatory review should focus on areas which will have the biggest impact on simplifying the regulatory framework for pensions and on giving flexibility to scheme sponsors to ensure the continued longevity of occupational pensions for future generations of workers.

Changes to Normal Pension Age

120. As described in paragraph 115, improvements in pensioner mortality and the corresponding increases in life expectancy have added significantly to the costs of providing pensions. Improvements in life expectancy are likely to continue, and with it the upward pressure on scheme costs. In a DB scheme, these costs are

generally borne by the sponsoring employer, in contrast to a DC scheme where the member bears the whole cost. The increase in costs is exacerbated in a low-interest, low-inflation environment.

121. One way in which schemes have, to date, sought to contain costs is by increasing Normal Pension Ages (NPA). However, schemes have only been permitted to do this for future accruals. So accruals up to a particular date have one retirement age, for example 60, and service beyond this date has a later retirement date, say 65. Whilst these changes go some way towards helping schemes meet higher costs, they do not go as far as they could and are complex to communicate to members. Yet in order to contain their own pension costs, successive UK governments have made adjustments to State Pension Ages that have had retrospective effect, first by raising women's State Pension Age from 60 to 65 in 1993, and again in the current White Paper which contains proposals to increase the State Pension Age from 65 to 68 by 2046.

122. By permitting defined benefit occupational pension schemes to follow the practice of the state and increase NPAs for the whole period of scheme membership, additional longevity costs could be alleviated.

123. To ensure that any changes are made in a way that strikes a fair balance between scheme sponsors and scheme members we propose that:

- schemes could raise NPAs for past and future service in line with life expectancy, in accordance with an agreed longevity index;
- schemes would only change NPA more than 10 years away from State Pension Age; and
- increases would take account of future increases in longevity only (in other words, members would not bear the costs of improvements in longevity already experienced).

124. To ensure that increases were made in a way that was fair to scheme members and did not move ahead of increases in life expectancy, we suggest that increases should move in line with a 'longevity index' which should be created for the purpose. Our proposed Pensions Monitoring Board should be tasked with ensuring that the longevity index was regularly updated. Larger schemes could develop their own scheme-specific mortality projections to take account of the particular mortality experience of their industry which is consistent with the approach used under the Minimum Funding Requirement (MFR) which permitted scheme-specific mortality projections. We suggest that the scheme actuary should be tasked with ensuring that the assumptions used in devising a scheme-specific index were appropriate.

125. Allowing schemes to make retrospective changes in NPAs would be an important factor in averting further DB scheme closures. Likewise, it would make it less likely that DB schemes would fall into the PPF (PPF levies would be lower that might otherwise be predicted). And whilst the costs of pre-retirement longevity increases would be shared, the scheme sponsor would still retain the whole of the risk (and costs) associated with future post-retirement mortality improvements.

126. The NAPF has costed the impact of the changes we are proposing on schemes and scheme members. To illustrate the difference our proposed changes will make to schemes, we have constructed a typical DB pension scheme. It has £500 million of liabilities and £425 million of assets. Under current conditions, its future contribution rate is 20% a year. As Table 3 shows, making changes to the scheme's NPA on the basis set out above would have the effect of reducing the scheme's past service liabilities by £10m a year (to £490m) and would represent a saving in terms of lower contributions of 6% a year.

Table 3: Impact on scheme costs of changes to NPA

	Scheme	After NPA changes
Liabilities (£m)	500	490
Assets (£m)	425	425
Deficit (£m)	75	75
Future service cont. rate	20%	19.5%
Contributions payable		
Future service (£m)	20	19.5
Deficit (£m)	8.8	7.6
Annual saving (£m)		1.7
Annual saving (%)		6

127. The following table shows the estimated additional liabilities falling on a typical DB scheme with NPA of 65 from anticipated future improvements in post-retirement mortality. The examples given are for scheme members at different ages and on different incomes (average earnings, half average earnings and twice average earnings) and with different periods of service at the time the change is implemented (2, 10 and 15 years). The amount shown represents the release of liability that the scheme would enjoy if pension ages were increased in line with a longevity index. It shows, for example, that for a 25 year old earning £25,000 with two years' service, the scheme's liabilities would reduce by £565. For a 35 year old on the same earnings, the reduction in liability would be £2,274. It can be judged, therefore, that the impact on an individual member's accrued benefits would be modest.

Table 4: Effect of changes to NPA

Member	Age	Service (years)	Earnings (£pa)	Accrued liability (£pa)	Reduction in liability (£pa)
A1	25	2	12,500	3,750	283
A2	25	2	25,000	7,500	565
A3	25	2	50,000	15,000	1,131
B1	35	10	12,500	21,875	1,137
B2	35	10	25,000	43,750	2,274
B3	35	10	50,000	87,500	4,548
C1	45	15	12,500	43,125	1,160
C2	45	15	25,000	86,250	2,320
C3	45	15	50,000	172,500	4,640

128. The NAPF would be pleased to work with the DWP's Deregulatory Review Advisory Group to develop proposals around changes to NPAs.

Recommendation 13: The Government should permit schemes to increase scheme Normal Pension Ages for the whole of the period of scheme membership thereby putting occupational and state pensions on the same footing.

Easing restrictions on changes to accrued rights (section 67)

129. Despite changes in the 2004 Pensions Act, the constraints of Section 67 (s67) often prevent schemes from implementing desirable rationalisations of benefit design where they might marginally have an adverse effect on a small minority of members at the expense of benefit improvements for a larger number. Box 6 gives examples of the types of modest scheme alterations that are currently prohibited under s67.

Box 6: s67 – the need for change

Example 1: A scheme provides a spouse's pension on death after retirement of one half of the member's entitlement but for historical reasons for a small number of members the entitlement is based on two-thirds for part of their service. A rationalisation to 60% for all members for all service (which would involve a reduction in value of accrued benefits for some members of less than 2% but an overall increase in value of accrued benefits of around 2.5%) would not currently be possible.

Example 2: A scheme provides guaranteed pension increases on pre-1985 accruals at the fixed rate of 3% but no increase beyond the statutory minimum for subsequent accruals, so that the portion accrued between 1985 and 1997 is not subject to any guaranteed increases. At present, it would be prevented from moving to a consistent basis of increase, such as the lesser of RPI and 2.5%, for all accruals because the value of some members' benefits could be marginally reduced.

130. Simplifying the current complex requirements of s67 and moving to a principles-based approach would be of considerable benefit to schemes and scheme sponsors. But we recognise, too, the need to provide appropriate protection for scheme members. Therefore we propose that schemes should only be able to amend accrued rights *provided* that the effect was not to reduce the actuarial value of any member's benefits by more than 5% *and* that total scheme liabilities did not fall in value.

Recommendation 14: section 67 should be amended to allow schemes to rationalise benefits provided that the effect is not to reduce the actuarial value of any member's benefit by more than 5% **and** ***that total pension liabilities did not fall in value.***

Debt on employer regulations

131. Until 11 June 2003, the debt on a solvent employer winding up a DB pension scheme was calculated by reference to the MFR. As it became apparent that the MFR was an inadequate measure, and in order to prevent solvent employers 'walking away' from their pension promises, the debt under section 75 (s75) of the 1995 Pensions Act was changed to a full buy-out basis. Whilst ostensibly aimed at enhancing scheme member security, in practice the costs of providing the additional security has proved to be disproportionate. Moreover, the move to full buy-out has had a profound effect on the nature of the contractual arrangements between the employer and any DB scheme it sponsors.

132. Of particular concern is the effect of s75 on legitimate corporate transactions where the requirement for a company involved in a takeover or merger to meet full buy-out costs is acting as a barrier to transactions.

133. A more appropriate level for the s75 debt which was not available in 2003 is the calculated value under section 179 (s179) of the PPF protected rights. As the basis for calculating s179 is prescribed in legislation, it can readily be determined and provides a level of protection that is consistent with the protection provided in the event of insolvency in aggregate by schemes through the mechanism of the PPF.

134. At present, the Pensions Regulator can relax the need for s75 if it believes there is more chance of buy-out being met if the corporate transaction goes ahead. But in practice this is little used. We therefore propose a simpler approach where in all circumstances *except where a scheme of a solvent employer is entering wind up* the debt on employer benchmark becomes s179 (PPF protected rights) rather than s75. This will aid corporate activity and, in turn, help secure members' employment and job prospects resulting from the corporate activity.

135. The example in the Box 7, based on real scheme experience, demonstrates how amendments to s75 would both be of assistance to pension schemes and provide added certainty for scheme members.

Box 7: Effect of changes to s75

An employer (ABC Ltd) participates in a multi-employer scheme (MES) in a section which has numerous employers and unsegregated, pooled assets. ABC is sold to XYZ Ltd on 6th December 2005. All three active members of ABC's pension scheme are TUPE transferred to XYZ Ltd which participates in its own separate section of the same multi-employer scheme but with its own segregated assets. Section 75 was triggered as ABC no longer had any active members. The debt is for the past service of the three active members, plus 3 pensioners and 1 deferred member. The entire unsegregated section (60 employers and 900 beneficiaries) must be valued on a s75 basis (by quotation from an insurer) and the ABC element apportioned (by the scheme actuary). The estimated debt in November 2005 stood at to approximately £200,000, although the MES is still waiting for the true s75 calculation.

A simpler approach (using a PPF basis) could allow the scheme actuary to determine the amount which would be easily and quickly finalised. Instead, members are at risk of ABC becoming insolvent without being able to make good the scheme deficit.

136. We do not believe that this change would put at risk members' benefits:

- scheme members would have their benefits protected to PPF levels at the time of the corporate event;
- in the event of any subsequent insolvency of the new entity, scheme members would, in any case, have their benefits protected to PPF levels; and
- in the event the solvent employer is wound up, members would have full s75 buy-out protection, as now.

137. This change would require a change in primary legislation, but this should be relatively straightforward. There should be an early opportunity for reform in the forthcoming Pensions Reform Bill.

Recommendation 15: s179 is a more appropriate measure of the debt on the employer and should be used in all cases, including corporate transactions, except where the scheme of a solvent employer is being wound up.

Mandatory increases to pensions in payment

138. Unlike DC schemes, DB schemes are required to provide Limited Price Indexation (LPI) of the lower of price inflation or 2.5% for each year the pension is in payment. This adds significantly to scheme sponsors' costs (and therefore risks) and places them at a serious competitive disadvantage compared to employers sponsoring DC schemes or contributing to Personal Accounts.

139. The additional costs and associated scheme funding pressures that arise from statutory LPI are already recognised by the Government. To reduce the possibility of the Government acting as the guarantor of last resort to the PPF, the Government has given the PPF powers to approach the Secretary of State for Work and Pensions for permission to reduce the benefit levels it can pay to failed schemes if its own funds are under pressure or insufficient. *However, before permission will be granted, the Secretary of State must be satisfied that the PPF has eliminated increases to deferred pensions and pensions in payment.*

140. The additional costs of statutory indexation, and restrictions on benefit design, are a barrier to innovation in risk-sharing scheme design where an element of DB provision is incorporated. If such innovation is not to be stifled, greater flexibility with regard to indexation to pensions in payment should be given to DB schemes.

141. There are a number of ways in which flexibility on indexation of pensions in payment could be reintroduced for DB schemes. At one end of the spectrum schemes could be given a high degree of flexibility. For example the Government could abolish the requirement to index pensions in payment for anyone yet to retire. So pensions already in payment would continue to be indexed, but those still to come into payment would be awarded on a discretionary basis. This option would generate the biggest cost-saving for scheme sponsors and put DB schemes on an even footing with DC schemes.

142. At the other end, LPI could be removed for *future accruals only.* LPI increases could be granted on a discretionary basis, when the scheme's funding position permitted. This approach operates in the Netherlands, with the approval of the main employer and employee organisations. There, the Pensions and Savings Fund Act stipulates that articles of association and standing orders of (in the main) large industry-wide funds must contain a passage covering the changes that can be made to *"the rights and obligations of the participants, former*

participants and other interested parties in cases where the financial position of the fund provides a reason to do so." This permits pension funds to adjust contributions and indexation, which is conditional in the event of a poor funding position. Scheme participants are informed that future indexations are conditional and that indexation in one year does not guarantee indexation in another. The discretionary nature of indexation in the Netherlands is reflected in the differing rates awarded by schemes[51].

143. Such changes would reduce the value of members' rights. But some protection for members could be achieved by requiring trustees to give priority in the use of any surpluses generated to increase pensions in payment up to LPI ahead of any possible reduction in the employer's contributions below the normal ongoing rate. A further safeguard for scheme members could be to require schemes to set their funding at a level that allows for indexation and, in the event of a surplus, schemes would be required to index pensions in payment.

144. Once again, the NAPF has costed the effects of permitting schemes to make these changes, using the hypothetical scheme set out in paragraph 126 above, and using the same range of hypothetical scheme members as in Table 4.

145. The cost savings to schemes of awarding indexation to pensions in payment on a discretionary basis is set out in Table 5. It shows that whilst scheme liabilities would not fall, the reduction in the scheme's future service contributions is significant and is reflected in an annual saving to schemes of 16%.

Table 5: Impact on schemes of discretionary LPI

	Scheme	After LPI changes
Liabilities (£m)	500	500
Assets (£m)	425	425
Deficit (£m)	75	75
Future service cont. rate	20%	15.5%
Contributions payable		
Future service (£m)	20	15.5
Deficit (£m)	8.8	8.6
Annual saving (£m)	_	4.5
Annual saving (%)	_	16

146. Table 6 shows the reduction in cost for a typical DB scheme of future accruals of benefits for members of different ages and earnings on the basis that the scheme would not fund in advance for any future post-retirement pension.

51 Vereniging van Bedrijfstakpensioenfondsen, 2006

Table 6: Impact on members of a discretionary LPI

Member	Age	Earnings (£pa)	Cost of one year's accrual (LPI) (£)	Reduction in cost of one year's accrual (£)
A1	25	12,500	1,875	283
A2	25	25,000	3,750	565
A3	25	50,000	7,500	1,131
B1	35	12,500	2,187	1,137
B2	35	25,000	4,375	2,274
B3	35	50,000	8,750	4,548
C1	45	12,500	2,875	1,160
C2	45	25,000	5,750	2,320
C3	45	50,000	11,500	4,640
D1	55	12,500	3,625	794
D2	55	25,000	7,250	1,588
D3	55	50,000	14,500	3,175

Recommendation 16: Legislation should be changed so that, **for future accruals only,** ***LPI is granted on a discretionary basis with the proviso that schemes would need to fund for the provision of increases and that the first call on any surpluses would be indexation of pensions in payment.***

Revaluation of deferred pensions

147. Whilst the ceiling for indexation on pensions in payment was reduced from 5% to 2.5% a year in the 2005 Pensions Act the ceiling for statutory indexation, revaluation of pensions in deferment remained at 5% over the whole period of deferment. We can see no justification for this difference to continue. However, in a low inflation environment, neither can we see any justification for making any changes to the revaluation of deferred pensions retrospective and the cost-savings to scheme sponsors of making this change fully retrospective are marginal.

148. Instead we propose that revaluation for pensions in deferment should be capped at 2.5% per year *for future leavers only*.

Recommendation 17: For future leavers only, the ceiling on revaluation on pensions in deferment should be reduced from 5% over the whole of the period of deferment to 2.5%.

Pensions Law Rewrite

149. It is undoubtedly the case that there is significant scope for the current body of pensions law to be simplified and written in plain English. But rewriting the current body of pensions law in English is, by itself, not the answer to relieving the regulatory and cost burden on scheme sponsors and trustees. And it would do little to secure the long-term future of occupational pensions.

150. The NAPF believes that to secure the Government's objective of supporting high quality workplace pensions, it would be far better to focus scarce DWP and industry resources on simplifying the current regulatory framework through an effective deregulation programme. Any resulting legislation should adhere to plain English standards, but this should be the output of the deregulation work and not the starting point for a DWP-led programme of work aimed at supporting occupational pension schemes. Before a Plain English project is commenced, Government should be clear about the overall regulatory framework.

Recommendation 18: The Pensions Law Re-write project should be postponed in favour of a concerted effort to reduce the regulatory and cost burden faced by schemes.

Contracting out

151. Contracting out is one of the factors that led the Pensions Commission to say the UK has "the most complex pension system in the world"[52]. We are pleased that the Government has recognised the additional complexity contracting out poses to schemes, and that it can act as a barrier to saving. We therefore welcome the Government's decision to abolish contracting out for DC schemes from 2012. This will be a significant step forward in simplifying the UK pensions landscape.

152. The White Paper has asked for views on the outstanding issues relating to DC contracting out. We believe the Government should extend the principle adopted in the 2004 Pensions Act in relation to indexation of DC pensions, namely that a DC is a pot of money and that consumers should be free to buy the annuity that best suits their needs. As such, all remaining restrictions on

52 Pensions Commission First Report, p210 investment, spouses' benefits and the type of annuity that must be bought with a DC pension should be removed.

153. Whilst noting the Government's objections to abolishing contracting out for defined benefit schemes, it is nonetheless the case that contracting out adds to schemes' administrative complexity and is complex to explain to members. As one respondent told an NAPF survey on the administrative complexities of contracting out: *"The membership as a whole does not understand contracting out…and is never likely to"*[53].

154. Therefore, we propose that the Government should develop ways for those schemes that wish to contract back in to do so. The NAPF would be pleased to work with DWP to develop proposals in this area.

Recommendation 19: The Government should develop simpler ways for contracted out DB to contract back in if they wish to do so. The NAPF would be pleased to work with the DWP to develop a solution.

Guaranteed Minimum Pensions

155. The NAPF supports the proposal to permit schemes to convert Guaranteed Minimum Pensions (GMPs) into scheme benefits. This would significantly simplify scheme administration and member understanding.

156. However, unless this easement includes a degree of flexibility for trustees, the cost and complexity of the conversion will deter most schemes from making any change. This is because there are a number of technical problems inherent in converting GMPs to scheme benefits using the actuarial equivalence test proposed in the White Paper.

157. The technical problems arise because, whilst the GMP is essentially embedded as part of the scheme benefits, the conditions attaching to GMPs are different from those attaching to normal scheme benefits. This is most clearly seen in relation to pension increases but may also apply to spouses' rights where a different proportion of members' pensions are provided (for example, two-thirds rather than one-half) or different eligibility conditions apply.

158. The problem is most easily illustrated by considering the issue of pension increases after State Pension Age. Consider a DB scheme with a pension formula of 60ths of final salary at age 65, which provides LPI pension increases

53 The Administrative Burden of Contracting Our, NAPF Research Report No 3, 2005 for all service. The GMP element is subject to no increase in respect of the pre-1988 accruals and RPI capped at 3% for the post-1988 accruals. If the pre-1988 GMP is converted to scheme benefits on an actuarially equivalent basis, the scheme pension would be reduced by perhaps one-quarter of the amount of the eventual GMP. The fact that the eventual GMP is not known could conceptually be dealt with by expressing the reduction as a proportion of the pre-1988 scheme pension but this reduction will vary from member to member, depending on their own specific details, and the already difficult communication problem of explaining the apparent reduction in scheme entitlement will be exacerbated by the variation between members.

159. The situation may appear simpler if the scheme provides pension increases only in accordance with the legal minimum, so that the excess over the GMP is not subject to guaranteed increases for service before 1997 but LPI applies for service after 1997. Here the requirement of actuarial equivalence may lead to an addition to the scheme pension of around one-third of the post-1988 GMP, to compensate for the loss of increases on that element. However, if the scheme has a history of granting discretionary increase on the pre-1997 excess over the GMP, the situation becomes more difficult, with any outcome between the two already described being possible.

160. As we made clear to the Government in our response to the 2002 Pensions Green Paper *Simplicity, Security and Choice – working and saving for retirement,* the decision to convert should be optional and the responsibility should rest with the trustees and sponsoring employer. Schemes should also have the power to decide when they convert and for which class of member. We would envisage that schemes would not wish to convert GMPs for pensions in payment. However, they may wish to convert them for active and deferred members.

Table 7: Issues for inclusion in the de-regulatory review

Issue	Reasons for inclusion in the review	Desired policy outcome
POLICY CHANGES REQUIRED		
Normal Pension Age	Occupational Pension Schemes are only permitted to increase NPAs for future service. This has the disadvantage of further complicating schemes, with different slices of pension becoming payable at different ages. And it does little to tackle the pre-retirement risks and costs borne by scheme sponsors.	Permit schemes to follow state practice and increase NPAs with retrospective effect. We suggest this could be done in line with a standard longevity index so as to strike a fair balance between employers and scheme members.
Debt on employer (s75)	The current debt on the employer rules under s75 represents a disproportionate cost for the level of security it provides and is a significant obstacle for corporate transactions.	Rather than requiring full buy-out as the standard for corporate transactions, PPF buy-out adopted.
Modification of existing rights (s67)	The constraints of s67 often prevent schemes from implementing desirable rationalisations of benefits which might marginally adversely affect a small minority of members.	Schemes able to modify accrued rights subject to a *de minimis* rule and the proviso that overall liabilities did not fall in value.
Revaluation of pensions in deferment	Revaluation for pensions in deferment is currently on the basis of 5% over the whole period of deferment. This compares to statutory 2.5% a year LPI increases for pensions in payment.	For future exits only, the ceiling on LPI increases for pensions in deferment is set at 2.5% a year. Schemes would be free to provide higher increases if they so wished.
Mandatory increases to pensions in payment	DB schemes are required to provide mandatory increases to pensions in payment which add significantly to scheme costs, particularly as longevity increases. However, the 2004 Pensions Act gave significant easements on up-rating pensions in payment for DC schemes, whether occupational or contract-based.	Schemes to be given greater discretion over increases to pensions in payment. For example, increases to pensions in payment for future accruals to be discretionary.
Stakeholder designation	Employers with 5 or more employees are	Abolish the requirement for employer designation

	currently required to designate a stakeholder pension scheme if they do not run a suitable alternative. This will be redundant following the introduction of Personal Accounts.	of stakeholder pensions. The requirement to contribute to a Personal Account supersedes the stakeholder designation requirement.
SIMPLIFICATION AND STREAMLINING		
Disclosure of information	Regulations are disjointed and spread over several pieces of legislation.	Legislation consolidated into a single set of regulations. It should also be simplified to ensure it is less prescriptive and that there is consistency in disclosure requirements between different types of pension arrangements.
Pensions Sharing on Divorce	Current legislation is complex and disjointed.	Legislation consolidated.
IDR	Whilst the 2004 Pensions Act sought to simplify the IDR requirements, it in fact had the opposite effect.	Adopt a principles-based approach that simply requires schemes to have an IDR procedure – details to be left to schemes. Any problems would be an issue for the Pensions Regulator.

6. Providing a foundation for retirement saving

Summary

- The **NAPF supports the broad thrust of the State Pension reforms** proposed in the White Paper. We agree with the Minister for Pensions Reform that the foundations laid by the White Paper "will only be solid if they are scrutinised now" and that we need to avoid a "mushy, wishful agreement"[54].
- However, the state system will remain very complicated. **The Government should review whether two flat-rate pensions can be consolidated into a simple, single benefit**. This review should begin around ten years after the reforms start to be implemented.
- Ensuring that the **Basic State Pension retains its value relative to average earnings should improve incentives to save**, provided people are confident that the earnings link will be maintained. All political parties must seek to give people confidence that this will be the case.
- With life expectancy rising by nearly a year each decade we support the Government's decision to increase State Pension Ages. **But the White Paper introduces "cliff edges" for State Pension Age increases which may appear unfair.**
- **The Government should make clear that its timetable for raising the State Pension Age is provisional.** The Pensions Monitoring Board should be charged with reviewing it in the light of changes in life expectancy.
- **Reforms to S2P will reduce the value of contracted-out rebates paid to defined benefit schemes. This makes it even more important that other steps are taken to support high-quality workplace pension provision.**

Simplicity

161. The NAPF supports the broad thrust of the State Pension reforms proposed in the White Paper. Many of the measures reflect key features of our own proposals. These include: increasing the value of the non-means-tested Basic State Pension in line with earnings; extending the coverage of State Pensions; and raising the State Pension Age as longevity improves. Like others in the pensions industry, we would have preferred the Government to propose a simpler, more generous and less means-tested State Pension system. We recognise, however, that Ministers have to decide how to balance these priorities against other objectives and that there are no easy solutions.

54 James Purnell MP, speech at the IPPR, 12 July 2006

162. Unless people know what they can expect from the State, they cannot work out how much they should save for retirement. The Pensions Commission identified a "simpler, less complex pensions system" as the single factor most likely to improve confidence in pensions[55]. The White Paper envisages a two-tier State Pension system and forecasts that one-third of pensioners will be entitled to means-tested top-ups. Whatever its merits, this system is not straightforward.

163. In focus groups, the Pensions Commission found that "information about S2P/SERPS had no impact on attitudes except to heighten impressions of the complexity and uncertainty of pensions"[56]. Once it has stopped providing earnings-related pensions, the State could offer a simple flat-rate benefit that provides a floor for private saving. Instead, the Government plans to maintain a complex two-tier system over the long term. Even when both generate flat-rate benefits, the Basic State Pension and the State Second Pension will have different qualifying conditions, different accrual rules and different indexation regimes.

164. Moving from the system outlined in the White Paper to a single-tier system would not be straightforward. Nonetheless, giving people a much clearer idea of what they can expect from the State remains a significant prize.

Recommendation 20: The Government should commit to reviewing whether two flat-rate State Pensions should be merged into a simpler single-tier pension. This review should take place by 2022.

A Basic State Pension linked to earnings

165. Simplicity is not the only requirement for a State Pension system that can provide a platform for private retirement saving. State Pensions must also provide a reasonable basic income that is not withdrawn from those who have saved. As the Basic State Pension is not means-tested, linking its value to average earnings reduces penalties for saving in the benefit system.

166. For every year that the Basic State Pension is increased only in line with prices, its value relative to average earnings declines. However, Table 8 shows that the White Paper proposals have more in common with the Pensions Commission's recommendations than with the *status quo*. They are therefore a significant step forward.

55 Second Report, Appendix D, p141

56 Second Report, Appendix D, p109

Table 8: The Basic State Pension (BSP)

	Weekly value of BSP in 2050 (today's earnings terms)
Earnings link from 2006	£84
Earnings link from 2010 (Pensions Commission)	£79
Earnings link from 2012 (White Paper objective)	£76
Earnings link from 2015 (White Paper commitment)	£72
No earnings link (today's policy)	£35

167. If a future Government decides the earnings link is not affordable after all, people will not be able to go back in time and alter their saving habits. They therefore need to feel confident that this will not happen. The cost of the proposed reforms to the Basic State Pension is projected to be biggest in the long term, rising from 0.2% of GDP in 2015 to 1.5% in 2050[57]. Even so, concerns about short-term costs have led the Government to retain the option of delaying this reform.

Recommendation 21: All political parties should make it clear that people can expect the earnings link to be maintained.

State Pension Age

168. If the Basic State Pension is to maintain its value, and if the system is to remain affordable, the State Pension Age must rise. Average life expectancy for men at 65 is projected to rise by nearly a year each decade over the next 40 years[58]. If we are to live longer, we must wait longer before receiving our State Pensions. Any debate should be about *how* we raise the State Pension Age, not *whether* it is raised.

169. The Government proposes to increase State Pension Age from 65 to 68 in three stages, raising it to 66 between 2024 and 2026; to 67 between 2034 and 2036; and to 68 between 2044 and 2046. We have two main concerns about this timetable. First, it introduces cliff edges which may appear unfair. Secondly, the timetable may not be sufficiently flexible when the forecasts on which it is based remain uncertain.

57 White paper, p24. Figures include the cost of changes to qualification conditions as well as earnings indexation

58 The principal 2004-based projections of cohort life expectancy produced by the Government Actuary's Department show male life expectancy at 65 rising from 19.5 years in 2006 to 23.2 years in 2046. Female life expectancy at 65 is projected to rise from 22.2 years to 25.6 years over the same period.

170. The White Paper proposes that each decade's increase in the State Pension Age be compressed into just two years. This gives 80% of people a straightforward State Pension Age (eg 66 years, not 66 years and four months). Delaying the first increase until 2024 also means that "no-one who reached the age of 47 on or before 5 April 2006 will be affected by these changes"[59].

171. However, these staggered increases create a "birthday lottery". For example, anyone born on 5 April 1959 will be eligible to receive their State Pension from the age of 65, but anyone born on 6 March 1960 will not receive their State Pension until they are 66 – even though they can on average expect to live just a few weeks longer. Future governments may find this difficult to defend.

172. Without recommending a timetable, the Pensions Commission advocated "the principle of pension ages rising proportionately with life expectancy"[60]. We agree, and believe that Parliament should establish the expectation that State Pension Age will rise beyond 68. However, accurately predicting future improvements in life expectancy is impossible. For example, in 1981 the Government Actuary's Department forecast that men reaching 65 in 2004 would on average live for a further 15 years[61]; it now believes this group will on average live for 19 years beyond 65. There should therefore be some flexibility in the timetable for increases in State Pension Age.

Recommendation 22: The Pensions Reform Bill should include the principles on which State Pension Age increases should be based, and should make clear that the timetable it sets out is provisional and will be reviewed in the light of changing life expectancy projections.

S2P reforms – consequences for DB schemes

173. The White Paper will accelerate the evolution of the State Second Pension (S2P) into a flat-rate benefit. This process would start in 2012 and be complete by around 2030. Under current policies, S2P would become flat-rate by around 2055.

174. We assume this will be achieved by freezing the Upper Earnings Limit in cash terms for S2P accruals, as recommended by the Pensions Commission. This will create a band of earnings on which employees pay the full rate of NICs without accruing additional State Pension rights. In today's earnings terms, employees in 2015/16 would pay NICs at 11% on earnings up to £28,065 but stop accruing

59 http://www.thepensionservice.gov.uk/planningahead/state-pens.asp

60 Second Report, p30

61 First Report, p2

extra S2P rights once their earnings exceed £25,425[62]. This will make S2P more redistributive.

175. In contracted-out defined benefit schemes, a single formula is used both to replace the S2P rights that members have given up and to provide additional benefits. Unless these schemes modify their rules, this reform will transfer resources from employers with DB schemes to the Exchequer. Without reform, rebates to DB schemes in 2031 would be based on any earnings up to £20,444. With reform, they will only be paid in respect of earnings up to £12,500[63]. The Government estimates that its gains could total £0.4 billion in 2015, £1.1 billion in 2020 and £2.7 billion in 2030[64].

Recommendation 23: State Pension reform should not have unintended consequences that increase costs for workplace pensions. The Government should take account of the additional costs of State Pension reform for DB schemes when developing policies to support good quality workplace provision.

Pension Credit: winners, losers and saving incentives

176. The distributional impact of the White Paper reforms depends on what would have happened without the White Paper. In 1998, the Prime Minister said his aim was to increase the minimum income guaranteed to pensioners in line with earnings over the long term[65]. Until May, however, the Government was only committed to uprating the Guarantee Credit in line with earnings for one more year[66]. If the Guarantee Credit would have been pegged to prices after 2007, linking it to earnings accounts for most of the extra public expenditure arising from the White Paper. The Government says its reforms will cost £84 billion a year by 2050, of which £60 billion comes from changes to Pension Credit[67]. On this interpretation, the perception that there has been a "retreat" from earlier plans to focus resources on "means-testing for the poorest pensioners"[68] appears wide of the mark.

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62 Figures in today's earnings terms. Calculations assume real earnings growth of 2% each year and RPI inflation of 2.5% each year from 2012

63 Assumptions as above.

64 White Paper Regulatory Impact Assessment, p125. Figures in 2006/07 prices. The figures would include employee rebates as well as employer rebates

65 White Paper, p103

66 In December, HM Treasury said that long-term earnings indexation "should not be taken as the Government's policy" (Pre-Budget Report 2005, p108)

67 White Paper, p24. Figures in 2006/07 prices

68 The Independent, 5 April 2006. The report was typical of those appearing in national newspapers on that day.

177. At the same time as increasing the value of the main means-tested benefit for pensioners, the White Paper aims to "limit the spread of means-testing" in order to prevent "problems with incentives" from emerging[69]. The obvious way to do this is to close the gap between the value of the Basic State Pension and the value of the Guarantee Credit. However, this would mean either higher public expenditure than envisaged in the White Paper or allowing the poorest pensioners to become poorer relative to the rest of society, or making more radical changes to future State Pension Age.

178. Instead, eligibility for Pension Credit will be constrained by restricting the value of the Savings Credit and the number of people who can claim it. This approach sits oddly with the Government's insistence that people receiving Savings Credit "are being rewarded for the savings they have made"[70]. If the Savings Credit is indeed a reward for saving, it is not obvious how curtailing its growth helps incentivise pension saving.

179. In order to restrict the Savings Credit, the White Paper proposes to create a band of income where pensioners with a full Basic State Pension will lose £1 of Pension Credit for every £1 of income from private savings or S2P. As a result, a projected 6% of pensioners will face a 100% marginal withdrawal rate in 2050, compared with around 1% under current policies. For these people, means-testing will erode any gains derived from compulsory employer contributions to Personal Accounts. Careful thought needs to be given to how people can be warned that there are circumstances where saving might not pay without deterring those who should save from doing so. This needs to be considered when the parameters around who and who should not auto-enrol into pensions are finally determined.

69 Hansard, 25 May, col.1649

70 Rt Hon John Hutton MP, evidence to Work & Pensions Select Committee, 7 June 2006

7. Recommendations

Recommendation 1: the Government should take time to develop fully its proposals and assess all the options. It must not rush into decisions, the effects of which will last for decades.

Recommendation 2: As part of its review of the institutional landscape, Government should create a small, focused, Pensions Monitoring Board to monitor the adequacy and sustainability of the pensions system.

Recommendation 3: The Government should only provide choice in Personal Accounts where it will add to savers' trust and confidence. Choice should be focused on whether, and how much, to save rather than complex decisions about "brand" and investment.

Recommendation 4: The Government should promote employer engagement in pensions as their involvement encourages confidence in pension saving.

Recommendation 5: The Government should hold firm to its objectives of developing a Personal Accounts regime which delivers low pension charges.

Recommendation 6: The Government should incorporate good governance, with independent experts acting for consumers, in Personal Accounts design.

Recommendation 7: New, more granular evaluation criteria for Personal Accounts should be developed which take as their starting point the need to increase the numbers of savers and overall levels of saving

Recommendation 8: Provided NPSS can be maintained as a well governed, targeted intervention that does not harm existing pension provision it should, subject to further consultation, be developed further

Recommendation 9: To meet its goal of creating more savers and more saving, Government must maintain Personal Accounts as a targeted intervention to help those who do not have access to a workplace pension and employer contribution.

Recommendation 10: The Government should adopt a Five Point Plan to help support good pension provision and prevent levelling down. This should comprise a Good Workplace Quality Mark; extra financial support for those employers paying contributions in excess of Personal Accounts minima;

placing restrictions on transfers to and from Personal Accounts; devising a simple "suitable scheme test"; and a package of transitional measures.

Recommendation 11: Government should work with NAPF, the Pensions Regulator and potential Super Trust providers to develop a regulatory framework that enables the establishment of Super Trusts.

Recommendation 12: The deregulatory review should focus on areas which will have the biggest impact on simplifying the regulatory framework for pensions and on giving flexibility to scheme sponsors to ensure the continued longevity of occupational pensions for future generations of workers.

Recommendation 13: The Government should permit schemes to increase scheme Normal Pension Ages for the whole of the period of scheme membership thereby putting occupational and state pensions on the same footing.

Recommendation 14: Section 67 should be amended to allow schemes to rationalise benefits provided that the effect is not to reduce the actuarial value of any member's benefit by more than 5% **and** ***that total pension liabilities did not fall in value.***

Recommendation 15: S179 is a more appropriate measure of the debt on the employer and should be used in all cases, including corporate transactions, **except** ***where the scheme of a solvent employer is being wound up.***

Recommendation 16: Legislation should be changed so that **for future accruals only** ***LPI is granted on a discretionary basis with the proviso that schemes would need to fund for the provision of increases and that the first call on any surpluses would be indexation of pensions in payment.***

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Recommendation 20: The Government should commit to reviewing whether two flat-rate state pensions should be merged into a simpler single-tier pension. This review should take place by 2022.

Recommendation 21: All political parties should make it clear that people can expect the earnings link to be maintained.

Recommendation 22: The Pensions Reform Bill should include the principles on which State Pension Age increases should be based, and should make clear that the timetable it sets out is provisional and will be reviewed in the light of changing life expectancy projections.

Recommendation 23: State Pension reform should not have unintended consequences that increase costs for workplace pensions. The Government should take account of the additional costs of State Pension reform for DB schemes when developing policies to support good quality workplace provision.