The Pensions Bill: Second Reading

Briefing from the National Association of Pension Funds for the debate on 16 January 2007

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Key Points

- **Personal Accounts Delivery Authority:** There is a strong case for giving the Personal Accounts Delivery Authority clear statutory objectives from the start. One objective should be to minimise the adverse impact of Personal Accounts on good quality workplace pension schemes.

- **How S2P changes affect defined benefit schemes:** By accelerating the move to a flat-rate State Second Pension, the Bill will reduce the value of contracted-out rebates paid to defined benefit schemes. This must be taken into account when Parliament considers how to encourage employers to continue offering good schemes after Personal Accounts are introduced.

- **Guaranteed Minimum Pension conversion:** The NAPF welcomes the opportunity for schemes to reduce administrative costs by converting Guaranteed Minimum Pensions into scheme benefits. However, the ability of schemes to take advantage of this facility will depend on how streamlined the process is.

- **Abolition of defined contribution contracting out:** We support the abolition of contracting out for defined contribution schemes. The Secretary of State says it would be sensible to use the money generated to support the introduction of Personal Accounts. This should include support for employers who continue to pay contributions above the minimum rate when auto-enrolment increases their costs.

- **Internal dispute resolution:** Giving occupational schemes the option to introduce a one-stage dispute resolution procedure will be a welcome move for smaller schemes.

- **State Pension system:** State Pension reform involves difficult trade-offs. The Bill improves the State system in many ways and we agree with the Government that rising life expectancy requires a higher State Pension Age. Any further reforms should aim to make the system simpler and less means-tested.

Personal Accounts Delivery Authority

The Bill establishes a Personal Accounts Delivery Authority (PADA). This will be responsible for the introduction of Personal Accounts – the new vehicle for pension saving that the Government plans to launch in 2012.

The Authority's remit
As legislated for in this Bill, the PADA's remit will be limited to preparatory work on the implementation of Personal Accounts. This will involve making recommendations to ministers and developing a commercial strategy for Personal Accounts.

It is intended that the Pensions Bill to be introduced in the next session of Parliament will give the PADA executive powers. Once this second Bill receives Royal Assent, the PADA would be responsible for procurement, project management, designing an investment strategy for Personal Accounts and developing communication strategies. PADA will be responsible only for setting up Personal Accounts. Managing the system once it is up and running will be the job of a new Personal Accounts Board.

The Authority's objectives
In December's White Paper, the Government set out a series of statutory objectives for the Personal Accounts scheme (p84). In its current form, the Bill does not explicitly require PADA to act in accordance with these objectives. Even during its advisory stage, the PADA will have considerable influence over the design of Personal Accounts and therefore on the future of UK pensions. There is a strong case for giving the PADA clear objectives from the start.

The objectives for Personal Accounts set out in the White Paper include "optimising levels of participation", "setting an investment strategy in the best interests of members", "minimising burdens on employers" and "considering the impact on other high quality pension provision". Because today's workplace pension schemes typically involve higher contribution rates than Personal Accounts, NAPF believes the PADA and Personal Accounts Board should seek to minimise the adverse impact on existing high quality provision, rather than merely considering this.

Membership of the Authority and stakeholder input
At all times, the PADA must have between three and nine members. The Government intends to recruit a chairman, chief executive and commercial director ("almost certainly from the private sector") by mid-2007.

The White Paper says that from 2012 the Personal Accounts Board should consult with stakeholder groups – either by giving them representation on the board or through a stakeholder advisory body (p86). It adds that, during its executive phase (beginning in mid-2008), the PADA should also have a responsibility to engage with stakeholders (p84). NAPF believes that the chances of designing Personal Accounts appropriately will be maximised if groups with relevant expertise have input to the PADA from the start. Formal arrangements, such as board representation or an advisory group, should be put in place to ensure this happens.

There is a strong case for giving the PADA clear statutory objectives at this stage. Minimising the adverse impact that Personal Accounts could have on more valuable workplace pension schemes should be one of the PADA's objectives.

The Pensions Bill and occupational pensions

The Bill contains a number of technical measures with the potential to simplify occupational pensions. However, reforms to the State Second Pension could add to the financial pressure on defined benefit schemes.

How S2P reforms affect DB schemes

The State Second Pension (S2P) combines a flat-rate benefit with an earnings-related top-up. This allows people earning more than £12,500 to accrue additional State Pension rights in return for the extra National Insurance Contributions they pay. Maximum S2P rights are accrued by people with earnings at the Upper Earnings Limit (£33,540 in 2006/07) or above.

Without legislation, the earnings-related part of S2P would disappear gradually. The Bill will abolish the earnings-related part of S2P more than twice as quickly, making new S2P accruals completely flat-rate from around 2030. It will achieve this by freezing in cash terms the top of the earnings band on which S2P rights are accrued[1].

This change will increase costs for employers with defined benefit schemes, the vast majority of which are contracted out[2]. Because the Bill shrinks the band of earnings on which S2P is accrued, it also shrinks the band of earnings on which contracted-out rebates are calculated[3]. Lower employee rebates will reduce take-home pay for scheme members. Lower employer rebates will make it more expensive for employers to allow defined benefit pension rights to be accrued on existing terms.

The formula used to determine someone's pension rights in a contracted-out defined benefit scheme (e.g., 1/60th of final salary for each year of service) is designed *both* to replace the State Pension rights they have given up *and* to provide additional benefits on top. If an employer leaves this formula unchanged while rebate values fall, employer contributions will have to rise.

The Regulatory Impact Assessment to the Pensions Bill shows the annual impact of S2P reforms on DB rebates in the public and private sectors peaking at £3.1 billion (in 2006/07 prices) in 2030 (p100).

From rising life expectancy to Pension Protection Fund levies, a number of factors have made defined benefit pensions more expensive to provide in recent years. There are good arguments for ending the State's role in earnings-related pension provision, but these proposals will add to the pressure on defined benefit schemes. This must be taken into account when Parliament decides what additional measures are needed to encourage employers to retain good schemes when Personal Accounts are introduced.

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[1] The Bill proposes that this should happen at the same time as the Basic State Pension is linked to earnings.

[2] The Government Actuary's Department says that "Nearly all active employee members of private-sector defined benefit schemes and sections [in April 2005] were contracted-out of the State Second Pension" (Occupational Pension Schemes Survey 2005, p9)

[3] Without reform, rebates would be paid for earnings up to around £20,400 (in 2006 earnings terms) in 2031. With reform, they would only be paid for earnings up to £12,500.

Conversion of Guaranteed Minimum Pensions

Good final salary occupational pension schemes can contract their members out of the state additional pension. In return, they must provide each contracted out member with an amount at least equal to the Guaranteed Minimum Pension (GMP) for pensions acquired between 1978 and 1997**.** The member's rights in the state scheme are reduced by an amount which roughly corresponds to this at State Pension Age**.** These GMPs are separate from the other benefits provided by the scheme.

The administration of GMPs is complex and costly. Contracted out schemes must keep detailed records, and report to HMRC when a member leaves, retires, dies, or transfers. Schemes must also provide Guaranteed Minimum Pensions for widows, widowers or civil partners. The Bill allows GMPs to be converted into scheme benefits of equivalent actuarial value provided that pensions in payment are not reduced. Conversion to money purchase benefits will not be permitted.

The NAPF welcomes this opportunity for contracted out occupational schemes to simplify their benefit structures and achieve savings in administration costs. However, the complexity of the procedure will affect the number of schemes and employers who feel able to take advantage of this option. When the details are finalised by regulation, they must deliver a streamlined process.

Abolition of contracting out for defined contribution pension schemes

Occupational and personal pension schemes may contract out of the state additional pension by choosing to invest each member's national insurance rebate in the scheme, to provide a pension at retirement which replaces the pension they would otherwise receive from the state scheme. The member then gives up the equivalent state additional pension rights, the value of which is deducted from his or her state additional pension at State Pension Age.

The Bill will end contracting out for these schemes. This will happen at the same time as the Basic State Pension is linked to earnings.

The Secretary of State has said it would be "entirely legitimate and sensible to use the savings that are generated from the DC rebate to support the introduction of the Personal Account system"[4]. It will be more expensive for employers with good schemes to apply auto-enrolment if they do not level down their pension provision than if they do. Any support should therefore include measures that encourage employers to offer contributions above the Personal Accounts level to new members as well as existing ones.

The NAPF supports the abolition of contracting out for defined contribution pensions. This will help savers to understand better what the state will provide and how they can build up additional retirement income.

Internal dispute resolution procedures

Under current legislation, occupational pension schemes must have a two-stage procedure for handling complaints from members where the second stage acts as an

[4] Evidence to Work and Pensions Committee, 7 June 2006

appeal to the first stage decision. The Bill proposes that schemes will be able to choose to have a single-stage procedure handled by the trustee body as a whole.

The NAPF welcomes this measure which gives schemes the option of simplifying the internal dispute resolution procedure if it fits their circumstances. This may be useful for smaller schemes. We recognise that larger schemes may wish to retain a two-stage procedure so that the trustee body does not necessarily have to handle every complaint.

State Pension Reforms

The Bill proposes a comprehensive set of reforms to the State Pension system. The Government estimates that these will increase spending on pensioner benefits by 1.4% of GDP in 2030, rising to 2.2% in 2050. More than two-thirds of this cost comes from uprating the means-tested Guarantee Credit in line with earnings[5].

Basic State Pension linked to earnings

The Government's objective is to link the value of the Basic State Pension to earnings by 2012. However, it has only made a firm commitment to doing so before the end of the next Parliament (i.e., no later than 2015). Delaying the earnings link until 2015 would save £600 million (in today's prices) in 2012. This annual saving would increase to £1.9 billion in 2015 and £4.2 billion by 2050[6].

The Bill requires the Secretary of State to name the date when the earnings link will commence before April 2011. It gives the Secretary of State discretion as to how average earnings should be measured and how increases are to be rounded.

State Pension Age to increase

The Bill will increase the State Pension Age (SPA) to 66 between 2024 and 2026; to 67 between 2034 and 2036; and to 68 between 2044 and 2046.

Compressing each decade's increase into a short period is simpler than a gradual increase: most people will continue to reach State Pension Age on their birthday. And by delaying the first increase until 2024, the Bill ensures that no one reaching the age of 48 by 5 April 2007 will be affected. However, this system may also be thought less fair than a gradual increase. Someone born on 5 April 1959 will get their full State Pension from the age of 65. Someone born on 6 March 1960 will get nothing until the age of 66, even though they can on average expect to live just a few weeks longer. Future governments may find this difficult to defend.

If current life expectancy forecasts prove correct, the Bill will mean that men reaching SPA from the mid-2020s spend roughly the same proportion of their adult life receiving a State Pension as those reaching SPA today. However, they will spend a smaller proportion of adult life receiving a State Pension than those reaching SPA shortly before 2024[7].

The Bill legislates on the basis of today's life expectancy forecasts and does not seek to anticipate whether the State Pension Age will need to increase further after reaching 68.

[5] *Pensions Bill Regulatory Impact Assessment*, pp 34-36
[6] *Hansard*, 8 November 2006, col.1639w
[7] *Security in retirement: towards a new pensions system*, p114. Women will spend a smaller proportion of adult life receiving State Pensions owing to the increase in female State Pension Age commencing in 2010.

The Government has said that periodic reviews of the pension system should look at whether this timetable remains appropriate as these forecasts are updated.

Pension Credit

The Bill requires the Government to uprate the minimum income guaranteed by Pension Credit (currently £114 a week for a single pensioner) in line with earnings over the long term. Prior to May's White Paper, the Government had an aspiration to increase the Guarantee Credit in line with earnings indefinitely but was not committed to doing so after 2007.

The Government plans to limit the value and scope of the Savings Credit by raising the income threshold at which people become entitled to Savings Credit. This reintroduces a band of retirement income on which people with a full Basic State Pension lose £1 of Pension Credit for every £1 of income from other sources. (This change can be implemented through an Uprating Order and does not require primary legislation.)

Curtailing the growth of Savings Credit will reduce the number of people eligible for Pension Credit. The Government estimates that around one-third of pensioners will be eligible for Pension Credit in 2050, compared with 70% if current indexation policies were continued indefinitely.

Eligibility

The Bill will replace Home Responsibilities Protection (which reduces the number of years needed for a full Basic State Pension) with a weekly credit for people with caring responsibilities. Parents who are not in employment will be credited into both the Basic State Pension and the State Second Pension until their youngest child reaches the age of 12 (rather than 16 for the Basic State Pension and 6 for the State Second Pension). Someone caring for a severely disabled person for at least 20 hours a week will gain entitlements to both the BSP and S2P (down from 35 hours a week today).

People reaching State Pension Age on or after 6 April 2010 will need just 30 qualifying years to receive a full Basic State Pension (currently 39 years for women and 44 years for men). This will enable more women to receive a full Basic State Pension. It also introduces a cliff edge. Some people reaching State Pension Age before this date will receive a smaller Basic State Pension than younger people despite having more qualifying years.

The Bill will improve the State Pension system in many ways, and the Government should be applauded for not shying away from the decision to increase the State Pension Age.

Because life expectancy forecasts are uncertain, Parliament should be clear about what it wants the increase in State Pension Age to achieve. After the Bill is enacted, this timetable should be reviewed if it looks unlikely to meet these objectives – though people must be given reasonable notice of when they will receive their State Pension.

While recognising the practical difficulties and trade-offs involved, we would like any further changes to make the State Pension system simpler and less means-tested in order to provide a more secure platform for private saving. After these reforms have started to bed down, the Government could examine the case for integrating the two flat-rate State Pensions.