NAPF

Securing the future of pensions

A Budget for pensions

An NAPF submission to HM Treasury on the 2010 Budget

February 2010

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About The NAPF

The NAPF is the leading voice of workplace pension provision in the UK. We represent some 1200 pension schemes from all parts of the economy and 400 businesses providing essential services to the pensions industry. Ten million working people currently belong to NAPF member schemes, while around 5 million pensioners are receiving valuable retirement income from those schemes. NAPF member schemes hold assets of some £800 billion, and account for over one sixth of investment in the UK stock market. Our main objective is to ensure there is a secure and sustainable pensions system in the UK.

Executive Summary

Pensions are under pressure. The recession, falling investment markets and increasing longevity are forcing many employers to reassess the pensions they offer their employees. Unhelpful accounting standards and the Government's 2009 proposals on pension taxation are adding to this pressure. The future quality and value of workplace pension provision may be determined by decisions taken in the next 12 months.

The NAPF is calling on the Government to adopt a **Budget for Pensions** which must include two important measures to support good quality provision:

- **Gilt issuance**: It must increase the supply of long-dated and index-linked gilts so as to help pension schemes and their sponsors reduce the volatility and risk they face in offering defined benefit pensions. There is a strong and on-going demand from pension schemes and insurance companies. Given low yields at the long-end of the curve, skewing issuance towards longer maturities will also provide the Government with a cheap source of finance. Greater issuance will be good for pensions, good for companies, and good for the Government.

- **Pensions tax**: It must abandon its 2009 proposals on the taxation of pension contributions by those earning £130,000 and over. They undermine the UK's long established approach to pensions taxation (EET) and will create uncertainty as to whether it "pays to save" in a pension. Our research shows that the proposals are also likely to affect many people earning far less than the target group, especially due to the arbitrary and random nature of the rules. These complex proposals are expected to cost 10 times more to implement than estimated by the Treasury and clearly fail to meet the Government's own Better Regulation Principles. Instead, the NAPF calls on the Government to adopt a simpler and fairer alternative approach of radically lowering the annual allowance from £245,000 per year to a far lower figure between £45,000 and £60,000. The NAPF approach will do less harm to pension provision, be less likely to catch people on earnings far below the target group, and achieve similar savings in pension tax relief to the Treasury's proposals.

Many feel that while the Government may be able to take pride in its measures to increase retirement incomes of the poorest pensioners, it must do more to support the UK's workplace pensions. The Government must use its last Budget of this Parliament to address this failing.

Introduction

1. We are approaching a critical period for workplace pensions in the UK. Not only are schemes and the employers who sponsor them still grappling with the harsh economic and investment conditions unleashed by the global recession, but changes to the legislative regime for pension provision – especially the recently announced changes to pensions taxation and the introduction of auto-enrolment from 2012 – mean that over the next year many employers will be reviewing the pension they offer their employees. There is a high risk that that this review of provision will result in worse pensions. However, the right action by the Government may yet avert this danger.

The current context – pensions under pressure

2. Today, while 2.6 million private sector employees are still accruing defined benefit pensions, only 23% of schemes are open to new members. Ten years ago, 88% of private sector schemes were still open to new members. Faced with the economic recession, poor investment returns and rising longevity many of the employers still offering such pensions are now contemplating closure. In addition, low gilt yields have resulted in an increase in schemes reported liabilities prompting widespread consideration of further closures.

3. The historically poor performance of equity markets over the last decade has also been a blow to defined contribution schemes. Not only have poor equity returns stifled growth but falling gilt yields have made annuities more expensive thereby reducing the level of pensions that can be bought at retirement.

4. The pressure on pension schemes comes not only from factors beyond human control such as longevity and global markets. The 2009 Budget proposals on pensions taxation threaten to apply enormous cost and complexity on pensions and also to undermine the UK's established approach to pensions taxation. Moreover, the decision of the accounting standards bodies to continue to measure pension funds assets and liabilities with a focus on short term market conditions without recognizing the long-term nature of pension provision has also harmed the UK's previously successful tradition of final salary pension provision.

5. Even positive initiatives, such as the Government's decision to require all employers to introduce auto-enrolment in 2012, is adding to the sense of uncertainty as many corporate Board rooms, facing substantially greater costs, are now taking stock of whether or not to offer a pension of a value or quality above the new legal minimum.

6. The next 12 months marks a uniquely important period for UK pensions and it is essential that the Government uses the next Budget to help and support them.

Gilts issuance

Why pension funds need long-dated and index-linked gilts

7. Pension funds have a strong and on-going demand for long-dated and index-linked gilts. Today they own over £110 billion of gilt holdings, amounting to over 20% of total issuance. Moreover, pension schemes also account for a significant proportion of the insurance sector's gilt holdings of over £150 billion.

8. The demand of pension funds for gilts will remain strong for many years to come, especially as holding them is directly or indirectly required by the regulatory environment:

   - Pension scheme liabilities are long-term with an average duration of 20-25 years. They need assets of the right duration to match these liabilities and, while the specific mix of assets required is not specified in law, The Pensions Regulator expects trustees and sponsors to make a "prudent" choice of assets to meet their scheme funding obligations required under the 2004 Pensions Act. Moreover, the closure of DB schemes to new entrants, and increasingly to future accruals, has had the effect of hardening their liabilities, further increasing their demand for gilts.

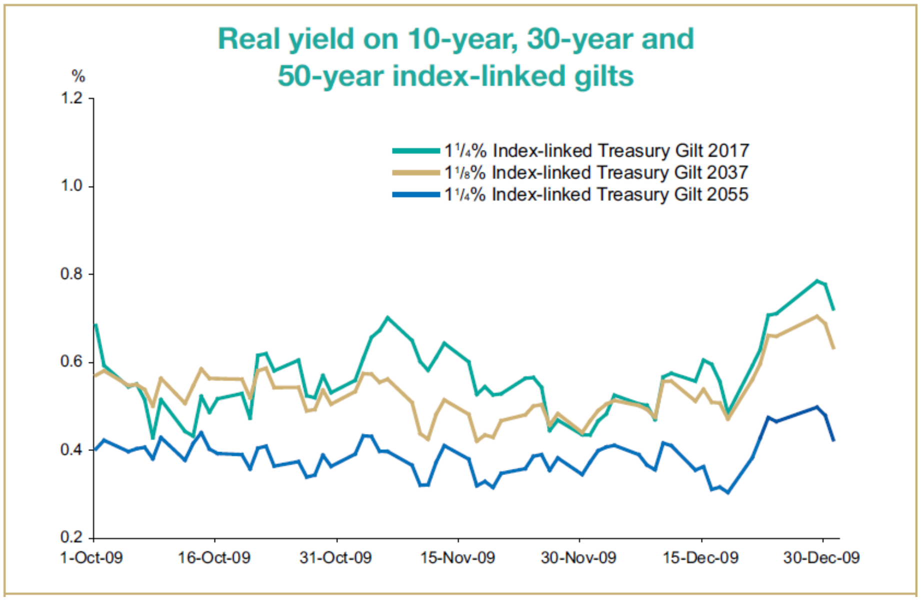
   - Corporate accounting requires companies to use current market values for measuring pension scheme assets and to quantify their liabilities by reference to the return on AA rated corporate bonds. If they do not invest in corporate or government bonds of a similar duration and nature to their pension liabilities, they are faced with unacceptably high levels of volatility in their corporate accounts.

   - DC schemes and their providers also have a strong and increasing demand for long-dated and index-linked gilts, especially for the purchase of annuities. Greater issuance at the long end would reduce annuity prices and increase pension values so lifting more pensioners out of means-testing at retirement.

9. It is for these reasons that our most recent Annual Survey showed that NAPF pension fund members rank greater long-dated and index-linked gilt issuance as the single most effective way Government could assist defined benefit pension schemes.

10. Further evidence of the strong demand for gilts of this nature and maturity can be seen in the shape of the UK yield curve for long-dated and index-linked gilts.

Figure 1: Real yield on 10-year, 30-year and 50 year index-linked gilts



Source: *DMO Quarterly Review, October - November 2009*

The Government must issue more long-dated and index-linked gilts

11. While we welcomed the decision taken at the time of the Pre-Budget Report in December 2009 to skew additional issuance to cover the net financing requirement almost entirely too long-dated and index-linked gilts, the amounts were relatively small and had little impact on the figures for the financial year. Therefore, the Government should use this Budget to announce increased issuance of long-dated and index-linked gilts for the coming financial year.

12. We are supported in this call by other end-investors and the Gilt Edged Market Makers (GEMMs). At their recent meetings with the Financial Services Secretary to the Treasury both sides pressed for increased index-linked issuance, particularly at the longer end, which has fallen well below previous levels.

A win-win-win solution

13. Given the low yields at the long end of the yield curve, skewing issuance towards longer maturities would provide the Government with a cheap and secure source of finance at a time of exceptionally large public sector deficits. We believe this will prove particularly helpful to the Government now that Quantitative Easing (QE) has been paused. Importantly, greater issuance of the nature called for will also help UK companies by reducing the strain of pension scheme volatility on corporate balance sheets. Taken together with the benefit for pension schemes, greater issuance offers a hat trick of wins.

Pensions tax

14. Like many others, the NAPF believes the Government's 2009 proposals for the taxation of those earning more than £130,000 per year will have detrimental effects on the UK pensions system stretching far beyond the higher earners the proposals purport to target. They will do enormous harm to pensions and must be abandoned. The proposals are damaging for three reasons:

- they undermine the EET principle and create uncertainty;
- they will harm those on incomes far lower than £130,000; and
- they have disproportionate implementation costs and are administratively complex.

Undermining the EET principle and creating uncertainty

15. Within the UK pensions system, to encourage people to lock away their savings until retirement, taxation is deferred until a pension income is drawn. This is the core of the EET system. However, the 2009 proposals abandon this approach and, in so doing, introduce uncertainty and confusion for individual savers. People can no longer be sure in all circumstances that it "pays to save" in a pension. Many may fear that even it if makes sense to save in a pension now, as their income is far lower than £130,000, it may not be so in the future as they can no longer trust the Government not to reduce the threshold further down the income scale.

Harming those on incomes far lower than £130,000

16. In December 2009 the NAPF undertook a survey of its pension fund members to ascertain the impact of the proposed tax changes on pension schemes and their members. It found that 48% of pension funds believe that the tax changes will have a secondary effect on people earning less than £130,000.

17. Many will be caught for random and arbitrary reasons, such as staff receiving performance bonuses, relocation packages and redundancy payments. Examples of how people on earnings in the range of £40,000 to £80,000 upwards could be caught are set out in the box on the next page.

Box 1. How those earning far less than £130,000 a year can be affected

A) Janet – the mid-career high achiever on £70,000 a year

Janet is a Chief Accountant aged 45 on a basic salary of £70,000 and is eligible for a performance bonus of £35,000 a year. She receives a car allowance of £8,000 per year and other benefits worth £2,000 a year. Janet has been with the company and in the DB pension scheme ($1/60^{th}$ accrual) for 20 years.

Janet is promoted to Financial Controller receiving a salary increase of £10,000 per year. It has been a very successful year for her employer and Janet has met her objectives so she also receives her maximum bonus of 50% of base salary. Her total income is now £130,000.

Janet's income is now higher than the income 'floor ' (£130,000) and so the deemed value of her employer contributions must be calculated and then added to her current income, to establish her gross income. As Janet is in a good DB scheme the deemed contributions are calculated as being £54,000, bringing her gross income for the purpose of the new pensions tax regime to £184,000. Janet will now become subject to a tax recovery charge of £14,200 – a figure greater than her £10,000 per year salary increase.

B) Dave – the successful manager on £40,000 a year who has to relocate with his job

Dave is a Sales Manager aged 50. He is on a salary of £40,000 a year and is eligible for a performance bonus of £12,000. He also receives a car allowance of £5,000. He has been with the company for 25 years and has been in the ($1/50^{th}$) DB pension scheme for 25 years.

Dave receives a promotion to Area Sales Manager with a salary increase of £10,000 per year and a larger potential bonus of £15,000 a year. However, to get this new role, he has to move to another part of the country. The company provides him with a relocation package of £40,000 which, when grossed up for tax purposes, amounts to £67,000. As a result, his total income is now £137,000.

Dave's income is now higher than the income 'floor' (£130,000)and so the deemed value of his employer pension contributions must be calculated and then added to his current income. Although originally only on a basic salary of £50,000 a year, due to the relocation package his gross income is now calculated as £137,000.

As the employer's deemed DB contributions are calculated as being the equivalent of £120,000, for the purposes of the new tax regime, Dave's gross income will be calculated as £257,000 and he will be required to pay a tax recovery charge of £34,700, which is more than three times greater than his salary increase.

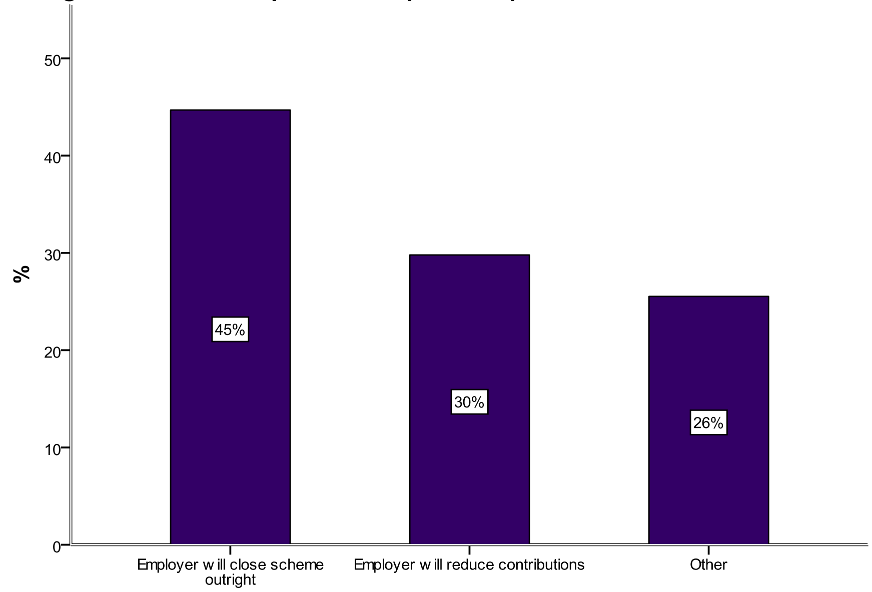
c) John – the middle ranking executive who gets made redundant due to the recession

John is an HR Manager aged 59. He is on a salary of £80,000 a year. He also receives a car allowance of £5,000. He has been with the company and a member of the ($1/60^{th}$) DB pension scheme for 20 years

John is made redundant and receives a redundancy payment of 1 x salary (£80,000) of which the initial £30,000 is tax exempt. John's income is now higher than the income 'floor ' (£130,000) and so the deemed value of his employer contributions must be calculated and then added to his calculated income of £135,000 to establish his gross income. As John is in a good DB scheme the deemed contributions are calculated on a prescribed formula, which in John's case includes allowance for payment of an unreduced pension from age 60, as £137,400. This brings his gross income for the purpose of the new pensions tax regime to £272,400. John will now become subject to a tax recovery charge of £39,720 plus £20,000 tax on the net redundancy payment - a total tax charge of £59,720.

18. The NAPF survey also found that where respondents indicated there would be an effect on the pensions of those earning less than £130,000, around a half thought that employers will close their scheme – possibly, where the economics of offering a defined benefit scheme no longer appears to make sense - and about a third believe employers will reduce contribution levels. We believe that this affect may take place over a period of time as senior executives, who have responsibility for company pension provision, opt out of their company provision due to the new tax regime, with the result that they become less engaged with the benefits of offering a good pension. Indeed, this message is given repeatedly to the NAPF at every one of our bilateral meetings with the pension managers of the largest private sector schemes in the country.

Figure 2: Secondary effect on pension provision



Disproportionate implementation costs and administrative complexity

19. There is a growing industry consensus that the figures in the Impact Assessment (one off costs for implementation of £265-305 million and ongoing annual costs of £50-90 million) are very significantly understated. NAPF members have suggested that the figures understate the cost by tenfold, particularly in relation to professional adviser fees for calculation work and advice. As a result, the NAPF believes that implementation costs could easily amount to between £2.5-3 billion. This is more or less the same as the Treasury's estimate of the yield.

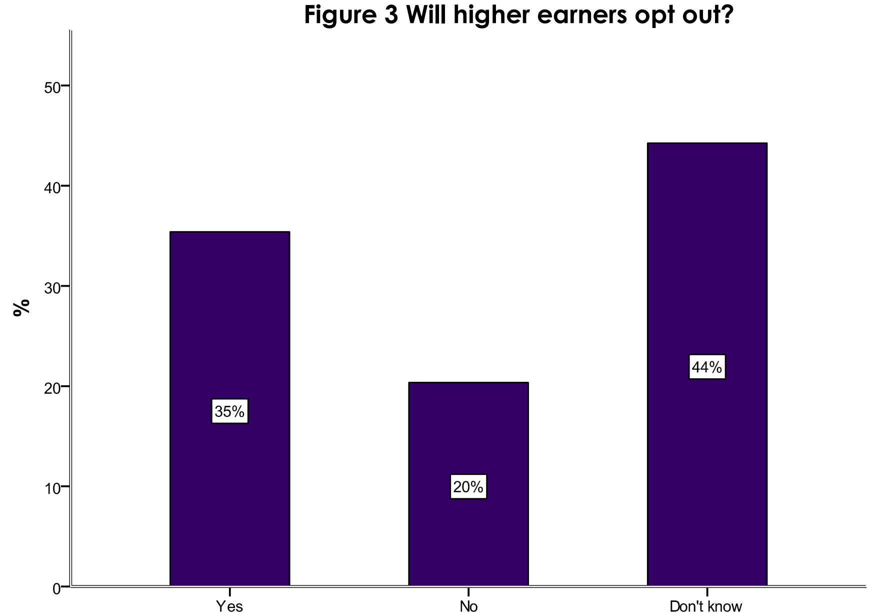
20. Clearly, such high implementation costs fail the Government's own "Better Regulation Principles" which require that any costs imposed should be proportionate to the policy objectives and minimized wherever possible. Moreover, the proposals also appear to fail the principle that regulatory change should be focused on the specific problem being targeted so as to minimise unnecessary consequences.

The tax yield – far lower than the estimated £3 billion

21. The Government's proposals almost certainly will fail to raise the projected tax yield of £3.1bn. The NAPF has been working with Punter Southall to assess the Government's tax estimates. The results of this analysis suggest that rather than saving £3.1 billion in tax relief, when the behavioural effects suggested by the NAPF survey of pension funds are taken into consideration, the yield raised could fall within a range of between £900 million and £1.5 billion.

22. Yields will be lower than expected because many of those on high earnings will cease to save in a pension. Indeed, respondents to the NAPF survey believe that 35% of high earners will opt out of provision and only 20% will remain. As many as a further 45% are unsure of how they would react.

Figure 3 Will higher earners opt out?



23. Given the relatively low yield to be expected and the very great harm that will be caused by these changes to UK pension provision, it is hard to understand why the Treasury has opted for their proposals – unless it is seen as a more "politically acceptable" alternative to simply applying further income tax increases on higher earners.

The NAPF's alternative – a lower annual allowance

24. If the Government does need to raise additional tax revenue from workplace pensions, it must do so in a way that works with the grain of our well established pensions tax policy in the UK, and does not result in some savers being taxed twice.

25. The NAPF believes this could be best achieved by maintaining the current post-A Day 2006 tax regime but radically reducing the annual allowance from its current level of £245,000 to a lower figure in the range of £45,000 to £60,000. The rationale for the new annual allowance is that someone saving for a pension over a typical period (30 to 40 years) would still have the potential to save up to the current lifetime allowance of £1.75 million. To provide flexibility and fairness, a carry back / carry forward system could be operated. Alternatively, it may be helpful to exclude past service effects for some groups of income.

26. This approach has a host of advantages:
    - It would maintain the current principle of pensions taxation based on the EET principle.
    - It would carry forward the gains of the April 2006 simplification agenda.
    - It would avoid most of the costs and complexities arising under the new regime.
    - It would also avoid the risk of many individuals earning less than £130,000 being discouraged from pension saving.
    - It would also reduce the risk key decision makers within company boards disengaging from pensions leading to reduced pensions for all employees.

27. It is impossible to assess with certainty the likely tax yield from this alternative approach – the relevant data is not in the public domain and the Treasury has not yet responded to our request for data on this issue. However, using reasonable assumptions we have estimated that our proposals could yield between £1-3 billion depending on the level of the annual allowance. Put another way, given the uncertainty surrounding the likely yield from the 2009 proposals, it is reasonable to assume that each method could raise a broadly similar amount.

The 2011 implementation date is too ambitious – it must be delayed

28. Given the excessive complexity of the proposals, under no circumstances should they be introduced in 2011. Instead, the Government should learn the lessons of the 2006 Pensions Simplification and, if it is decided to go ahead with its proposals or with those proposed by the NAPF, implementation should be delayed by at least a year.

Conclusion

29. Since coming to power in 1997, the Government has tried hard to improve pensioner incomes and to reform the UK's pension system. The introduction of targeted pension benefits and the forthcoming 2012 reforms, which have been actively supported by the NAPF, will have an enduring effect on UK pension provision.

30. But more must be done to support workplace pension provision – especially over the next 12 months, when the economic and policy environment means that the value of offering a workplace pensions will be subjected to special scrutiny by company decision-makers. The Government must use its last Budget of this Parliament to address this need. We call on the Government to adopt a **Budget for Pensions**.

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