NAPF

Securing the future of pensions

Fit for the Future

NAPF's vision for pensions

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Executive Summary

The nation's pensions landscape has changed dramatically over the past two decades. Our pensions system, which was once the envy of the world, has been transformed to one in which 12 million people are either not saving or are not saving enough and DB pensions are in decline. And the landscape is set to change still further. The 2012 reforms will give almost every working age person a right to a pension with an employer contribution and will give 7 million people the right to join a scheme for the first time.

These reforms are significant, and undoubtedly a major step forward, and for this reason they have been strongly supported by the NAPF. But they are the start of the journey, not journey's end.

The UK will continue to face pensions challenges and uncertainty. Over the next 25 years, the number of people over state pension age is projected to increase by 32%. But the working age population is projected to increase by only 14%. NEST will mature, but it and other schemes with only minimum contributions are likely to generate only modest benefits – on current projections just around 15% of average earnings; by the middle of this century, over 50% of pensioners will still retire on means-tested benefits; and there is a risk employers may withdraw further from pension provision.

> "Our pensions system, which was once the envy of the world, has been transformed…

The UK's pensions crisis is far from resolved.

This document *Fit for the Future – the NAPF's vision for pensions* aims to take us beyond the 2012 pensions settlement and tackle these outstanding issues. Building on the 2012 reforms it sets out a programme to transform the UK's pensions landscape to one that delivers:

- an adequate retirement income for all through a more generous state pension and stronger workplace pensions;
- stability based on clear and shared objectives; and
- flexibility to adapt to the environment (economic and demographic) in which it operates.

Ours is a vision where strong workplace pensions play the central role in providing people's retirement incomes, supported by a solid base of state pension provision, and which provides the right incentives to

individuals to save for the future and employers to offer high quality schemes, and in which both have confidence.

Taken together, our package of proposals would allow everyone to have a pension in their own right – a workplace pension into which they were auto-enrolled with mandatory contributions (over time moving above the 8% minimum) and a state pension that provided a much more adequate floor of benefits and which would be indexed in line with earnings.

We hope, too, that it has the potential to replicate the consensus that has been a successful feature of the post-Turner reforms and is capable of accommodating the realistic future challenge that either costs have to rise or retirement ages have to increase without the need for future reform.

> "Ours is a vision where strong workplace pensions play the central role in providing people's retirement incomes.

OUR RECOMMENDATIONS

1 **A simpler, more adequate state pension system:** A new state **Foundation Pension** should be created, combining the current basic state pension and state second pension. This would be worth £8,000 a year, around a third of pre-retirement income for someone on median earnings. It would give pensioners an additional £25 a week in income and take around 2 million pensioners out of means testing. It would provide a solid floor on which to provide workplace pensions.

2 **The power of scale:** Strong encouragement should be given to creating large, low cost, **Super Trusts** which would offer benefits to savers and to employers, who will be able to provide access to high quality pension arrangements. The low costs of Super Trusts could add around 30% to the eventual size of someone's pension.

3 **Sharing risks – a fresh approach to workplace pensions:** New forms of risk sharing pension schemes for both defined benefit and defined contribution schemes should be developed. For defined benefit schemes this could include permitting employers to offer **'core DB pensions'** that were not required to provide spouses' pensions or inflation proofing. Such schemes would give scheme members the certainty of a guaranteed level of benefit without taking on the investment and annuity risks inherent in DC, and would give employers more certainty over the costs of the scheme, thereby helping to stem the tide away from DB.

4 **Sufficient income:** The Foundation Pension will ensure people have a basic level of income that lifts them out of poverty. The mandatory level of contributions required from employers and employees from 2012 will improve people's prospects further. However there is scope to **increase mandatory contributions**. This would ensure that the overarching objective of the pensions system – to provide people with an adequate income in retirement – is achieved.

5 **Reforming public sector pensions:** Further reform of public sector pensions is inevitable. But we must avoid a 'race to the bottom'. Instead, a **Public Sector Pensions Commission** should be established, comprising employer and employee representatives and pensions industry experts. It should conduct an informed, evidence-based debate and make recommendations for reform.

6 **Simple, suitable and risk-based – the right approach to regulation:** The combination of the Foundation Pension and larger, well run, schemes presents opportunities for a regulatory dividend. This must have at its heart a move to a genuinely **principles-based regulatory framework** that provides the right protection for scheme members but which is simple to operate and which encourages rather than discourages pension provision.

7 **The right regulatory framework:** A **single regulator for pensions** (with responsibility for stakeholder pensions and group personal pensions transferring from the FSA) would provide clarity to scheme members and scheme sponsors alike. But the new regulator must also be the right regulator. It must have a **new statutory objective** to ensure the health and longevity of workplace pensions.

8 **The right incentives for pension saving:** Even with auto-enrolment, individuals will still need the right incentives to save – and to save above the statutory minimum – in pensions. The signals the Government send through the tax system will be important. The pensions tax system should be returned to a **simpler form of EET**. **Targeted incentives for employers** to encourage them to contribute above the statutory minimum should be developed.

9 **Working longer:** In exchange for a higher state pension, people may need to **work for longer**. Extending working lives involves more that just considerations about pensions. The Government will also need to consider other issues such as health inequalities and employment practices.

10 **Staying on track:** The long term nature of pensions requires a long term and enduring political settlement that commands the support of politicians, the pensions industry, the social partners, and, most importantly, savers and pensioners. A permanent independent **Retirement Savings Commission** should be established to ensure that the new pension settlement continues to deliver and to command widespread support. It would report to Parliament on the state of the nation's retirement savings and on changes needed to keep on track.

Chapter 1
The Foundation Pension

The Foundation Pension
a decent state pension for all

The state has – and will continue to have – an important role to play as a direct provider of pensions, to provide an adequate floor of benefits that keeps its citizens out of absolute poverty without resorting to means-testing for the majority.

But notwithstanding the current Government's welcome and much needed state pension reforms[1], the state pension system fails to meet these most basic objectives:

- Today almost 3 in 5 (58%) pensioners need some form of income-related benefit in old age. Even after the latest round of reforms, that number will fall only slightly to 53% – which is still unacceptably high.
- It is one of the lowest state pensions in the developed world. According to the OECD, the gross replacement rate for a median earner in the UK in 2009 was just 30.8%, compared to an OECD average of 59%.[2]
- The system is complex and poorly understood by individuals.
- While men and women will begin to experience similar outcomes from the state pension system, it will take decades for the difference to equalise – even by 2030 the difference could be as great as £17 a week[3].

A new, more radical approach is needed – the Foundation Pension.

The Foundation Pension builds on and accelerates these reforms by bringing forward to 2017 the pension that will be payable once the current reform package has been fully implemented in 2050. The NAPF believes this faster, more generous path to reform is a necessary precondition to reforming the rest of the UK pension system.The Government should signal its early intention to introduce a Foundation Pension by bringing forward legislation within the lifetime of the next Parliament.

> A new, more radical approach is needed – the Foundation Pension.

Benefits of the Foundation Pension

The Foundation Pension has considerable advantages over the current reformed state pension arrangements.

Set at £8,000 a year, many pensioners would receive an increase in their weekly income of £25 a week (£1,300 a year) on average. This is a significant increase which will take around 2 million pensioners out of means-testing. Under our proposals, 43% of pensioners would still require means-tested benefits (MTBs) of some kind. This compares to 53% of pensioners needing means-tested support under the Government's reformed state pension proposals. Crucially though, under the Foundation Pension, the numbers relying on Pension Credit would fall dramatically, from 48% today to 30% in 2017 and 27% in 2050. It is likely that those who do continue to require MTBs will need them in much smaller amounts.

Table 1: Eligibility for means-tested benefits (MTBs) current reforms (CR) v Foundation Pension (FP) – percentage of pensioner population in receipt of some benefits

	2010		2017		2020		2030		2040		2050	
	CR	FP	CR	FP	CR	FP	CR	FP	CR	FP	CR	FP
Pension Credit	48	48	45	30	44	31	44	32	43	32	43	27
Housing Benefit	22	22	21	19	21	19	22	20	21	20	21	18
C Tax Benefit	46	46	43	36	41	36	41	37	40	35	37	32
Any MTB	58	58	56	46	54	46	55	48	54	48	53	43

Source: PPI modelling for the NAPF

BOX 1: THE FOUNDATION PENSION

How it works

- The Foundation Pension would combine the current basic state pension and the state second pension to form a single, universal, flat-rate benefit.
- The Foundation Pension would be worth £8,000 a year – around a third of median male earnings. A full Foundation Pension would be earned after 30 years of National Insurance contributions.
- It would be paid on an individual basis to everyone over state pension age.
- Once in payment, it would be increased annually in line with earnings.

No-one is left worse off as a result of the Foundation Pension being introduced.

Importantly, those in work and saving in workplace pensions will have a much clearer understanding of the income they can expect when they reach state pension age. They will know it will "pay to save" and that what they save through their workplace scheme will not be lost through means testing in later years. This should act as an additional incentive to save. The impact on people's likely saving habits is shown in figure 1 on page 9.

1. From April 2010, the number of years needed to earn a full basic state pension will fall from 49 to 30 – a major benefit to women and others with broken career patterns – and the earnings link for increasing the pension each year will be restored (from 2012, subject to affordability). To help meet the costs of these improvements, state pension ages will increase to 68 by 2046.
2. The OECD replacement rates quoted here consider all mandatory sources of income relative to individual earnings.
3. Pensions Policy Institute, Briefing Note 36, "Will the Pensions Bill Solve the Problems of State Pension Reform?"

Reflecting developments in the workplace pensions sector, women would receive a Foundation Pension in their own right, giving them the opportunity for better incomes in retirement. The need for married couples' state pensions (ie where the woman's pension is 60% of the husband's pension) would cease.

> The Government should signal its early intention to introduce a Foundation Pension by bringing forward legislation within the lifetime of the next Parliament.

The system is simple – combining two state pensions into one, abolishing contracting out (the existence of which caused the Pensions Commission to dub the UK pensions system "one of the most complex in the world"[5]) and reducing reliance on a maze of complex and poorly understood (and therefore often under-claimed) means-tested benefits.

Phasing in

During the phasing in period, the Foundation Pension would be paid to people whose basic state pension (BSP) and state second pension (S2P)[4] was lower than the new Foundation Pension level in the form of a top up. Anyone who had a state pension entitlement worth more than the Foundation Pension would continue to receive BSP and S2P. Because the Foundation Pension would be increased each year in line with earnings, it would increase relative to BSP and S2P in payment (S2P is currently indexed in line with prices and not earnings) and eventually overtake the maximum possible combined BSP and S2P. At this point, everyone would receive the Foundation Pension.

Once the Foundation Pension is introduced, individuals would no longer accrue S2P entitlements. On current projections, by the time the Foundation Pension is introduced, many contracted out DB schemes are likely to have closed to new members and/or future accrual, or will have already contracted back in to the state second pension. In addition, contracting out for DC schemes will have already ended. Therefore, the number of schemes that are likely to be affected by the requirement to contract in will be relatively small.

Costs of the Foundation Pension

Under the reforms introduced in the 2007 Pensions Act, spending on state pensions and other related benefits is projected to increase by around 1.7% of GDP (around £46bn) between 2010 and 2050. Inevitably, a more generous Foundation Pension would increase further the costs of providing state pensions.

The NAPF commissioned the Pensions Policy Institute (PPI) to model the long-term cost implications of introducing the Foundation Pension at £8,000 a year, and how these costs could be met on a cost neutral basis ie not increasing spending on state pensions beyond the current projected 1.7% GDP increase.

The PPI's modelling suggests that the additional costs of the Foundation Pension would be partially offset by savings from means-tested benefits which, as table 1 shows, would be paid to far fewer people. Once these and other savings (including those from not having to pay the Foundation Pension to people already in receipt of a full BSP and S2P entitlement during the phasing in period) are taken into account, the Foundation Pension would add an additional 0.9% to GDP by 2050.

Figure 1: Certainty is key

Knowing that you would get a guaranteed state pension worth £8,000 a year, how much more would you save each month into your own arrangements?

If a 30 year old woman were to start saving an extra £24 a month into her private pension pot (currently worth £3,600), she would get an extra income of £110 a month when she retired at age 68, with an additional lump sum amount of £6,690[6].

If she were to save an extra £50 a month into her pot, she would get an extra £228 a month, with an additional lump sum of £13,900.

Source: NAPF Workplace Pensions Survey, Spring 2010.

4. Extra spending on State Pensions and S2P here includes entitlement to other earnings related state pensions such as SERPS and Graduated Pension.
5. Pension Commission first report, 2004
6. Calculated using the FSA Pensions Calculator.

Table 2 sets out the impact of the cost changes over the long term.

Table 2: Costs of introducing Foundation Pension at £8,000 in 2010 earnings terms (the level of a 'full' BSP and S2P in 2050) in 2017 (£bn in 2010 earnings terms)

	2010	2017	2020	2030	2040	2050
Foundation Pension	0	+31	+29	+26	+26	+24
Other State Benefits	0	0	0	0	0	0
Guarantee Credit	0	-4	-4	-4	-4	-4
Savings Credit	0	0	0	0	0	0
Housing Benefit	0	-1	-1	-1	-1	-1
Council Tax Benefit	0	-1	-1	-1	-1	-1
Extra spending on State Pensions and related benefits	0	+25	+23	+21	+20	+17
% GDP	4.9%	7.0%	7.1%	7.7%	8.0%	7.5%

Source: PPI modelling for the NAPF. Note: these figures do not take account of any additional savings that might result from higher NI receipts as contracting out was abolished.

It would be possible to introduce further measures to raise revenue (or offset costs) so that the Foundation Pension could be introduced on a cost neutral basis. The measures that have been considered here, which could be used individually or in combination, include:

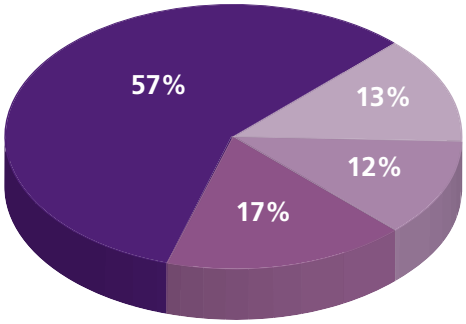
- increasing the state pension age further – to age 70 by 2046;
- increasing employer and/ or employee National Insurance Contributions (NICs);
- abolishing targeted pensioner benefits;
- transferring welfare benefit savings from the young to the old; and
- additional revenue from contracting out.

The impact of each is set out in table 3 (page 11).

> "The Foundation Pension would lift 2 million pensioners out of means testing.

Figure 2: Work longer for more money – trade offs

Would you be prepared to work 2 years longer if it meant you get a guaranteed state pension of £8,000 per year compared to £6,800?



Source: NAPF Workplace Pensions Survey, Spring 2010.

- Over half of respondents were prepared to work longer if it meant receiving a higher state pension.
- Younger people were more likely to be prepared to work the additional years.
- 58% of the 55-64 age group (those closest to retirement) said they would be prepared to work longer

- Yes
- No
- It would make no difference
- Don't know

Table 3: Foundation Pension – further potential savings

ISSUE	DESCRIPTION OF MEASURE	POTENTIAL COST SAVING (2050 IN 2010 TERMS)
Increase state pension age	One way of meeting the additional costs of the Foundation Pension would be to raise further the age at which it became payable, increasing the SPA to 70 by 2046. Current state pension age (SPA) is 60 for women and 65 for men. Under the Government's reforms the SPA (which is already due to increase for women to 65 by 2020) will increase further to 66 by 2026; 67 by 2036; and 68 by 2046. In the scenario modelled for the NAPF, the SPA increases to 66 between 2024 and 2026; to 67 between 2029 and 2031; to 68 between 2034 and 2036; to 69 between 2039 and 2041, and to 70 between 2044 and 2046. In other words, it doubles the rate of increase between 2024 and 2046 embedded in the current reforms.	The projected saving from increasing the SPA to 70 by 2046 would be around £14bn by 2050, or 0.7% of GDP. In terms of its impact on the overall costs of state pension reform, it would leave a 'spending gap' of 0.2% of GDP (or £3bn a year), if the Foundation Pension were to be introduced on a cost-neutral basis.
Increase employer and/or employer NICs	A direct way to meet the increased costs of a Foundation Pension would be to increase employer and/or employee National Insurance Contributions (NICs). Two options have been considered: 1. increase the employer and employee NICs by 1% each between the Primary Threshold and Upper Earnings Limit. Employee NICs would rise from 11% to 12%, and employer NICs from 12.8% to 13.8%. In this scenario it is not assumed that employee contributions above the UEL are altered – they remain held at 1%. 2. In addition to the changes modelled in a) above, employee NICs above the UEL are increased from 1% to 2%.	Option 1 would generate an additional £11bn in additional revenue, or 0.6% of GDP, leaving a 'spending gap' of 0.3% of GDP, assuming Foundation Pension was to be introduced on cost neutral terms. Option 2 would generate an additional £13bn in additional revenue, or 0.7% of GDP, leaving a spending gap of 0.2% of GDP.
Abolish targeted pensioner benefits	A range of age-related benefits is currently available to older citizens, often from age 60. These include a £10 Christmas bonus (paid each year with the state pensions); £25 a week age addition for people aged 80+; Winter Fuel Payments (currently £250 per household a year, depending on age); free TV licences for the over 75s, and subsidised travel. A higher state pension – worth nearly £25 a week more than today's state pensions – and paid as of right could negate the need for many of these benefits, which are often poorly targeted and costly to administer.	Excluding administration costs, targeted pension benefits cost around 0.2%-0.3% of GDP.
Intergenerational transfer of welfare benefit spending	In the UK today there are already more people over the age of 65 than there are under the age of 16.[7] Falling birth rates and continuing longevity will accentuate these trends. The ONS estimates that, by 2031, there will be over 2 million more pensioners than people under the age of 16.[8] One consequence of this demographic change will present the potential for welfare spending currently allocated to younger people to be transferred to older people.	Shifts in welfare spending from younger people to older people could be as great or as small as the Government felt was appropriate.
Changes to contracting out	The introduction of the Foundation Pension would result in the end of the S2P and with it the ability to contract out. (Contracting out for DC schemes will end around the time that the earnings link to the Basic State Pension is restored, so in a few years will only be available to DB schemes.) This will provide extra revenue as all employers and employees would need to pay the full level of NICs.	Additional revenue from abolishing contracted-out rebates would be around £4bn or 0.2% of GDP.

7. ONS, News Release. "UK Population set to increase to 65 million over next ten years," Oct 2007.
8. Ibid.

Table 4 below shows the combined effects of a number of measures designed to offset the additional costs of introducing a Foundation Pension at £8,000 a year. It shows that if state pension ages and NICs were to rise from the date of the Foundation Pension's implementation, it could generate a cost saving to the Exchequer by 2050.

Table 4: Costs of introducing Foundation Pension at £8,000 (in 2010 earnings terms) in 2017, increasing the level of SPA, 1% increase in NI Contributions (£bn in 2010 earnings terms and as a % of GDP)

	2010	2017	2020	2030	2040	2050
Total Spending above current reforms considering the increase in SPA to 70	0 (0%)	+25 (1.5%)	+23 (1.4%)	+13 (0.8%)	+6 (0.4%)	+3 (0.2%)
Extra NI Contributions	0 (0%)	+11 (0.7%)	+11 (0.7%)	+13 (0.8%)	+15 (0.9%)	+16 (0.9%)
Extra revenue from Contracted-Out Rebates	0 (0%)	+8 (0.5%)	+7 (0.4%)	+5 (0.3%)	+4 (0.2%)	+4 (0.2%)
Total Extra Cost	0 (0%)	+6 (0.4%)	+5 (0.3%)	-5 (-0.3%)	-13 (-0.7%)	-17 (-0.9%)

Source: PPI modelling for the NAPF

> "Without further, more radical, state pension reform like the Foundation Pension, we will never be able to build a pension system fit for the 21st century.

Ultimately, however, paying for the Foundation Pension would be a political decision: politicians could decide to meet the additional costs with no compensating policy measures; or accept additional costs in the short term in the knowledge that other policy changes will result in cost savings over the longer term.

What cannot be left in doubt, however, is that without further, more radical state pension reform like the Foundation Pension, we will never be able to build a pension system fit for the 21st century.

BOX 2: CASE STUDY – LOW EARNERS WOULD BENEFIT FROM THE FOUNDATION PENSION

Under the Foundation Pension system, people on low earnings will often receive more income in retirement than under the current system. Frances worked throughout her life as a part-time receptionist in a small local firm before retiring at age 65 in 2020 earning on average about £16,000 a year. Frances had no access to a pension at work for nearly all her working life and anyway felt she could not afford to save in a private pension. She lives in a rented flat and she also receives Housing Benefit.

Under the current system, Frances would get around £245 a week or £12,730 a year but under the Foundation Pension system, Frances would get an income of £246 a week or £12,770 a year.

In the future, Frances would be considerably better off under the Foundation Pension system as the whole of the pension would rise in line with earnings. In 2035, she would receive an extra £7 a week or £320 a year. In 2045, she would get £10 a week or £520 a year more than under the current system.

If Frances was one of the 40% of pensioners who do not claim the means tested benefits she was entitled to her gains would be even larger. When

she retires in 2020 she would be £13 a week (£700 a year) better off under the Foundation Pension system. By 2035 this would have risen to £25 a week (£1,330 a year), and by 2045 £32 a week (£1,660 a year)

Source: PPI modelling for the NAPF

BOX 3: CASE STUDY – COUPLES WOULD BENEFIT FROM THE FOUNDATION PENSION

With the Foundation Pension, many couples will be better off, especially if one them was on low earnings before they retired. Martin and Lesley both worked throughout their life before they retired in 2020. Martin worked in the hotel business where he worked as junior manager and was on average earnings (£25,000) during much of his working life. Lesley worked in catering, sometimes in the hotels, sometimes in the restaurant business. She earned around £16,000 a year. While Martin received a workplace DC pension with an 8% contribution for around 35 years, Lesley either did not have the option of joining a pension or, after being given the option after the 2012 reforms, chose to opt out as she felt that she could not spare the money.

Under the current system, Martin and Lesley's total pension income would amount to £323 per week but under the Foundation Pension system it would total as much as £337 a week. Moreover, due to auto-enrolment, Martin would receive a weekly income of £89 per week, thereby bring the couple's combined weekly income up to £426 a week or £22,150 per year. (It is true, however, that the value of private pension income would fall over the following years as Martin, like most people, chose a level annuity.)

Source: PPI modelling for the NAPF

Chapter 2
Workplace Pensions

Workplace Pensions
the heart of good pension provision

Pensions work best when they are provided through the workplace. And it is why the NAPF believes that all working people should be entitled to a decent pension that comes with their job. Our goal is that workplace pensions should provide someone on median earnings with an income in retirement of a third of their previous in-work income.

But faced with rising operational costs, and increasing employer sensitivity to the scale of pension scheme liabilities, workplace pensions are now under significant pressure.

- DB pensions are in steady decline. Today, only 23% of defined benefit pension schemes in the private sector remain open to new members. 70% are closed. Just 10 years ago, these numbers were reversed.
- Further – rapid – DB decline is likely. 40% of schemes currently open to new members are likely to close that scheme over the next five years, whilst a further one in three are likely to take the final step of closing schemes already closed to new entrants to existing members[1].
- Whilst, as the response to the NAPF's Pension Quality Mark demonstrates, there is much good quality DC provision in place, many DC replacement schemes have lower contributions and less effective – or no – scheme governance.

> "All working people should be entitled to a decent pension that comes with their job.

Unless further action is taken, the pension landscape for workers in the private sector could very quickly become one of minimalist provision dominated by pension schemes receiving statutory minimum contributions.

BOX 4: STRENGTHS OF COLLECTIVE WORKPLACE PENSIONS

Trust: The 2008-9 economic crisis saw a collapse in consumer confidence in financial institutions including pensions. Yet throughout the crisis, working people continued to trust their employer over any other form of pension provider, including the State. According to the NAPF Workplace Pension Survey 2010, 28% of the individuals surveyed said they trusted their employer the most, while only 17% said they trusted the Government.[2]

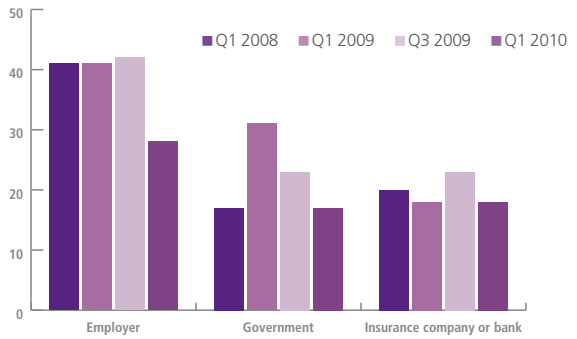
Economies of scale: Pensions that are provided wholesale through the workplace can generate economies of scale not available on a retail basis. Retail pensions are costly and inefficient, especially for low to moderate earners.

Reach: Workplace pensions are the only way to reach efficiently low to moderate earners – those most at risk of not saving or under saving for old age.

Governance: The move away from occupational pensions towards individualised, contract-based schemes has created a "governance vacuum". Without strong, independent, governance there can be no assurance that the scheme is operating in the members' interests, for example keeping costs low.

Risk sharing: Employer involvement can help to share risks. In DB schemes the risks are placed on the employer. But in DC schemes, especially contract-based schemes with no governance, the risks are placed entirely on the members who are generally ill-placed to assess and manage those risks. Ultimately shifting all risk onto individuals may prove untenable.

Figure 3: Who do you most trust to provide your pension?



- 28% of people trust their employer the most to provide their pension
- Only 17% trust Government the most
- 18% said they trusted insurance companies or banks the most

Source: 2010 NAPF Workplace Pensions Survey

1. NAPF Annual Survey 2009. 23% of open DB schemes said they would switch to occupational DC scheme, 15% said they would switch to contract-based DC, and 2% said they would switch to NEST.
2. NAPF Workplace Pension Survey 2010.

Recent policy focus has (understandably) been on developing and launching NEST in 2012. The NAPF has supported, and actively contributed to, this process. This focus, though, has meant that problems surrounding existing workplace pension provision – and steps to ease those pressures – have been largely ignored. For example, the Department for Work and Pensions' 'rolling de-regulatory review' has been moving very slowly and has yet to deliver any meaningful policy changes that will ease the burden on scheme sponsors.

We are not suggesting that there is likely to be resurgence in defined benefit provision. But we do not accept, as some have suggested, that occupational pensions are a thing of the past. It would be a mistake to abandon aspirations for a thriving workplace pensions sector. Only *collective* workplace pensions can deliver the key ingredients of successful private pensions. The alternatives expose individuals to unacceptable risks and costs, and above all the risk of retiring on an inadequate income.

SIZE MATTERS

Pensions work best when they are provided through the workplace. But workplace pensions work better still when they are provided in scale.

Good workplace pensions incorporate the following features:

- they are better able to operate at lower costs,
- can access a wider range of investment and other products at better value because of their superior buying power;
- they are more likely to have more effective and more expert governance and greater access to expertise; and
- are more likely to have higher quality administration systems.

> "Only collective workplace pensions can deliver the key ingredients of successful workplace pensions.

These features are most likely to be found today in larger pension schemes. Yet the UK is unusual in having a long tail of small pension schemes. 95% of DC schemes have fewer than 1,000 members and just 5% have more than 10,000 members[4]. Average scheme membership in the UK stands at just 2,600, compared to 10,500 in the Netherlands and 27,000 in Australia[5].

Small schemes are less able to capture the scale efficiencies in terms of the cost, investment optimisation and administration available to larger schemes and so they tend to be more expensive than larger schemes. Capita Hartshead's Pension Scheme Administration Survey 2009 shows that schemes with more than 50,000 members report costs of around £15-£20 per member, whilst schemes with fewer than 1,000 members report costs of around £150 per member[6]. The impact on the member's final pension can be significant: an individual saving

in a large employer's occupational scheme at 0.3% AMC could have a pension worth 30% more than an individual facing a 1.5% AMC.[7]

It is not only scheme operating costs where small schemes are at a disadvantage: small schemes often have less effective governance (and sometimes none at all, if set up under contract), reduced access to expert advice, higher investment fees and investment risk. It was for these reasons that the Government endorsed the Turner Commission's recommendation to establish a large-scale scheme to provide benefits for those who did not already have access to an employer-based pension and contribution. The National Pensions Savings Scheme (now being developed as NEST) will be a low cost trust-based multi-employer occupational pension scheme.

NEST will be one form of large collective scheme. But others could – and should – be encouraged to operate along side it. The NAPF believes there is a strong case for encouraging the development of Super Trusts.

Super Trusts would be large, not-for-profit, multi-employer pension schemes (offered on a regional, sectoral or national basis) managed by an expert board of trustees whose job would be to put the interests of members first. As such, Super Trusts would operate in a similar way to NEST. But unlike NEST they would have less direct government involvement. To ensure that Super Trusts reached scale, they should be limited in number – no more than 20, each licensed to operate by the Pensions Regulator.

4. DC Trust, The Pensions Regulator, July 2009.
5. UK Pensions Regulation Compared NAPF, October 2008. [Note: figures exclude schemes with fewer than 100 members.
6. The Capita Hartshead Pension Scheme Administration Survey May 2009.
7. The Pensions Commission, A New Settlement for the Twenty First Century: The Second Report of the Pensions Commission, 2005.

BOX 5: BENEFITS OF SUPER TRUSTS

- Super Trusts would be large scale low-cost DC pension arrangements. NAPF modelling suggests that Super Trusts could operate at around 40bpts. They have the potential to remain low cost due to their independent governance and buying power resulting from their scale.
- Built around auto-enrolment, Super Trusts would achieve high levels of coverage. Indeed, because employers have a more clearly defined role, and because members would not be faced with a bewildering level of complex and off-putting choices, levels of opt-outs may remain lower than for other forms of pension.
- Super Trusts would be centred around good scheme governance, guaranteeing high levels of consumer protection, putting the interests of scheme members, and not commercial interests of providers, first – reinforced by their not-for-profit status.
- By providing a pooled approach to scheme investments, Super Trusts can offer members lower investment risks. Members would share in a fund (and its returns) that would be invested in a basket of assets for growth and security. The Super Trusts would provide up-side opportunities whilst managing down-side risk by applying the Super Trust's investment and governance expertise to asset allocation and investment strategy.
- Super Trusts would provide some diversity in the market place and a managed choice and competition for employers to choose the appropriate Super Trust for them and their employees. Super Trusts would also help to ensure that the costs and services provided by NEST were competitive and high quality.

Super Trusts need not simply be for future accruals. They would be ideal vehicles for consolidating the many single employer DC schemes already in operation. Whilst accrued DC pension benefits currently stand at around £500 billion[8], many of the schemes that stand behind those assets are small. By consolidating under the umbrella of a Super Trust, scheme sponsors would be able to put their scheme on a more efficient footing. Scheme members, in return, would find more of their money working for them.

Fewer, larger, schemes could provide the opportunity for a 'regulatory dividend'. As the Pensions Regulator has noted "larger schemes are better governed than smaller schemes"[9]. Chapter 3 sets out how this regulatory dividend could work.

A MIXED ECONOMY OF PENSION PROVISION – SHARING RISKS

Whilst strong encouragement should be given to the development of larger schemes, including the consolidation of existing ones, a one-size-fits-all approach is not appropriate for today's labour market. Some employers, especially larger ones, will wish to continue to provide their own pension arrangements directly (and for a minority, this will continue to be on a DB basis); others will wish to adopt a multi-employer solution using Super Trusts; and others may wish to opt for a more hands-off approach using NEST. Some employers will be content to carry more risk than others. In other words, a healthy workplace pension system needs to offer a mixed economy of provision so that employers are free to provide the form of pension provision that is right for them and their employees, whether DB, DC or options in between.

Increasingly, however, the form of provision is being dictated by the regulatory and economic environment (the growing burden of cost and regulation and the desire by scheme sponsors to manage down sharply their pension liabilities and exposure to the associated risks).

When altering their pension arrangements, scheme sponsors have tended to switch from DB to DC provision. In large measure this has been because, in practice, the scope for risk-sharing arrangements is limited. For example, the 2009 NAPF Annual Survey reports that just 13% of schemes are based on CARE. Scheme change has, in effect, become a zero-sum game: one of either keeping the DB scheme or moving straight to DC.

8. Aon DC Pensions Tracker. Aon Corporation. Global Media Relations – News Releases.
9. TPR press release, 5 September 2006.

Rather than see pensions as being either DB or DC, we should view types of provision along a risk spectrum which gives scheme sponsors greater choice and flexibility. Whilst it is unlikely that we will see employers who have already moved from a DB to a DC arrangement move back to DB, risk sharing could help slow the exodus from DB. This matters because 2.6 million people are still accruing rights to a DB scheme today.[10] It is disappointing, therefore, that the current Government has rejected calls for the development of risk sharing arrangements.

> "A one-size-fits-all approach is not appropriate for today's labour market.

DB risk-sharing

In a DB scheme, all the risks – longevity risk, inflation risk, investment risk, salary escalation risk – are borne by the employer.

The NAPF believes the best way to secure the future of DB would be to allow schemes to go 'back to basics' and permit scheme sponsors to provide single life, level pensions. Benefits such as indexation in deferment and in payment and spouses' benefits would no longer be a legal requirement. This would be a core DB.

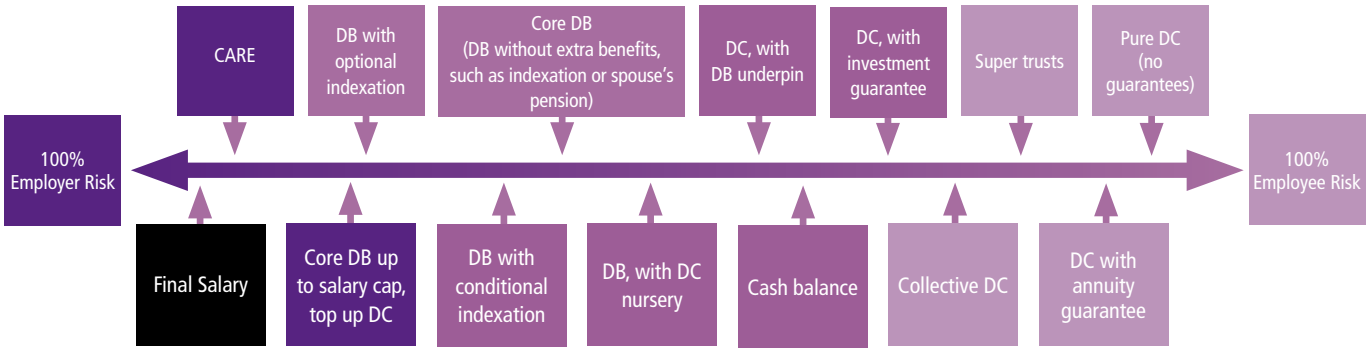
The right for every working person to build up a workplace pension with an employer contribution, combined with a higher state pension paid equally to women and men and indexed in line with earnings, reduces the need for these benefits to be paid from employers' DB schemes. Schemes could provide spouses' benefits and indexation if they wanted and, in the case of indexation, this could be on a 'conditional' basis, ie paid when the scheme's funding position so permitted. Equally, scheme members should be able to choose to fund extra benefits on a discretionary basis, giving members more choice over which extra benefits they wish to fund. Employers would continue to bear investment, salary escalation and some longevity risk, whilst scheme members would bear some inflation and longevity risk. So whilst from a regulatory perspective DB would be placed on a level playing field with DC, there would be one important difference: it would continue to provide more assurances for the scheme members than DC as scheme members would continue to benefit from a pension related to their salary at the point of retirement.

Reducing the benefits DB schemes would be required to provide as a legal minimum would have the effect of reducing the employer's accounting liabilities, and would also improve the scheme's funding position. By containing the liabilities and the costs of providing defined benefits, it is more likely DB schemes still open to new members and/or future accrual will continue to remain open.

Any changes to benefit structures along the line proposed here would apply to future accrual only. They would not affect benefits already earned.

10. ONS Occupational Pension Schemes Annual Report 2008.

Figure 4: Risk sharing spectrum



BOX 6: CORE DB – IMPACT ON COSTS

Adopting a core DB pension rather than a traditional final salary will make DB pension provision far more affordable to provide and so more likely that a salary related benefits will continue in existence. The NAPF estimates that providing a single life pension without indexation compared to a DB pension under today's rules (where indexation and a spouse's pension must also be provided) would reduce the cost of offering the pension significantly. Individuals would still continue to enjoy the security and guarantee of a DB pension while the scheme would benefit from reducing funding and accounting costs.

For one of today's typical DB schemes with 500 members, an accrual rate of 1/60th and an average pensionable salary of £20,000 per year, switching to a core DB pension would reduce annual funding and accounting costs from around £2 million to just under £1 million.

Risk-sharing in DC

In pure DC, all the risks are borne by the employee. Principally these are annuity rate risk and investment risk.

The sharing of these risks could be achieved in a number of ways, including through guarantees, either of annuity rate or investment.

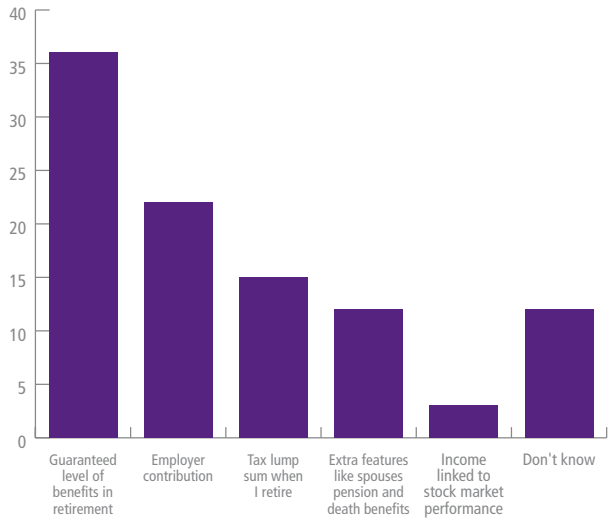
- A guaranteed annuity rate would remove members' uncertainty about the amount they would need to save in order to be able to secure the kind of income level they wish to have in retirement.
- A guarantee on investment would put a floor under the fluctuation of DC investments. This might, for example, mean guaranteeing that the members' 'pot' would – at the very minimum – be equal to the sum of contributions paid. Similarly, there could be a guarantee of the return to be achieved on investment.

> "Pensions work best when they are provided through the workplace.

There would, of course, be a cost to employers or pension scheme members – just as any other kind of insurance requires a premium to cover the risk. But it is quite possible that many members would be content to make higher contributions or accept a lower pension if the arrangement did not involve the significant uncertainties that can be a disincentive to saving in a DC pension.

Figure 5: Consumer favourites

What is the most important feature you look for in a pension?



- 36% of respondents said they value a guaranteed level of benefits the most when it comes to pensions.
- There were slight gender differences evident in the choices made: 40% of men would prefer a guarantee compared to 31% of women.
- A shift in priorities as respondents age is evident in the different choices made by different age groups. 52% of 55-64 year olds prefer a guaranteed level of benefits, while 23% of 18-24 year olds chose guarantees as their most important feature.

Source: NAPF Workplace Pensions Survey, Spring 2010.

BOX 7: PUBLIC SECTOR PENSIONS

The NAPF envisages a pensions system which provides an adequate pension for all – whether individuals work in the private sector or in the public sector.

Five million public sector workers are accruing pensions on a DB basis.[11] Although they have been the subject of increased scrutiny over recent years, it is important to recognise that public sector pension schemes provide pensions to many low to moderate earners. For example, the average pension paid out by the Local Government Pension Scheme (LPGS) is approximately £4,000 a year. The main public sector schemes (for workers in local government, the civil service, the NHS and teachers) have undergone some reform. For example the NHS Pension Scheme has increased its Normal Retirement Age from 60 to 65. However, we recognise that further reform is necessary – public sector pension schemes, especially those that are unfunded, represent significant liabilities.

Many people have suggested that the key to public sector pension reform – and the key to ending the so-called 'pensions apartheid' between public and private sector workers – lies in levelling down public sector pension provision to benefit levels more typically seen in the private sector, with lower levels of contributions and benefits. The NAPF does not believe this "race to the bottom" is the way ahead. Whilst recognising the need for reform in public sector pensions, the real way to close the public-private sector pensions gap is to take steps to improve provision in the private sector.

To address these issues we propose that a Public Sector Pensions Commission is established which includes employer and employee representatives, and pensions industry experts. The Commission should conduct an informed, evidence-based, debate and make recommendations for reform.

11. "An Assessment of the Government's reforms to public sector pensions", PPI, 2008, p. 6.

WORKPLACE PENSIONS – TARGETING AN ADEQUATE INCOME

The form of the pension is one determinant, and is one that can certainly make a difference – as demonstrated above, the lower costs available to large schemes such as Super Trusts can add significantly to an individual's retirement outcomes. But it is only one ingredient. Crucial to the amount of eventual pension is the amount of contributions paid into the scheme and whether it is providing former employees with adequate benefits.

> "A Public Sector Pensions Commission should be established.

The pension reforms due to start in 2012 – based on auto-enrolment and mandatory contributions – provide the right framework for securing higher levels of coverage. But with the statutory minimum level contributions set at 8%, they may not provide the right outcome in terms of adequacy, even if underpinned by a higher state Foundation Pension. If future generations of pensioners are not to suffer the same fate as previous generations and retire into poverty, contributions must be increased beyond the current 8% minimum.

The NAPF believes that over time the statutory minimum contribution rate should increase to 11%. This would increase the replacement rate available from a DC scheme for a median earner from just under a quarter of earnings to a third, as illustrated in the table below:

Table 5: replacement rates compared

	At retirement	Retirement + 10 years
8% contributions	24%	16%
11% contributions	33%	22%

Source: PPI modelling for the NAPF. Replacement rate for a median earning man with a flat earning profile. He starts contributing at age 22 in 2012, is continuously enrolled until SPA of 68 in 2058, and contributes on band earnings. Upon retirement, he buys a level annuity and takes a 25% lump sum.

Chapter 3
The Right Regulation

The Right Regulation
simple, suitable and risk-based

Pensions must not only provide a decent income to working people in retirement. They must also command the confidence of those saving in them and those who sponsor them. The NAPF believes this is best achieved through well run schemes supported by the right regulatory framework that ensures appropriate safeguards are in place so that savers are not exposed to excessive risk.

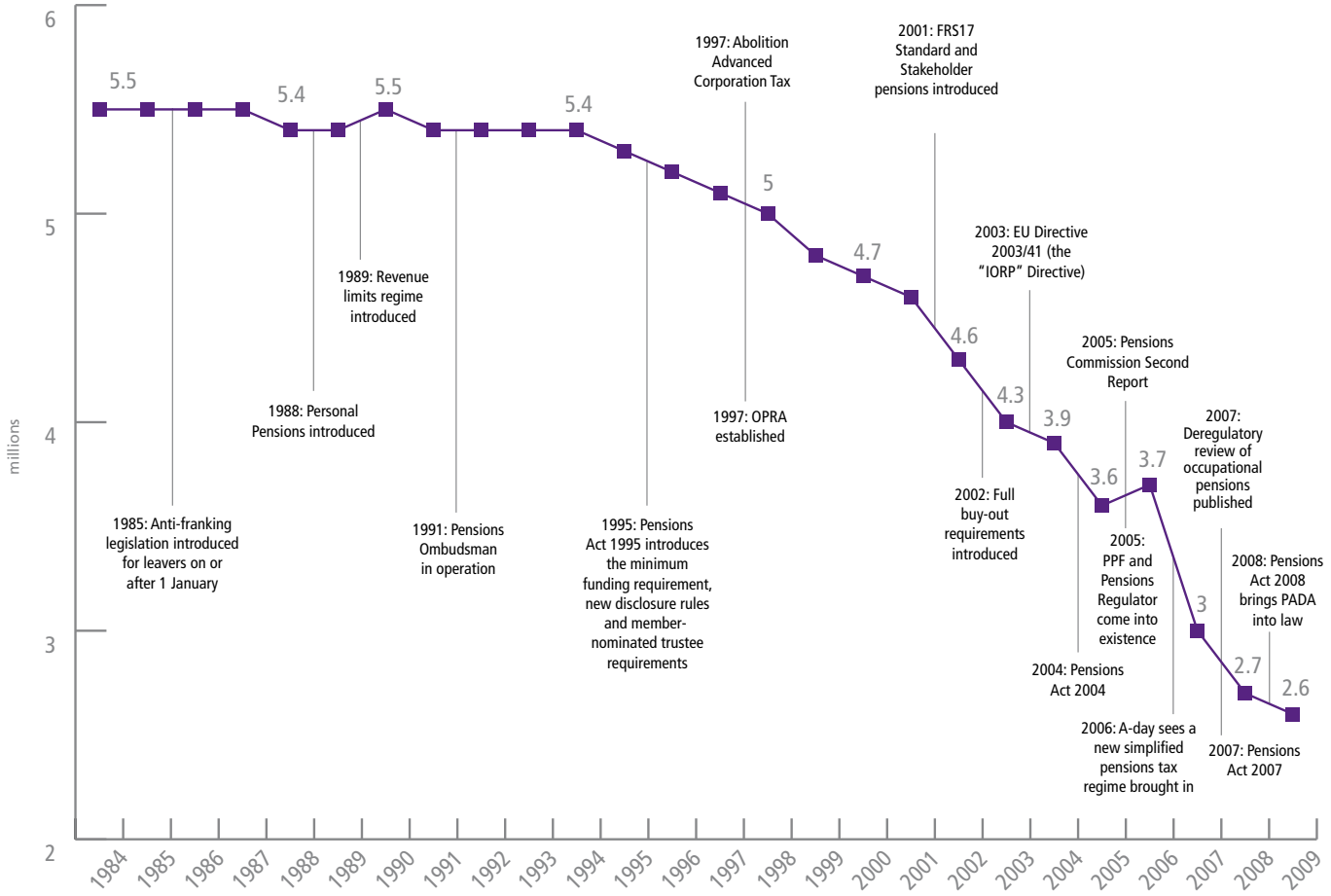
But this must be achieved through a regulatory framework that is simple to operate for trustees; understandable for sponsors, trustees, and members alike; cost-effective; and flexible to the environment in which it operates. Above all, the regulatory framework must encourage rather than discourage pension provision. And it must also recognise that a completely risk free environment is neither possible nor desirable.

> "Since 1995 there have been over 850 pieces of regulation or legislation – roughly one a week – directly relating to workplace pensions.

However, the UK's private pension system is far from this regulatory ideal. As the Pensions Commission acknowledged, our private pension system is "the most complex in the world"[1]. It is also one of the most highly regulated:

- Since 1995 there have been over 850 pieces of regulation or legislation –

Figure 6: Regulation and DB decline – cause and effect?



roughly one a week – directly relating to workplace pensions.

- The NAPF's 2008 report UK Pensions Regulations Compared[2] showed UK pensions schemes face a higher regulatory burden than other OECD countries. For example;
  - the smaller scale of most UK schemes mean that governance requirements for trust-based arrangements are more onerous in the UK than in other countries; and
  - in the UK, the DB employer covenant is subject to unparalleled levels of regulation when compared to other countries. Regulation of the employer covenant does play an important role in maintaining the security of the member benefits, but the UK regime is an anomaly compared to international practice.
- The UK is one of only two OECD countries that requires mandatory indexation of pensions in payment and pensions in deferment.
- Regulatory restrictions also make it difficult for risk sharing schemes to thrive.

The impact of decades of legislation – often designed to fix yesterday's problems instead of being part of tomorrow's solutions – has added significantly to schemes' running costs. According to the Pensions Commission, scheme costs have doubled since many schemes were first established[3]. The 2009 NAPF Annual Survey found that scheme costs increased significantly in the past year -- median cost of fund management increased by 18%, professional fees increased by 15%, and administration fees increased by 11%[4]. The direct correlation between the decline of DB schemes and regulatory intervention is charted on page 24.

The time is now right for a more radical rethink that moves away from today's highly prescriptive approach to regulation, to one which helps support and facilitate workplace pensions – in whatever form the benefits are provided – through a genuinely risk-based approach that continues to place a premium on consumer protection.

1. Pensions: Challenges and Choices – the first report of the Pensions Commission, 2004.
2. The 2008 NAPF report UK Pensions Regulation Compared looked at the types of pension regulation in other major OECD countries and compared this with the UK.
3. First Report of the Pensions Commission, 2004, p. 123. According to the Pensions Commission, scheme costs ran at about 10-14% at the time of the introduction of many DB schemes. In 2004 scheme costs were typically 22-26%.
4. 2009 NAPF Annual Survey.

BOX 8: REGULATING SUPER TRUSTS

In a Super Trust world there would be a small number of large scale, professionally run bodies to supervise so the regulatory regime would be simpler than that which currently exists.

The Pensions Regulator would be responsible for authorising Super Trusts which could be established by a range of entities. In order to ensure that Super Trusts were established by organisations that had the potential to run successful schemes the Pensions Regulator would need to set the eligibility criteria, which could include the robustness of the business plan, ability to reach scale, and – importantly – management credibility and capability. The Pensions Regulator would also approve the appointment of individual Super Trust trustees. In doing so, the Regulator would have regard to the fitness, competence and expertise of the trustees. The Regulator would also keep a register of approved trustees.

Each Trust Board would be required to adhere to a Code of Practice that would set out trustees' key responsibilities and the standards which they were expected to meet. Trustees would be expected to meet the Code of Practice on a 'comply or explain' basis, stating in their annual report to the Pensions Regulator where and why they did not meet one of the requirements of the Code. Requiring trustees to follow a high level Code of Practice as opposed to a large volume of highly detailed legislation and regulation would be just one of the regulatory dividends that could be achieved if there were fewer boards of trustees requiring regulation.

Ultimately, the Pensions Regulator would have the power to de-authorise Super Trusts, eg if they did not operate in the interests of scheme members by failing to keep costs low.

Super Trusts would be required to provide the Regulator with an annual report on all costs and charges, investment performance, service standards and scheme membership. In turn the Regulator would publish an annual report assessing the performance of each Super Trusts and comparing their performance. This would be a beneficial competitive pressure on Super Trusts to maintain high standards in the interests of scheme members and to adopt best industry practices.

In the NAPF's view this requires action on three fronts:

- a wholesale simplification and recasting of pensions law;
- reform of accounting standards for pensions; and
- major reform of the regulatory architecture and its institutions.

Simplification and recasting of pensions law – a genuine risk-based approach

As set out in the previous chapter the NAPF believes that Super Trusts have the potential to deliver not only a superior service to scheme members, but also a regulatory dividend. Box 8 on page 25 sets out how that regulatory dividend could be delivered.

But for those schemes which are not constituted as Super Trusts, the NAPF also believes there is significant scope to scale back the existing volume of regulation and legislation surrounding workplace pensions. In place of the current raft of highly detailed, highly prescriptive legislation and regulation, we propose higher level regulations or codes that place more initiative and resonsibility with the trustees and others charged with running the scheme.

By adopting a risk-based approach we believe it should be for trustees and, where appropriate, scheme sponsors to determine precisely how they would meet their obligations under the law using their expertise, judgement and knowledge of the scheme. The Pensions Regulator would have the power to intervene where it had reasonable cause to believe the scheme was not fulfilling its duties. A risk-based approach would offer significant scope to simplify and slim down existing primary and secondary legislation, as the "before and after" example on the next page demonstrates.

Accounting standards

There can be little doubt that a major factor contributing to the rapid decline of DB schemes in the past 15 years has been accounting standards. The NAPF will continue to support transparency in reporting on scheme liabilities – this is important to pension funds as the UK's larger institutional investors. However, the nature of the standards (FRS17 and IAS19) themselves – adopting a short term view of liabilities that are by their very nature long term, and which do not adequately take account of the corporate sponsor or the flexibilities open to schemes – has had a detrimental impact on UK pension provision and reduced the time horizons over which decisions on pensions are taken as Finance Directors and company boards seek to reduce their balance sheet liabilities.

A new approach that takes account of the long term nature of pension funds is required.

Over the next few months NAPF, in conjunction with others, will be developing new thinking on a more appropriate accounting standard for pensions that provides the transparency pension funds and other institutional investors require whilst at the same time ensuring long term decisions on UK retirement provision are not reduced to a snap shot accounting number.

Politicians must encourage the accounting standard setters in the UK and internationally to adopt a 'real world' approach to accounting for pension scheme costs in corporate accounts. It cannot be right that standard setters can operate in a vacuum without regard to the consequences of their actions.

Figure 7: NAPF Pensions Confidence Index

Workplace pensions have not escaped the downturn in consumer confidence in financial products brought about by the global financial crisis. The latest NAPF Workplace Pensions Survey Pensions Confidence index stood at just 3%, compared to 21% at the start of the financial crisis. The right consumer protection framework will also help to maintain strong levels of consumer confidence in pensions.

Source: 2010 NAPF Workplace Pensions Survey

BOX 9: CASE STUDY: DISCLOSURE REGULATIONS "BEFORE AND AFTER"

BEFORE
Current Disclosure Regulations Require Employers to Disclose

- amount of benefit payable
- amount of death benefits that would be paid if the member were to die or leave service within one month;
- date on which pensionable service commenced;
- formula for calculating any benefits;
- amount of pensionable remuneration;
- details of how any deductions are calculated
- value of protected and accrued rights;
- options available to the member under the scheme rules and the rights and options in the event of the member's death.

Technical Memorandum No 1 also specifies

- the pension figures must be rounded down to three figures and how annuity rates must be calculated, among other things.
- that a long list of data must be presented including the fact that the illustration is presented for the purposes of illustration and must be provided by law and the means by which further information may be uptained.
- that annuity rates must be calculated on the basis of 50% of the FTSE Actuaries Government Securities Indexed-linked Real Yields over 5 years.

AFTER
Disclosure requirements – risk-based approach

'Members should be given sufficient information that allows them to understand the benefits to which they are entitled'. The method of calculating benefits should be based on a set of prescribed assumptions and include information on accrued and projected benefits. Schemes would then have a choice: either to take their own decisions on which information to provide, or to follow the Pension Regulator's guidance.

BOX 10: SIMPLIFYING THE DISPUTES PROCESS

As it currently stands, there are a number of pensions institutions involved in the management of disputes between pension scheme members, employers and pension providers. From the perspective of the pension scheme member, this system can be confusing and overwhelming. A simpler, easier to understand system would amalgamate the responsibility for all member-employer/provider disputes into a single Ombudsman.

The regulatory infrastructure – a single regulator… and the right regulator

A genuinely, risk-based regime needs to be supported by the right regulatory infrastructure.

There is currently a multiplicity of regulatory and quasi regulatory bodies whose existence is confusing both to practitioners, but above all pension scheme members. This is especially the case with the Financial Services Authority (FSA) and the Pensions Regulator (TPR), both of which have responsibility for aspects of Group Personal Pension (GPP) and Stakeholder Pension regulating which is difficult to justify, makes little sense to scheme members, and opens up the possibility for regulatory arbitrage or duplication.

A simpler regulatory framework requires a simpler, slimmer regulatory architecture. The NAPF believes there should be a single regulator for pensions. The FSA's responsibilities for GPPs and Stakeholder Pensions (including point of sale regulation) should transfer to the Pensions Regulator. Prudential regulation for insurance companies and pension providers would remain with the FSA.

> "The Regulator should have a new statutory objective: to promote good pension provision and to ensure their health and longevity.

However, the single regulator must also be the right regulator. At present, the Pensions Regulator is charged with three statutory objectives:

- to protect the benefits of members of work-based pension schemes;
- to promote good administration of work-based pension schemes; and
- to reduce the risk of situations arising that might lead to claims for compensation from the Pension Protection Fund.

In practice, however, it is the last of these objectives that dominates the Regulator's activities with the result that it is overly focused on the DB run off and insufficiently focused on the continuation of good quality workplace pensions.

The Regulator's activities should be reoriented to make its primary focus on ensuring the longevity and health of workplace pension schemes. To give it this required focus, the Regulator should have a new statutory objective: to promote good pension provision and to ensure their health and longevity.

Chapter 4
Encouraging Saving

Encouraging Saving
the right incentives

Taxes have two purposes for governments: first, to raise the revenue required to fund public services; and, second, to influence behaviour for the good of society in general. As far as pensions are concerned, successive governments have accepted that there is a strong case for using the tax system to incentivise their use as a means for saving for retirement.

The Government itself has acknowledged that the tax system can be used to encourage pension saving, saying "[the Government] encourages and supports people to make additional pension provision for themselves, by providing generous tax incentives for retirement saving."[1]

The current tax regime was originally designed on the EET (Exempt, Exempt, Taxed) principle – not to charge tax whilst the pension is being built up (both on employer and employee contributions and on investment returns), but to levy tax on the pension on retirement (with the exception of a tax-free lump sum of up to 25% of the individual's accumulated pension assets).

> "The NAPF believes that the pension tax system must return to the clarity and simplicity of the pure EET regime.

However, a series of Government decisions has gradually eroded the principle that pensions should be taxed as deferred income in return for (and as an incentive to) individuals locking their money away during their working lifetimes until retirement. The reduction of ACT tax relief from 25% to 20% in 1993 and the removal of dividend tax credits in 1997 harmed pension provision and the 2009 Budget changes which restrict 'relief' on employer and employee contributions for higher earners, threaten to do the same.

The NAPF believes that the pension tax system must return to the clarity and simplicity of the pure EET regime.

We recognise that this cannot be achieved easily. But we believe a return to EET, as a practical way to support workplace pensions, should remain a long-term Government commitment. Over time, and as the public finances allow, the Government should:

- exempt pension funds from paying a tax on share dividends;
- place private sector DB schemes on a level playing field with insured and local authority DB schemes and DC schemes and exempt them from paying VAT on investment management fees; and
- exempt schemes from paying Stamp Duty on purchases of shares, securities, land and property.

More immediately, the Government should abandon its current plans to restrict, from 2011, tax 'relief' on pension contributions made for and on behalf of higher earners (those earning more than £130,000). Our analysis[2] shows that this tax, which the Government claims is targeted on the UK's top 250,000 pension savers could inadvertently affect people on incomes far below this level who, for example, are made redundant. Where it does affect higher earners, it is likely to act as a serious disincentive to save in a pension. Once again, this could have consequences for people on lower incomes, as those directly affected will tend to be the company pensions decision-makers. If they are disengaged from the company pension scheme, their willingness to maintain the scheme for others may be reduced.

A pure EET system is more easily understood by savers and is heavily incentivised towards saving at the front end. For the same reasons, we believe the 25% tax-free lump sum should be retained as it has an important role to play in incentivising individuals to engage with pension saving, particularly for those on lower incomes and at older ages. In a recent NAPF survey[3] 33% of people said its removal would discourage them from saving.

Evidence suggests that many individuals use their lump sum payments to achieve financial security in later life. A 2008 survey by Scottish Widows found that 41% of current pensioners used their lump sum either to pay off their mortgage or to pay off other debt[4]. For these individuals, the removal of the 25% tax-free lump sum would be particularly harmful.

1. HM Treasury, "The Annuities Market", December 2006.
2. "A budget for pensions – a NAPF submission to HM Treasury on the 2010 Budget" February 2010.
3. NAPF Workplace Pensions Survey, March 2010.
4. Scottish Widows, News Release, 10 September 2008.

BOX 11: ADDITIONAL INCENTIVES FOR EMPLOYERS

Employers already have a set of incentives to contribute to their employees' pension provision, such as Corporation Tax relief and reduced National Insurance Contribution rates (for employees who are in contracted-out schemes).

However, with many employers looking to reduce their exposure to risk by withdrawing from final salary pension provision, there is a case for incentivising employers to continue providing workplace pensions of good quality.

There are a number of ways in which current fiscal incentives for employer support for pensions could be extended:

- Higher Employer Tax Relief. Employers could be awarded higher rates of tax relief where they make more than a certain level of contributions. This could be linked to the level required for PQM Plus – 10 per cent. The relief could be given on Corporation Tax, or in some other convenient way, eg a higher VAT threshold. If the relief were given through existing tax or PAYE systems, this incentive would be very easy for employers to understand and administer. [NB. While not all employers pay Corporation Tax, they all have to pay NI employer contributions.]

- Higher Employer NIC rebates. As it was previously mentioned, employers already receive reduced NI contribution rates for employees who belong to contracted-out schemes. But employers who offer high contribution levels – perhaps above the PQM level of 10% – could get an extra 1% or 2% rebate on their NI contributions.

The pay out phase

It remains the case that there is considerable consumer support for annuities. The Spring 2010 NAPF Workplace Pensions Survey found that 26% of respondents said that the guarantee of an income that paid out for life (ie, an annuity) would be a key determinant in encouraging them to save more for old age.

It will, therefore, be important that retirement income products are able to respond to the needs of savers, in particular the need to fit with:

- Changing work patterns. Individuals may accumulate multiple, smaller DC pots over their working lives.
- Trends in working longer. People may not need access to their whole pot if they have alternative sources of income.
- Increasing longevity. Annuity prices could increase as a result of increasing longevity and a shortage of gilts.

The NAPF believes that the key issue to address, therefore, is in ensuring there is sufficient flexibility in the annuity market. Issues around abolishing the requirement to annuitise are of secondary importance. However, in line with rising state retirement ages, there could be a case for increasing the maximum age at which an annuity must be purchased, eg to age 80.

Product types

The UK annuity market is already one of the most sophisticated in the world. As HM Treasury's 2006 report demonstrates, innovative annuity products are already starting to develop:

- Stepped or Variable Annuities, ie, a generic type of unit-linked product with an optional income component.
- Fixed-Term or Temporary Annuities which pay a lump sum at the end of the term (typically 10 years), which can then be used to purchase another annuity.
- Flexible Lifetime Annuity. One insurer offers a flexible lifetime annuity which allows the individual to review every three years: the income level, the investments, and the amount ring-fenced for death benefits.
- Another insurer takes a 'retirement account' approach where benefits can be drawn from the account by either:
  - moving or designating part or all of the account from Retirement Planning to Retirement Income; or
  - using the account to purchase an annuity.

But the market will need to evolve further to meet the changing needs of an ageing workforce. For example, many people could benefit from products which combine a baseline guaranteed income with investment options and additional income drawdown options. Such innovative products could help individuals who are considering working longer by helping improve the adequacy of income in retirement by allowing the assets to remain invested for longer; and/or allowing fluctuations in their annuity income to reflect changes in working patterns (eg, moving from full-time to part-time).

It is, therefore, important that the Government and the pensions industry work together to identify and remove the barriers to product innovation.

> "Many people could benefit from products which combine a baseline guaranteed income with investment options and additional income drawdown options.

The "small pots" issue

As a result of automatic enrolment, many people could accumulate small pots of pension saving – because they were auto-enrolled close to retirement, because they changed jobs frequently, or because they opted out of pension saving for financial reasons.

However, individuals with small pots often do not get the best annuity rates, and many cannot shop around for the best rates through the Open Market Option because advisers do not view small pots as economical. Further thought should be given to helping those with small pots.

BOX 12: DEALING WITH SMALL POTS

- Couples should be allowed to combine their pots to purchase one joint-life annuity, as the ABI has recently proposed.
- Super Trusts and NEST should provide their own annuity products, as they could take advantage of their large-scale buying power.

Figure 8: Early access – proceed with caution

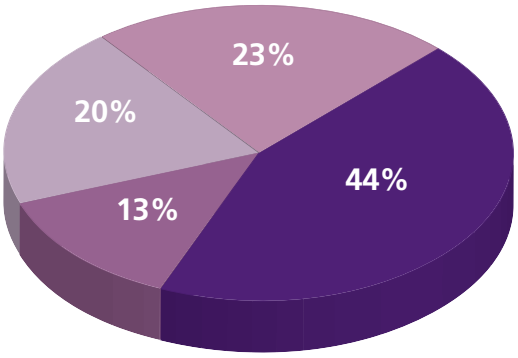
In many countries, individuals are allowed to access the funds in their retirement savings vehicles before they reach retirement age. The most well known example of "early access" comes from the US, where early access to funds in 401(k) plans is allowed under various circumstances – principally medical expenses and other hardship needs.

It has been argued that, in the UK, early access could encourage saving behaviour as individuals would not fear locking away their money. Data from the US suggests that schemes that allow early access do have slightly higher participation rates. However, recent research by the US Government Accountability Office into the effects of early access shows that it can negatively affect the size of an individual's final retirement income as people do not repay to their pension scheme funds they have accessed early.

It is difficult to interpret the effects of early access in the UK. For example, in the US, individuals are allowed to withdraw funds to help pay for medical expenses, which is not the case in the UK.

To assess the likely impact of early access on pension saving, the NAPF sought the views of consumers. The majority of respondents (44%) said that early access would not affect their saving decisions at all. Overall, it is unclear whether early access would have a positive impact on pension saving in the UK. We must approach early access with caution.

If you could use part of your pension before you retire in special circumstances, what would be the effect on your pension saving?



- More likely to start saving in a pension scheme
- More likely to increase your pension contributions
- It would make no difference to me
- Don't know

Source: NAPF Workplace Pensions Survey, Spring 2010.

Chapter 5
Extending Working Lives

Extending Working Lives
helping people to work longer

The NAPF's vision for pensions aims to provide people with a decent and adequate retirement income building on the strong platform of the Foundation Pension. To help meet the additional costs associated with the more generous Foundation Pension, retirement ages may need to rise, first to 69 and then to 70, if spending on the state pension is to remain stable in real terms.

The path to later working lives was set by the Pensions Commission in its first report and is now widely accepted as a demographic necessity: the population of individuals over state pensionable age is expected to increase by 32% over the next 25 years. In contrast, the working age population is expected to rise by just 14%.[1] In principle, having a further two million older workers in the labour market may be seen as a good thing. Most importantly it will enable employers to match labour supply and demand, filling vacancies that might, in the past, have been taken by younger workers. This in turn should be viewed as a positive outcome for economic growth. According to the Select Committee on Economic Affairs[2], population ageing will reduce the rate of growth (and ultimately the size) of the working age population. In order to maintain a constant GPD, labour market activity will need to increase. Since the older cohort is projected to increase at a faster rate than the working age population, any labour market activity necessary to stimulate economic growth would need to be undertaken by older workers.

However, a further increase in State Pension Age to 70 would only be possible if the Government addresses some of the difficulties inherent in extending working lives. Current labour market trends do suggest a shift in working practices. But for this shift to help people extend their working lives issues such as health inequalities, employment practices, tax and pension law which can all affect an individual's ability to work longer will need to be tackled. Pensions are only one part of the puzzle.

Demographics and the world of work

Over the last few decades, the structure of the UK labour market has been changing. At a high level, there has been a marked shift in the UK from manufacturing to the service industry. At the same time, skills levels have increased dramatically. Since 1984, the percentage of workers in "elementary jobs" has fallen from around 16% to 8%, while the percentage in the top three groups has risen from 30% to almost 45%[3]. So there is a clear trend towards less physically demanding jobs which would seem to make extending working lives a more attractive proposition. But extending working lives across the UK does uncover issues around social status, health inequalities, and life expectancy, as the recently published Marmot Review of health inequalities[4] identified.

Average life expectancy at age 65 is improving at a fast pace. In its first report, the Pensions Commission estimated that, if current trends continue, average male life expectancy at age 65 could be between 24.4 and 27.7 years by 2050[5]. But these averages conceal the fact that different socio-economic groups have different outcomes in terms of life expectancy. The Marmot Review revealed that people living in the poorest neighbourhoods in England will, on average, live for seven years less than people living in the richest neighbourhood.[6]

> "A further increase in State Pension Age to 70 would only be possible if the Government addresses some of the difficulties inherent in extending working lives.

For these individuals, further increases in the State Pension age would be unfair: put simply, some of the people who require the Foundation Pension most may not live long enough to enjoy its benefits. Overcoming this unfairness will not be easy. Working longer should be an option open to everyone – and for this reason we must work not only on improving quality of life in retirement but also the quality of working lives.

Extending working lives

Currently an individual's decision to work past state pension age generally depends on a number of factors. For example, statistics show that older people with partners who work are more likely to work themselves. But more significantly, individuals make the decision to extend their working lives based on four main internal factors: health, job security, caring for others, and financial security.[7]

1. ONS Statistical Bulletin, "National population projections 2008-based", October 2009.
2. House of Lords Select Committee on Economic Affairs, "Aspects of the Economics of an Ageing Population." 2003.
3. Working Futures, SSDA, 2005.
4. Fair Society, Healthy Living, The Marmot Review of Health Inequalities, 2010.
5. The Pensions Commission, First Report, 2004.
6. Fair Society, Healthy Living, The Marmot Review of Health Inequalities, 2010.
7. DWP, Factors affecting the labour market participation of older workers (qualitative), 2005.

While the Government has signalled its desire to introduce more flexibility for older workers through its review of the default retirement age, health policy and employment practices will need to change dramatically to allow individuals to extend their working lives easily. We must enable individuals to work longer by making improvements in healthcare, employment practices, and educational opportunities for older workers.

> We must enable individuals to work longer by making improvements in healthcare, employment practices, and educational opportunities for older workers.

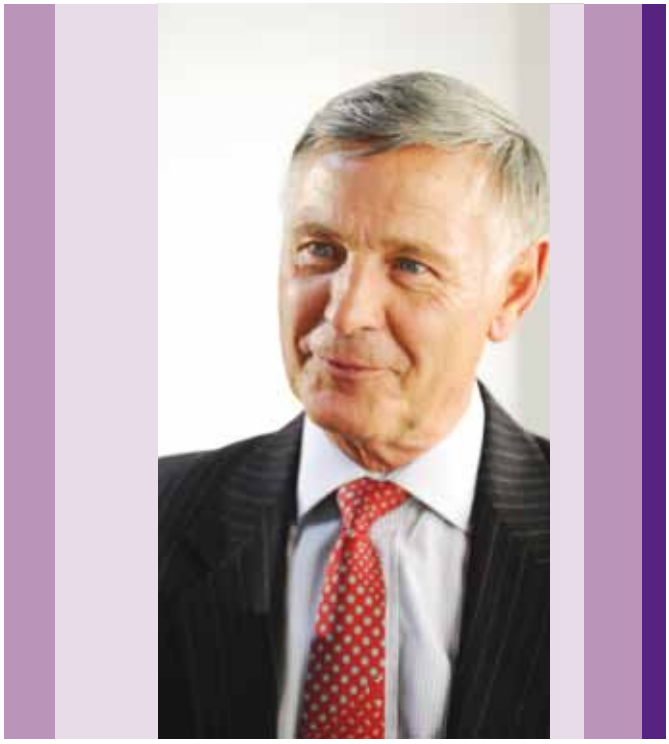
Further education and re-training

One factor that does affect the quality of health during working life is having a "good job" – one characteristic of which is the opportunity for training, re-training and/or further education. Lifelong learning and on-the-job training provide excellent opportunities for employees to cultivate skills and capabilities, while at the same time improving productivity for the employer.

BOX 13: WAYS TO HELP PEOPLE EXTEND THEIR WORKING LIVES

- Improving quality of jobs. This will reduce health inequalities. Good jobs are linked to better health and longer life expectancy and will help to ensure that more people can stay active in the labour market for longer.
- Improve legal environment. Legal barriers to working longer must be removed. As employers move to redefine the way they move their employees out of the labour market, it will be crucial that more flexible working patterns are introduced.
- Focused ill-health prevention and better access to long term care. A health system that focuses on ill-health prevention could help curb the costs of an ageing population. Additionally, a more adequate long term care system would help people spread their caring responsibilities, allowing them to continue working.

Demographic changes and shifts in the labour market mean that many individuals will be relied upon to extend their working lives in order to supply the skills and experience needed to stimulate economic growth[8]. Employers themselves will need to adjust their employment strategies to accommodate for this shift – and the NAPF believes that re-training and further education opportunities should be a part of any strategy to motivate and retain workers (whether young or old) for longer.



> For older workers, flexible work options may be the key to staying in employment and thus remaining happier and healthier.

Legal barriers to working longer

Demographic changes and shifts in the UK labour market will present a unique set of challenges for UK employers over the next few years. The Government has already taken steps to improve the legal position of older workers by introducing anti-discrimination legislation for older people.

It is also likely that a new Government will introduce more flexibility into the system by removing the default retirement age. This move will certainly be welcomed by employees wishing to extend their working lives. This move will also force employers to reconsider their "exit" strategies – the way employers manage their employees' exits from the labour market.

8. OECD, Employment Outlook, 1998.

In many cases, flexible working options will be a good way to provide flexibility for employees wishing to extend their working lives by:

- allowing individuals to adjust working hours around declining health, doctors appointments, etc;
- moving individuals to part time work instead of making them redundant;
- helping individuals meet part of their caring responsibilities through a reduction in working hours; and
- making individuals more financially secure by providing a reduced, but steady, stream of income.

A better health care system

For older workers, flexible work options may be the key to staying in employment and thus remaining happier and healthier. But for many individuals, the decision to extend his or her working life will depend on their current health situation and whether they are fit enough to continue working.

The UK's health system must be able to cope with the growing needs of an ageing population. The 2001 interim report published by Sir Derek Wanless, the average cost to the NHS of a person over age 85 is six times higher than individuals aged 16-44.[9] The key to controlling the escalating costs of healthcare – and to alleviating some of the symptoms of health inequalities – lies in ill-health prevention.

For those with caring responsibilities, long term care will be another concern. Both the current Government and Opposition parties have recognised the need for an overhaul of Britain's long term care system. There will, of course, need to be separate debates about how a National Care Service would be funded or at what level one-off payments should be set. But it is also important to acknowledge that a more structured, easier to understand system would be beneficial not only to individuals needing care, but to the individuals who would have otherwise been providing care.

9. Sir Derek Wanless, Changing Health Care Needs, 2001.

Chapter 6
Staying On Track

Staying On Track
a Retirement Savings Commission

Our vision for pensions sets out a clear direction for UK pension policy: a state pension worth around 1/3rd of average earnings to provide a robust floor of benefits, supplemented by a workplace pension built around auto-enrolment and mandatory contributions. Stable, simple and secure, it is a settlement to last generations.

Yet the history of UK pension policy over the last several decades has been anything but one of stability and durability. Instead it is a history littered with political interference, short-term fixes and changes of political direction. The consequence has been to cause instability, undermine scheme sponsor confidence, to confuse pension savers, and weaken our pension system. This cannot be permitted to continue. The long term nature of pensions requires a long-term and enduring political settlement that commands the support of politicians, the pensions industry, the social partners and – most importantly – savers and pensioners.

To ensure the new pension settlement stays on track and continues to command wide political and stakeholder consensus, the NAPF recommends that a permanent Retirement Savings Commission should be established. We believe this would help insulate pensions from knee-jerk changes in direction and provide much needed stability.

The Commission would be independent of government and would comprise experts drawn from the pensions industry, academia, business, member representatives and the voluntary sector. It would provide an independent assessment of the state of the UK's pensions system – in other words, a regular "pensions health check".

- The Retirement Savings Commission (RSC) would report to government and Parliament at least every three years. Its report would provide an assessment of the strengths and weaknesses of the pensions system, measuring progress on issues such as participation rates (ie the effectiveness of auto-enrolment), adequacy levels (eg measured by replacement rates), employer and employee attitudes to (and understanding of) pensions, and pensioner poverty levels.
- The RSC would not be a policy-making body. That would be a role reserved for the government. However, just as with the Pensions Commission, it would be able to recommend changes to the both state and workplace pensions to ensure the pensions system stayed on track.
- The Government would be required to publish a response to the report, explaining what adjustments – if any – it planned to pension policies in order to maintain progress.
- There would be a statutory requirement that the RSC's report – and the government's response – was debated in both Houses of Parliament.

BOX 14: RETIREMENT SAVINGS COMMISSION'S TERMS OF REFERENCE

The Secretary of State for Work and Pensions will appoint a Retirement Savings Commission to:

- Report to the Sectary of State for Work and Pensions and to Parliament at least once every three years on the strengths and weaknesses of the UK pensions system (including both state and workplace pensions).
- Assess demographic trends and their impact on pension provision.
- Identify emerging patterns in employment and retirement and to assess their impact on pensions.
- Make forecasts of the levels of pension income that would result from current policies, and to assess how these compare with the government's policy objectives, and against benchmarks of adequacy and pensioner poverty.
- Assess the adequacy of current and forecast saving levels.
- Make recommendations on changes that might be needed to pension policy to achieve the nation's agreed policy objectives.
- Assess levels of public knowledge and confidence about pensions, and the adequacy of financial education.
- Work with the Office of National Statistics to ensure that official figures capture the information required by policy-makers in the areas of pensions and retirement.

We have modelled the Retirement Savings Commission on the Low Pay Commission, which operates to tightly defined objectives and has around 10 staff. It makes recommendations to government on the operation of the National Minimum Wage and developments to it. However, it is for the government of the day to implement and develop policy.

A similar approach to the one recommended here is already operating successfully in New Zealand where, in 2001, the government set up an independent Retirement Commission. It has a statutory duty to review the retirement income policies and conducts three-yearly reviews of the retirement income landscape. The Commission also conducts surveys of financial knowledge and awareness among the adult population.

We believe a similar approach would work well in the UK. We are not alone. Others, including Age Concern, the TUC, and the Pensions Commission itself[1], have called for an independent permanent Commission to be established.

1. The Pensions Commission called for a permanent, independent Pensions Advisory Commission in its Second Report.

Annex A
List of Boxes, Figures and Tables

BOXES

FIGURES

TABLES

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