NAPF

Securing the future of pensions

Revitalising Pensions

An NAPF submission to HM Treasury on the June 2010 Budget

June 2010

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Contents

1. Executive summary	2
2. Introduction	3
3. Pensions tax – an NAPF alternative to protect good pensions for all	5
4. Public sector pensions – seven principles for reform	9
5. Gilts issuance - help for pensions, employers and Government	10
6. EU regulation – decisions in Brussels must not damage UK pensions	12
7. Responding to the economic crisis – the right approach to corporate governance and banking reform	14

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.

NAPF Securing the future of pensions

Executive Summary

Pensions under pressure: Workplace pensions play a crucial role in the well-being of today's and tomorrow's pensioners. But they currently face huge pressure as rising longevity, poor investment returns, and an unhelpful regulatory and fiscal environment push up the cost of pension provision and create uncertainty.

We welcome the Coalition Government's statement that it wishes to encourage good quality workplace pensions and to create a savings culture. The Government must now turn its words into actions. We have identified five ways in which the Chancellor can demonstrate he will stand by these commitments.

- **Pensions tax relief – an NAPF alternative to protect good pensions for all**: The Finance Act 2010 changes to pension tax relief for high earners will be hugely damaging to UK pensions. We call on the Government instead to adopt the NAPF's alternative approach to reform – radically lowering the annual allowance from £255,000 to £50,000. This will avoid harming pensions, be less expensive to implement, and maintain the UK's long established tax principles.

- **Public sector pensions – seven principles for reform**: The NAPF welcomes the decision to establish, as we proposed earlier this year, a commission on public sector pensions. We urge the Government to adopt our seven principles for effective reform. These will inject objectivity into the debate and ensure a better outcome for pension savers and taxpayers.

- **Gilts issuance – help for pensions, employers and Government**: Pension schemes and employers have an on-going need for Government gilts to manage pension risks. The Government must use the Budget to issue more long-dated and index-linked gilts - doing so will help employers provide good quality pensions.

- **EU regulation – decisions in Brussels must not damage UK pensions**: The EU is planning a wave of proposals on pensions - some crucially important for the UK. The Treasury must remain vigilant and protect the UK approach. Active intervention will help sustain UK pensions for the future.

- **Responding to the economic crisis – the right approach to corporate governance and banking reform**: The NAPF's members continue to play an active role in improving the oversight of UK industry. But implementation of the new regime must be proportionate and focus on results. This is the best way to raise standards of corporate governance.

Introduction

1. Workplace pensions play a crucial role in the well-being of today's and tomorrow's pensioners. A newly retired person with a workplace pension can expect on average to receive almost £7,000 of pension income – an amount higher than the maximum Basic State Pension. But workplace pensions are under enormous pressure as rising longevity, poor investment returns and an unhelpful regulatory and fiscal environment push up costs. The new Government says it wishes to encourage good quality pensions and to create a savings culture. The decisions it takes on pensions in this Emergency Budget will show us all whether it will abide by its commitments.

2. We have identified five ways in which the Government can demonstrate its support for pension saving:

    1. Pensions tax relief – an NAPF alternative to protect good pensions for all
    2. Public sector pensions – seven principles for reform
    3. Gilts issuance – help pensions, employers and Government
    4. EU regulation – decisions in Brussels must not damage UK pensions
    5. Responding to the economic crisis – the right approach to Corporate Governance and banking reform

Background – pensions under pressure

3. Too many people in the UK today – over 12 million – are either not saving or not saving enough for retirement. Over half the workforce is not in a workplace pension scheme. This is why it is essential that the Government presses ahead with the 2012 pension reforms – auto-enrolment, mandatory employer contributions and Nest – as agreed by consensus among all the three main political parties. It is also why it must listen to the NAPF's calls to introduce regulatory and fiscal reforms in support of pension provision.

4. The last decade has been marked by unprecedented pressure on UK pensions. Rising longevity, the dotcom crash of 2000, unhelpful accounting rules, and now the worst economic crisis for more than 60 years. Poor equity returns have made it harder for employers to keep their defined benefit schemes open and falling gilt yields have made annuities more expensive thereby reducing the level of pensions that can be bought at retirement. Together all these factors have made it more difficult for employers to offer good quality pension schemes.

5. 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. And, while they have

often been replaced by good quality defined contribution schemes, average contribution rates are often lower than for the schemes they replace.

6. Moreover, the regulatory regime for defined benefit pensions is still too rigid, accounting rules discourage risk-sharing schemes and the recent changes to pensions taxation threaten to apply enormous cost and complexity on pensions.

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

Pensions tax relief – an NAPF alternative to protect good pensions for all

8. The NAPF has always supported a regime of fiscal incentives to encourage pension saving and has long championed the UK's traditional approach to pensions taxation – EET (Exempt, Exempt, Taxed), in which no tax is due until the point the pension is paid.

9. Governments use taxation in two main ways – to raise revenue to fund public services and to influence behaviour for the good of society. In the case of pensions, successive governments have provided tax incentives to both employers and employees to encourage retirement saving. They have been right to do so. Behavioural economics demonstrates that people value income now over income in the future (hyperbolic discounting) and find it hard to lock money away for use at a later time (myopia). However, the right tax incentives can help people overcome these impediments.

10. The Finance Act 2010, introduced a series of measures aimed at restricting tax relief for those earning £150,000 a year and, in some cases, those earning £130,000 or over. We believe these measures, as currently designed, will be hugely damaging to pension provision in the UK. They will be extremely harmful for three reasons:

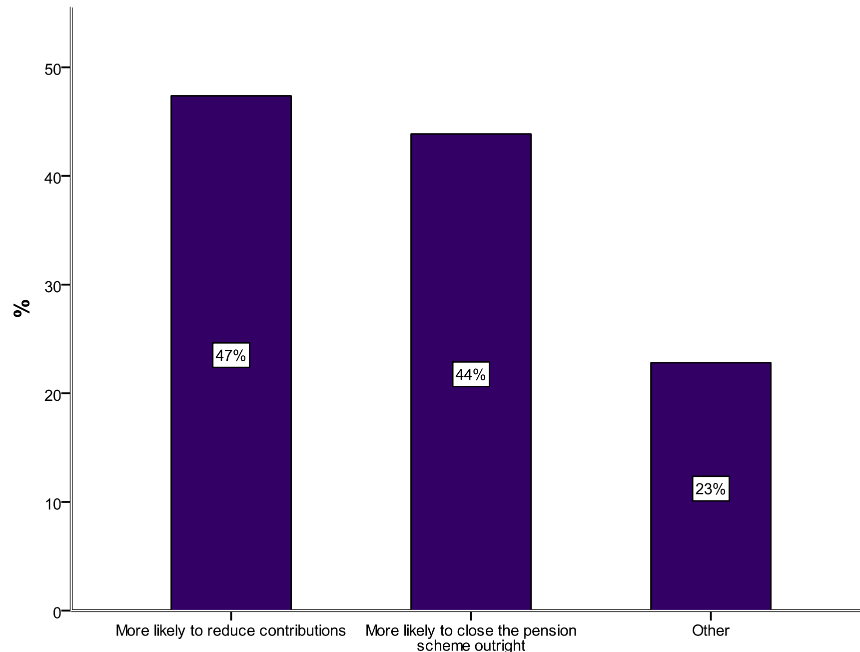
    - they will result in lower pension saving for many people earning far less than the target group;
    - they will undermine the UK's long established approach to pensions taxation, EET, and mean that for many people it will no longer pay to save in a pension; and
    - they will place an unacceptable administrative burden on employers and pension schemes – in contradiction to the Coalition's declared aim of reducing burdens on business and pension schemes.

11. We urge, therefore, the Government to abandon the Finance Act 2010 measures. We recognise, however, that the public finances are in need of repair and that the Government is planning to raise over £3 billion from reduced expenditure on pensions tax relief. In light of this, while we object to the tax changes in principle, we are proposing that the Government goes about the reform in an alternative way – a radical reduction in the annual allowance from £255,000 a year to a figure around £50,000. We are confident that this will be far less harmful to pension provision and that it will raise the same money for the Treasury as the Finance Act 2010 measures.

Lower pensions for those earning far less than £150,000

12. It is now becoming clear that senior corporate decision-makers will leave their workplace pensions as a result of the new regime and it is expected that this will be accompanied by reduced pension provision for the rest of the workforce. According to a survey of our members conducted last month, 70% of respondents expect those earning £150,000 or more to leave their workplace pension and 58% believe that this will have a secondary effect on the pensions of people lower down the income scale. Almost half of these felt that the effect would be for pension contributions to be cut or for pension schemes to be closed.

Figure 1. Secondary effect on pension provision of those earning less than £150,000



13. Moreover, due to the way in which the new regime is to be applied to defined benefit schemes – and it is important to recall that 2.6 million employees in the private sector are still accruing pension rights in such schemes – the proposals will affect many people earning far less than £150,000. As a result of deeming the value of defined benefit provision not just for the current year of accrual but also for past service, many middle managers on earnings in the range of £40,000 to £80,000 a year who are in traditional final salary defined benefit schemes risk being subject to very high annual tax bills simply due to receiving a promotion, a relocation package, or even a redundancy.

Undermining the UK's long-established approach to pensions tax

14. 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 Finance Act 2010 abandons this approach and, in so doing, introduces 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 if it makes sense to save in a pension now, as their income is far lower than £150,000, it may not be so in the future as they can no longer trust the Government not to apply the new rules to lower incomes.

Unacceptable administrative costs

15. The NAPF believes that the implementation costs of the new proposals could easily amount to £2.5-£3 billion, far higher than the Treasury's initial estimate (one off costs of £265-305 million and ongoing annual costs of £50-90 million) and still more than double the Treasury's revised estimate of £1 billion. Such high implementation costs surely fail the new Government's commitment to reduce regulatory burdens.

Box 1. Implementation Costs – NAPF Estimates

- **Scheme Pays -** £420 million - £840 million
- **Administration -** £300-600 million
- **Guidance and Advice -** £210 million-£500 million
- **Other –** IT upgrades / advice from lawyers, actuaries and consultants (£500 million- £1billion)

16. It is important to note that the proposed changes also reverse the hard won major simplification of pension taxation that was introduced as recently as 2006 after many years of careful analysis and preparation by both the Government and the pensions sector.

17. Finally, such is the complexity of the new approach and given that many issues are not yet resolved and much is still unknown, it is hard to see how it would be possible to implement the changes by March of next year – now only 8 months away.

The NAPF's alternative – a lower annual allowance

18. As we have already stated, the NAPF is opposed to the changes to pensions tax in the Finance Act 2010 but we recognise that the Government is determined to press ahead with the reforms and is aiming to save over £3 billion of public

expenditure. If the Government is unwilling to abandon its proposals outright, we urge it to adopt our alternative approach to reform.

19. Our alternative proposal - to radically reduce the annual level of pension contributions that can receive tax relief from the current level of £255,000 down to a figure around £50,000 – has a number of advantages.

    - It will ensure that all corporate decision-makers can continue to save in a workplace pension, albeit to a lower level, without facing severe penalties. As a result they will continue to be personally engaged with their company scheme and can be expected to maintain their current commitment to workplace pensions.

    - It will be less expensive and easier to implement than the Finance Act 2010 approach as it will not be necessary for employers or schemes to apply the income test which involves developing and holding records of the income (from all sources) of each of their employees.

    - It would maintain the UK's long established approach to pensions taxation (EET - Exempt, Exempt, Taxed) and preserve the gains of the tax simplification agenda so recently introduced.

    - It could be implemented by April 2011 as it would simply involve minor legislative modifications to the Post A day regime and the pensions sector, already familiar with the approach adopted, would not need extra time to revise systems and to train staff.

20. It is impossible to assess with certainty the likely tax yield from our 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 estimate that our proposals would yield £3 billion or more – the same figure as that expected under the Finance Act 2010 changes.

Public sector pensions – seven principles for reform

21. The NAPF champions good quality pension provision across both public and private sectors. Our membership includes schemes from both parts of the economy and it is why in February we called for the establishment of an independent commission on public sector pensions to consider their affordability and fairness in an objective and rational way. We welcome, therefore, the Coalition Government's decision to set up a Public Sector pensions commission.

22. The long-term affordability of public sector pensions will be a key focus for the Commission, but any reforms must be based on a much wider range of considerations. We have set out seven principles for reform which we believe should be adopted by the Commission in order to secure a balanced debate and a durable outcome which has the support of all.

Box2: Seven principles for effective reform

1. **Fit for purpose**: public sector pensions should be an integral part of pay and reward and support the recruitment and retention of staff needed to deliver vital public services.

2. **Adequacy:** public sector pensions should not be 'dumbed down' but must continue to provide good standard of living in retirement.

3. **Affordability**: public sector pensions must be affordable in the long term. The scheme should be designed to meet changing circumstances and ensure intergenerational equity.

4. **Transparency:** the costs of public sector pensions must be clear and transparent.

5. **Shared responsibility and risk:** the employer and employee should share the burden of contributions and the risks of costs increasing.

6. **Quality and efficiency:** public sector schemes should demonstrate efficient and high-quality administration and governance.

7. **Mobility**: public sector pensions should not put up barriers between the public and private sector workforces, which might make the UK workforce and economy less flexible.

Gilts issuance – help for pensions, employers and Government

23. Greater issuance of long-dated and index-linked gilts will help pension schemes, employers and insurers manage the risks of pension provision. While we greatly welcome the decision in the March 2010 Budget to skew this year's issuance towards such gilts, demand still outweighs supply. Notwithstanding the Government's current fiscal position, it will have an on-going need to for debt financing via gilts. The Government should use the Emergency Budget to provide practical support to pension schemes and the employers that sponsor them by further increasing the proportion of issuance towards long-dated and index-linked gilts.

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

24. Pension funds have a substantial on-going demand for long-dated and index-linked gilts. Today they hold over £110 billion of gilt holding, 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. 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.

25. 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.

A win-win-win solution for employers, pension schemes and the Government

26. 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. 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.

NAPF Securing the future of pensions

EU regulation – decisions in Brussels must not damage UK pensions

27. Few EU countries rely as heavily on workplace pension provision for the well-being of their pensioners as the UK. This means that decisions on workplace pensions taken in Brussels affect the UK more so than in most other EU countries. The formation of a new European Commission earlier this year has resulted in a renewed EU programme on pensions which, if the wrong decisions are taken, could be extremely harmful to the UK. We urge the Treasury, which has prime responsibility in the UK for negotiating EU financial regulation, to remain vigilant and to preserve the integrity of the UK approach.

Box 3. Current or expected EU legislation with an impact on UK pensions

- EU Green Paper on Pensions
- EU Green Paper on Corporate Governance
- Possible review of the IORP Directive
- Possible proposal on the Portability of Pensions
- Alternative Investment Fund Management Directive
- EIOPA Regulation

28. In the next few weeks, an EU Green Paper on pensions is due to be published. Although its precise contents are not yet in the pubic domain, it is expected that in addition to raising questions on the affordability and sustainability of state pensions, it will also consider a wide range of issues related to workplace pensions. Chief among these will be the question of the right funding requirement for defined benefit pensions.

29. On the basis of past discussions, there is a real risk that the European Commission will propose using the funding regime for insurers, Solvency II, as a template, even though insurance companies and occupational pension schemes are entirely different entities. While a pension promise, such as an annuity provided by an insurance company, is entirely dependent on the strength of the insurer, in the case of a pension fund, both the sponsoring employer and, in extremis, the Pension Protection Fund, are available as an additional source of financial support or member security. Moreover, in many EU countries, the option is available to those who manage the pension fund, often a group of employer and employee representatives, to alter the value of pension payments if the fund's growth is not as high as expected.

30. Therefore, for all these reasons and others, the EU would be wrong to propose that the funding regime for defined benefit pensions should be the same as that applied to insurance companies. This is a view shared by pension funds throughout the EU.

31. If, however, the EU does decide to require insurance-style regulation to pension funds, the result would be to substantially increase the money to be provided by company sponsors to meet their pension commitments. This requirement would apply not only to companies offering defined benefit schemes still open to new or existing members but also to those entirely closed. The additional funding requirement would amount to between 40-60% in four EU countries, including the UK, Ireland, Belgium and Spain.

Figure 2: The impact of Solvency II on pensions in seven EU countries (2008)

Country	Increasing in funding ratio (%)
Austria	12
Belgium	41
Germany	7
Ireland	62
Netherlands	39
Spain	46
UK	57

Responding to the economic crisis – the right approach to corporate governance and banking reform

32. Both the FSA's (Turner) and the EU's (de Larosiere) reports into the causes of the economic crisis found that its roots lay in banking. The Turner review identified three underlying causes of the crisis – macro-economic imbalances, financial innovation of little social value and deficiencies in key bank capital and liquidity requirements.

33. While neither report found pension schemes as being responsible, in the aftermath of the economic crisis, corporate governance rightly has attracted increasing attention from investors, companies and government. The NAPF is continuing to play an active role in improving the oversight of UK industry. As major institutional shareholders, pension funds take their responsibility as owners very seriously. But implementation of the new regime must be proportionate.

34. Pension funds, while broadly satisfied with the engagement activities of the asset managers, plan to increase their oversight of engagement activity. At the same time, the revisions to the Corporate Governance Code and the introduction of the Stewardship Code herald significant changes to the way in which companies and their institutional shareholders interact.

35. Pension funds, despite their declining share in the ownership of UK companies, have an important role to play in encouraging higher standards of corporate governance at companies and of engagement by investors. The NAPF and its members, therefore, will:

    - Continue to press companies for restraint on executive pay and for a clearer link between pay and improved company performance.
    - Seek speedy implementation by companies of the FRC's proposals for improved Board evaluation and greater transparency around the prospects for, and risks in, a business.
    - Urge asset managers to improve the standards of reporting to their end clients (including pension funds) and encourage better links between investment decisions and corporate governance activities.
    - Expect asset managers, during the next year, to decide on how they will sign up to the Stewardship Code. Scrutiny of these commitments should become an integral part of manager reviews by pension fund trustees.

36. The NAPF supports the changes to the Corporate Governance Code and was an author, jointly with the ABI, AIC, and the IMA of the ISC Stewardship Code which, it is expected, will be the basis for the FRC Stewardship Code to be published later this month. However, it is important that these welcome measures are not treated only as a compliance exercise by either companies or investors. The NAPF believes that the best way of ensuring that these initiatives lead to a genuine improvement in corporate governance is that the standards are implemented in a flexible and proportionate way so that they are achievable by as many asset managers and pension funds as possible.

37. Turning to banking reform, the NAPF believes that the Government is right to consider a regulatory solution. Better calibrated capital requirements would reduce the commercial attraction of excessive risk-taking, while measures to reduce leverage are required for institutions seen by the market as being "too big to fail". However, to avoid unwanted effects, such steps should be taken in a gradual and progressive manner. We shall play our role in commenting on Government proposals as they emerge.

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