NAPF

Securing the future of pensions

Budget 2011 – making progress towards *"reinvigorating occupational pensions"*

March 2011

www.napf.co.uk

Contents

Executive Summary 3
Recommendations 4
About the NAPF 5
Detail 5
Introduction 5
Foundation Pension 6
Reinvigorating workplace pensions 7
Public sector pensions 8
Gilt issuance 9
Pensions tax 10

NAPF
Securing the future of pensions

Executive summary

The Coalition Government has embarked on an ambitious programme of pension reform since May 2010. The NAPF supports the Government's commitment to *"reinvigorate occupational pensions"*. Particular highlights have included:

- Introducing the basic state pension triple guarantee.
- Reversing the previous Government's pensions tax proposals through introducing an innovative approach – advocated by the NAPF – of a reduced annual allowance.
- Pushing ahead with the introduction of auto-enrolment and the new National Employment Savings Trust, and making welcome changes to auto-enrolment with the aim of safeguarding good provision.
- The 2010-2011 debt financing remit having a large and welcome shift of issuance towards long-term and index-linked issuance.

Overall the NAPF welcomes the progress made by the Coalition Government. However, there is still much to do if we are to fix Britain's broken pensions system and get people saving so they have the retirement income that they desire and deserve.

The NAPF calls on `the Government to be ambitious in securing a pensions reform that will serve future generations. Ahead of the election, the NAPF argued for a **radical reform of the state pension system** to cut through the complexity and uncertainty associated with the current system, and for it to be replaced by a new Foundation Pension that would be set at or just above the level of means tested benefits. Such a Foundation Pension would protect the poorest pensioners while providing a firm foundation on which people could save for their retirement. With a Foundation Pension, never again would people be saving into a pension only to find their benefits are lost through means testing. This is the single most important reform the government needs to make if auto-enrolment and NEST are going to be a success. Paragraphs 6 to 13 set out the key features of, and case for, a Foundation Pension, and its importance to the success of the 2012 pension reforms.

To help the Government meet its commitment to **"reinvigorate occupational pensions"**, the NAPF has launched the Workplace Retirement Income Commission headed up by Lord McFall of Alcluith, former Chair of the Treasury Select Committee. The Commission will be looking at long term saving through the workplace with the aim of understanding the key barriers to saving. The Commission will propose a roadmap for reform to ensure individuals have the opportunity to save for their retirement (paragraphs 14 to 18).

The NAPF welcomes the formation of Lord Hutton's Public Service Pensions Commission and we await its final report. We hope this report will set out the blueprint for fair and sustainable public service pensions. However, we are concerned that short-term increases in employee contributions over the next few years could damage public sector pensions and make the important long-term reforms we all seek harder to deliver. The NAPF has always recognised that some small, phased increases in employee contributions are inevitable in the current financial situation. However, the 3% increase announced in the autumn 2010 spending review risks going too far. We believe the Government

should look at the recommendations made by the Hutton Commission and see if any shorter-term savings can be made through implementing some of these changes. This would be much more preferable to pressing ahead with contribution increases, which might fail to deliver savings as employees opt out. Paragraphs 19 to 22 have more details on public service pensions.

Following calls from the NAPF, the 2010-2011 remit saw a large and welcome shift of issuance towards long-term and **index-linked Gilt issuance**. We continue to recommend a further increase in long-term – and particularly long-term indexed -issuance in 2011-2012. Paragraphs 23 to 29 have more details on Gilts.

While the NAPF welcomes the new Government's proposals for **restricting pensions tax relief** through restricting the Annual Allowance, we remain concerned at the pace of introduction of the reforms and a number of issues remain to be resolved to ensure the new system is workable and fair when it comes into effect. Our concerns are set out in paragraphs 30 to 31.

Recommendations

Recommendation 1: The Government should set out plans for reform of the state pension system in the Budget.

Recommendation 2: The Government should make progress against its objective to "reinvigorate occupational pensions".

Recommendation 3: The Government should consider Lord Hutton's recommendations before considering increases in employee contributions.

Recommendation 4: We recommend a further sharp increase in long-term – and particularly long-term indexed – issuance in 2011-2012.

Recommendation 5: The Government should continue to work with the industry to ensure the pensions tax changes are implemented in a way that does not increase administrative burdens. Given the speed at which the changes have been implemented, the Government should be ready to react to employers' and schemes' concerns post implementation in April 2011.

NAPF
Securing the future of pensions

About the NAPF

1. The NAPF is the leading voice of workplace pension provision in the UK. We represent 1,200 pension schemes from all parts of the economy and 400 businesses providing essential services to the pensions industry. We represent both public and private sector schemes, including 75% of the local authority pension funds. Our members provide pensions for 15m people and collectively hold assets of £800bn, accounting for a sixth of investment on the UK stock market. Our main objective is to ensure there is a secure and sustainable pensions system in the UK.

Detail

Introduction

2. The Coalition Government has an ambitious agenda for pensions. We have seen changes to the pensions tax system, liberalisation of the annuitisation rules, the welcome introduction of the triple guarantee to the basic state pension, an acceleration of the planned increase in state pension age, and the green light given to auto-enrolment and the establishment of the new National Employment Savings Trust. There has been a lot of activity, but there remains much to be done if we are to get people saving for the long term so that they have an adequate income in retirement.

3. The NAPF's view is that pensions work best when provided through the workplace. That is why we believe that all working people should be entitled to a decent pension that comes with their job. But workplace pensions are under significant pressure because of rising operational costs and increasing employer sensitivity to the scale of pension scheme liabilities:
   - Over the last few decades there has been a significant decline in defined benefit pensions, in favour of defined contribution pensions. Today less than a quarter of defined benefit schemes in the private sector remain open to new members.
   - At the same time, defined contribution (DC) based pension coverage has grown from 10% of the workforce in 1997 to 16% in 2009.

4. The reasons for these changes are many: regulatory costs, increasing employer contributions and rising administration costs, changing investment conditions, increasing longevity and change in the accounting rules.

5. Unless further action is taken to arrest this decline, private sector pension provision will wane and individuals will not achieve the income they need or deserve in retirement. That is why the NAPF supports the Coalition Government's commitment to *"reinvigorate occupational pensions"*. We hope that Budget 2011 will show a real commitment to making progress against this objective.

Foundation pension

6. The UK's state pension system is the bedrock of retirement provision. Or rather it should be.

7. While the state system has, and will continue to have, an important role to play in providing an adequate floor of benefits for people – safeguarding them against poverty and providing a starting point for their own saving – successive changes have left the UK state pension system as one of the most complicated and least generous in the world.

8. The state system fails to meet its most basic objectives:
   - Today 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 around 53% – still unacceptably high[1].
   - It is one of the lowest state pensions in the developed world. OECD figures show the gross replacement rate for a median earner in the UK in 2009 was just 30.8%, compared to an OECD average of 59%.
   - It is complex and poorly understood.
   - 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[1].

9. The current state pension system is too complicated. People do not understand how much they will receive from their state pension, which makes planning for the future difficult. Add to it the complex interaction between state pensions and means tested benefits and people lose the incentive to save for their own retirement. Many simply will not know if it "pays to save".

10. That is why the NAPF has been arguing for a new and more radical approach – the Foundation Pension. The Foundation Pension would combine the current basic state pension and State Second Pension into a single flat rate benefit. It would be paid at a level above means tested benefits and uprated each year by earnings.

11. The Foundation Pension is key to getting Britain saving again. 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. Research conducted by the NAPF shows that people would be more likely to save more if they knew clearly what they were receiving from the state.

12. The Foundation Pension would also be simple to administer and would reduce instances of overpayment due to fraud and error. The DWP's 2009 Departmental Report reveals that the department spent £646 million in 2007/8 administering pensioner activity. An extra £343 million was overpaid in pension credit. The Foundation Pension would reduce spending on administration, fraud and error because pensioners would no longer be required to fill out complicated forms or disclose financial information to receive the Foundation Pension – they

[1] Numbers do not include the impact of the basic state pension triple guarantee.

would automatically receive the Foundation Pension as long as they meet the contribution criteria.

13. The NAPF would welcome an early signal of the Government's intention to introduce a Foundation Pension so it can bring forward legislation within the lifetime of this Parliament. The NAPF believes that the Government has a good opportunity to signal an ambitious path of travel in its Budget on 23 March.

Recommendation 1: The Government should set out plans for reform of the state pension system in the Budget.

Reinvigorating workplace pensions

a) Workplace Retirement Income Commission

14. Pensions work best when they are provided through the workplace. That is why the NAPF believes that all working people should be entitled to a decent pension that comes with their job. But workplace pensions are under significant pressure because of rising operational costs and increasing employer sensitivity to the scale of pension scheme liabilities.

15. Unless further action is taken to arrest this decline, private sector pension provision will wane and individuals will not achieve the income they need or deserve in retirement. That is why the NAPF supports the Coalition Government's commitment to *"reinvigorate occupational pensions"*.

16. To support this objective, the NAPF has recently launched an independent Workplace Retirement income Commission (WRIC) chaired by Lord McFall of Alcluith. It will investigate why the pensions system is failing so many people and ask how the UK can radically change its approach to saving for retirement. It will consider coverage and adequacy; public trust and understanding,;and the barriers to workplace pension saving for employees and employers (including fiscal and regulatory barriers). It has been tasked with developing a roadmap for reform.

17. The Commission will publish a report outlining its interim findings in June or July. The Commission will report at the NAPF Annual Conference and Exhibition in October 2011. Its report will set out recommendations around which a consensus can be built to help meet the Government's commitment to *"reinvigorate occupational pensions"*.

b) Supporting good workplace provision

18. But in the meantime there are some immediate actions that the Government can take:
    - The Government should reorient the Pensions Regulator's objectives so its primary focus is on ensuring the longevity and health of workplace pensions. The Regulator's current objectives mean that it is overly focussed on the DB run-off and insufficiently focussed on the continuation of good quality workplace pensions.

- The Government should look at ways of scaling back the existing volume of regulation and legislation surrounding workplace pensions and adopt a more risk-based approach to the regulation of pensions.

Recommendation 2: The Government should make progress against its objective to "reinvigorate occupational pensions".

Public sector pensions

19. The NAPF has a unique perspective on public sector pensions – we represent over 70 local authority funds. We called for an independent commission on public sector pensions ahead of the 2010 General Election, and strongly welcome the formation of the Independent Public Service Pensions Commission under Lord Hutton. We believe reform should be guided by key principles: affordability; transparency; and adequacy and are pleased that Lord Hutton has focused on these principles in his interim report. We await Lord Hutton's final report which we hope will set out a blueprint for fair and sustainable public service pensions.

20. However, we are concerned that short-term increases in employee contributions over the next few years could damage public sector pensions and make it harder to deliver the important long-term reforms we all seek. There is a real risk that increasing employee contributions by 3% during a period where there is a pay freeze and inflation is above the Bank of England inflation target could increase the number of members who opt out from the schemes. This would not only threaten their viability, but could also negate the purpose of the increases, namely to reduce taxpayer contributions in the short term. A big increase in opt-outs would cut income to the schemes, without reducing expenditure in the short term.

21. Our local authority members tell us they are already seeing signs that opt-out rates are increasing, as family budgets are squeezed – GMB survey data shows that potentially 40% of current scheme members will opt out[2].

22. The NAPF has always recognised that some small, phased increases in employee contributions are inevitable in the current financial situation. However, the 3% increase risks going too far. We believe the Government should look at the recommendations made by the Hutton Commission and see if any shorter-term savings can be made through implementing some of these changes, and then consider what increases in employee contributions might be required. This would be much more preferable to pressing ahead with contribution increases, which might fail to deliver savings as employees opt out.

Recommendation 3: The Government should consider Lord Hutton's recommendations before considering increases in employee contributions.

[2] GMB LGPS - 3% contribution tax bulletin - February 2011

Gilt issuance

23. Pension funds have a strong demand for long-dated and index-linked gilts:
    - Pension scheme liabilities are long-term and schemes need assets of the right duration to match liabilities. The Pensions Regulator expects trustees and sponsors to make a "prudent" choice of assets to meet their scheme funding obligations. 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.

24. Over the past decade, pension scheme allocations to fixed income and index-linked securities have risen from 16 per cent of scheme assets to over 30 per cent. Today pension funds own over £100 billion of gilt holdings, amounting to around 11% of total issuance. Moreover, pension schemes also account for a significant proportion of the insurance sector's gilt holdings of over £170 billion. The continuing trend to de-risking means that schemes will wish to increase their allocations to such assets, which better match their liabilities.

25. The 2010-2011 remit saw a large and welcome shift of issuance towards long-term and index-linked issuance (a 25 per cent increase in proportion of long-term and index-linked gilts from 36 per cent to 45 per cent of total gilt issuance).

26. Demand for gilts remains strong. The forthcoming 2010 NAPF Annual Survey reveals a strong appetite by pension funds for gilts. Pension funds' allocation to UK index-linked gilts increased by a quarter, from 7.9% to 12.3% during 2010. The survey also indicates a continuing strong demand for long-dated gilts: 60% of respondents saying greater issuance of long-dated gilts would help DB schemes manage their liabilities. This would indicate that there is considerable demand to meet additional supply of long and index-linked gilts.

27. We continue to recommend a further sharp increase in long-term – and particularly long-term indexed – issuance in 2011-2012. Pension scheme de-risking and insurance company solvency requirements mean that there will be continued strong demand from pension schemes and insurance. We believe that there is pent-up pension fund demand for long-term conventional and indexed issuance that will become even more apparent if interest rates rise.

28. Long-term gilts remain extremely good value for the Government. The yield on conventional long-term gilts remains low even following the normaliastion of an upwardly sloping yield curve. The yield curve for long-term indexed gilts is still inverted, with the real yield on the ultra-long 2055 index-linked hovering around zero suggesting strong demand.

29. Moves towards CPI (rather than RPI) indexation of pensions is likely to create a demand for CPI-indexed gilts. We look forward to working with the UK Debt Management Office (DMO) in its consultation on CPI-indexed issuance expected later this year. We have already started work to identify potential pension fund demand for CPI issuance.

Recommendation 4: We recommend a further sharp increase in long-term – and particularly long-term indexed – issuance in 2011-2012.

Pensions tax

30. The NAPF supports the new Government's proposals for restricting pensions tax relief through reducing the value of the Annual Allowance people can save tax-free – an approach first advocated by the NAPF in early 2010. However, while we welcome the overall approach, there are a number of implementation issues that the Government still needs to resolve to ensure the new system is workable and fair when it comes into effect. These include:
    - Confirmation of the method by which individuals may mitigate high tax charges from their pension and the practical impact on scheme administration of this option being introduced.
    - What, if any, exemptions would be permitted from the mandatory requirement to provide a mitigation option (eg DB schemes closed to future accrual).
    - To ensure equal application of mitigation options across all types of pension schemes.
    - Further clarity on the detail regarding the election of Pension Input Periods (PIPs) by individual pension schemes.
    - The future indexation of the reduced AA and LTA and by what metric (eg National average earnings or prices).
    - The potential for high tax charges on actuarially enhanced late retirement.
    - The unintended consequence that 'dynamised earnings' protection could hamper the ability of some DB schemes attempting to redesign annual benefit accrual to remain within the reduced Annual Allowance from doing so.

31. The NAPF has been foremost in arguing the case for a pensions tax regime which offers good practical incentives and protection for savers, but which also allows employers respite from further unnecessary regulation and additional cost and which is operationally simple and easy to understand by all. The predictability of the tax regime for pensions is an important driver in the encouragement of future saving, and a period of policy stability in this area would be particularly helpful to UK pension schemes and savers. The NAPF urges the Government to commit to such a period of stability so that schemes have time to adapt to the new reforms and do not incur further unnecessary costs.

Recommendation 5: The Government should continue to work with the industry to ensure the pensions tax changes are implemented in a way that does not increase administrative burdens. Given the speed at which the changes have been implemented, the Government should be ready to react to employers' and schemes' concerns post implementation in April 2011.

NAPF
Securing the future of pensions

Further information

For further information please contact:

Darren Philp
Director of Policy
darren.philp@napf.co.uk
020 7601 1700

Or visit our website: www.napf.co.uk

March 2011