NAPF

Securing the future of pensions

A state pension for the 21st century: a response by the National Association of Pension Funds

June 2011

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Contents

Executive Summary 3

The need for radical state pension reform 4

NAPF recommendations 7

Findings of PPI Research 14

Answers to Specific Questions 18

About the NAPF

The NAPF is the leading voice of workplace pension provision in the UK. We represent some 1,200 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 the security and sustainability of UK pensions.

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Executive Summary

Summary

- The NAPF is extremely supportive of the proposals for a single tier foundation pension contained in the Government's Green Paper *A state pension system for the 21st Century.* We believe radical reform is necessary to ensure the long-term viability of the state pension system and to re-engage with people about the importance of saving for retirement.
- The NAPF believes the Government should move forward with Option Two – the Single Tier Pension. The Single Tier pension would:
  - be broadly cost neutral over the long term;
  - reduce the number of pensioners entitled to means tested benefits from 4.4 million under the current system to 0.8million under the Single Tier pension; and
  - complement the introduction of auto-enrolment by ensuring that everyone knows it "pays to save".
- Combining the Basic State Pension and State Second Pension has implications for contracted out arrangements. Schemes must be given support from the Government to help make the abolition of contracting out as simple as possible. We have outlined a number of measures which the Government must implement to reduce the likelihood of schemes levelling down.
- We recognise the fact that people are living longer and therefore need to work for longer. Further increases in State Pension Age (SPA) are inevitable, but they must be done in a fair and reasonable manner that takes account of the variations in life expectancy across the country. The NAPF has long argued for the creation of an independent standing commission that would revise all aspects of retirement saving in the UK, including potential increases in SPA.

NAPF's main recommendations:

1. **The Government should press forward with its plan for radical reform for the UK state pension system by implementing Option Two – The Single Tier option.**
2. **The Government must permit schemes to amend scheme rules in response to ending of contracting out with minimal consultation with scheme members. Schemes should be granted temporary overriding powers to amend rules, but only if they are adjusting benefits in an actuarially neutral way due to the loss of the National Insurance rebate.**
3. **The Government must provide schemes with at least five years to prepare for the end of contracting out.**
4. **The Government must develop ways to help make contracting out easy to administer, especially around GMP reconciliation.**
5. **The Government should provide a state pension "reference test" for schemes that calculate benefits using a Basic State Pension deduction.**
6. **In conjunction with the ending of contracting out required by the Single Tier option, the Government should implement a programme of other supportive measures for private sector pension schemes to demonstrate its commitment to "reinvigorate occupational pensions" as outlined in the Coalition Agreement.**

7. **The Government should signal its early commitment to providing coordinated support and guidance to employers when communicating to scheme members about reform of the state pension system and the impact of the abolition of contracting out. HMRC must be adequately resourced to cope with the ending of contracting out.**
8. **The Government should create an independent standing commission on retirement saving and income issues, which would also consider increases in Sate Pension Age.**
9. **The Government should give people around 10 years notice before increasing SPA so people have enough time to adjust their retirement saving plans.**
10. **Schemes should be able to link their normal retirement age to SPA for future accrual only.**

The need for radical state pension reform

1. The NAPF has long argued for radical reform of the UK's state pension system. We believe the State Pension system has a key role to play in providing an adequate retirement income for pensioners and in providing a solid foundation on which to base private pension saving. Next year, millions of people will begin saving in a workplace pension for the first time. The introduction of automatic enrolment from October 2012 is one of the biggest reforms to UK pensions in decades. To ensure the success of auto-enrolment, it is imperative that the state pension system is reformed in an equally radical way.

2. Last year, the Coalition Government committed to restore the link between earnings and the Basic State Pension from April 2011 and to introduce the "triple lock". The introduction of the triple lock is an important first step in maintaining the value of the state pension system, but in our view this does not go far enough. We have one of the lowest state pensions in the developed world and, as the Pensions Commission acknowledged, it is also one of the most complicated. Currently, around half (45%) of pensioners need some form of means tested benefit to support their income.[1] According to the OECD, the gross replacement rate for a median earner in the UK is just 37% compared with the OECD average of 60%.[2]

3. Last year, the NAPF published proposals to combine the Basic State Pension and State Second Pension into a simple, more generous *Foundation Pension.* The introduction of a single, more generous Foundation Pension coupled with innovations in workplace pensions would significantly increase the size of individuals' pension pots and would provide a powerful incentive to people by ensuring that it pays to save for their own retirement. Without radical reform, even after the introduction of auto-enrolment, the current system would continue to deliver inadequate incomes—especially for those on low to median incomes where the value of their savings are eroded away by means tested benefits. The introduction of the Pension Credit fulfilled its purpose by lifting 900,000 pensioners out of poverty since 1998[3]. However, the political debate has moved on considerably, especially given the current pressures on Government spending. The

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[1] DWP, *A State Pension System for the 21st Century,* 2011.
[2] OECD, Pensions at a Glance, 2011.
[3] Work and Pensions Select Committee, *Tackling Pensioner Poverty: Fifth Report from the Committee,* 2008-9 Session.

gap between the level of the Basic State Pension and the Pension Credit has continued to widen. High levels of eligibility to means tested benefits simply do not chime with the Government's objectives of encouraging personal responsibility, especially with the introduction of auto-enrolment scheduled for 2012.

Box 1: A Foundation Pension for all

The Foundation Pension, as proposed by the NAPF in *Fit for the Future: NAPF's Vision for Pensions,* has the following characteristics:

- The Foundation Pension would combine the current Basic State Pension and State Second Pension to form a single, flat-rate benefit.
- The Foundation Pension level would be set above means tested benefit levels. A full Foundation Pension would be earned after 30 years of National Insurance contributions.
- It would be paid on an individual basis to people over State Pension Age.
- Once in payment, it would increase annually in line with the triple guarantee.

4. The introduction of the Foundation Pension for both current and new pensioners would, in an instant, remove around 2 million pensioners from means tested benefits[4] if introduced overnight in 2017 and would give current and future savers confidence in knowing that what they save in private pensions would not be eroded away by means tested benefits when they retire. The Single Tier builds on this idea. A Single Tier pension would reduce the number of relying on means tested benefits by almost 4 million in 2050. It would also increase people's incentives to save in a pension as people would know that it "pays to save". A survey conducted by the NAPF in June 2011 showed that people would save on average £60 more a month into the pension that comes with their job if they were guaranteed £140 a week from the State Pension[5].

5. We therefore welcomed the publication of the Government's Green Paper *A State Pension for the 21st Century.* The Green Paper outlines two possible options for reform of the state pension system. Option One would accelerate the flat-rating of the State Second Pension, which is currently legislated to become completely flat-rate around 2030. Option Two is similar to the Foundation Pension: it would combine the Basic State Pension and State Second Pension into a single, more generous pension set around £140 a week in 2011 earnings terms.

6. In thinking about which option for state pension reform best meets the needs of current and future savers and pensioners, we have used the following principles to assess each option:

Box 2: Principles of State Pension Reform

1. **Reform of the state pension must result in a simpler, more generous system.** The current system is too complex. People cannot predict what they will receive from the state, making their decision to save in private pensions more difficult. Reform of the state pension must

[4] According to PPI analysis. The Foundation Pension as proposed by the NAPF was set at £8,000 a year or around £153 a week.
[5] Populus poll commissioned by NAPF, conducted between 3rd and 5th June 2011.

ensure that people will know what to expect from the state pension system and give them certainty that it will "pay to save".

2. **Any new state pension system must complement auto-enrolment and help ensure it is a success.** People must have confidence in the new state pension system to encourage them to remain opted in to pension saving.
3. **Reform of the state pension system must also complement the Government's wider commitment to "reinvigorate occupational pensions".** The Government should look to implement other deregulatory measures alongside the reform of the state pension to simplify the UK's pension system as a whole.
4. **Communicating about the importance of saving must be made easier**. Reform of the state pension must be implemented in conjunction with a long-term strategic communication campaign about the importance of saving.
5. **Reform of the state pension system must not be implemented in a piecemeal fashion.** Pension schemes and savers have already grappled with a great deal of change over the last few decades. It is important the new system remains stable for the long term.

7. To help illustrate the effects the two options for State Pension reform outlined in the Green Paper*,* the NAPF commissioned research from the Pensions Policy Institute (PPI). The research report *An assessment of the Government's options for state pension reform* analysed each option in detail, considering:
    a. what each option would cost to implement, taking into account any flexibility that might be available in terms of benefit levels or changes to the means tested benefits system which could make each option cost neutral;
    b. how each option impacts on incentives to save and eligibility to means tested benefits;
    c. who would gain and who would lose from each policy option; and
    d. what the wider impacts on the pensions and retirement income sector would be.

8. PPI analysis concluded that both options contained in the Green Paper would be broadly cost neutral over the long term.

    a. From 2016 to 2019 the Single Tier would cost the same as the current system
    b. The Single Tier would cost less than the current system by around 0.1% of GPD between 2019 and 2050.
    c. It would cost marginally more than the current system by 0.1% of GDP by 2055.

9. The PPI also determined that the introduction of a Single Tier pension would significantly reduce the number of pensioners living in low income households and would reduce eligibility to Pension Credit from 45% (4.4 million pensioners) in 2010 to 5% (0.8 million pensioners) by 2050. Under Option One – the faster flat rating of S2P – no one would be better off and approximately 12 million people would receive less from S2P than now. Further details on the PPI's analytical work can be found in Chapter 2.

10. In the sections below, we have set out our thinking about the best option for reform of the state pension system based on our own objectives for reform and the findings from the PPI research. We have also made a number of recommendations which we believe will help ensure a successful transition to a new state pension system. It is imperative that the abolition of contracting out as required by Option Two, the Single Tier model, is handled in a way that enables both public and private sector schemes to make changes to their benefits in an efficient and balanced manner.

11. Later in our response, we outline a package of easements which the Government must implement to make the ending of contracting out easier for schemes to manage. We have developed these easements following extensive discussions with our members. If the Government decided to move forward with the Single Tier pension and therefore the abolition of contracting out, it is important that these easements are developed in greater detail. The NAPF is keen to continue working with the DWP and HM Treasury over the coming months on this issue.

12. For reform of the state pension system to meet the Government's wider objectives of personal responsibility, fairness, simplicity, affordability and sustainability, it must provide people with a clear and simple message about the importance of saving for retirement on top of the baseline of the state pension. For this reason, we believe the reformed state pension should be called the "Foundation Pension," which would give people a clear signal about the need to save more for old age. We also believe transition to the new system must take place in as short a time as possible, taking into consideration constraints on affordability. Once transition is achieved, the system must remain stable with the new state pension maintaining its value relative to means tested benefits. Any further change will cause confusion amongst savers and will undermine employer confidence.

NAPF Recommendations

13. The NAPF is extremely supportive of the proposals contained in the Government's Green Paper *A state pension system for the 21st century.* We believe radical reform is necessary to ensure the long-term viability of the state pension system and to re-engage with people about the importance of saving for retirement.

14. In considering the NAPF's own criteria for state pension reform and Government's principles as outlined in the Green Paper, together with the analysis conducted by the PPI for the NAPF, we believe that Option Two – the Single Tier Model – is the best design for reform of the state pension system. Our current state pension system is extremely complex, making it difficult for people to know how much they should save for their own retirement. In June 2011, the NAPF conducted a survey of consumers to determine how well they understand the current state pension system. Over 60% of respondents agreed with the statement that uncertainty over the amount they will receive from the state pension makes it difficult for them to plan for their retirement.[6] Younger people in particular felt unable to plan, with 70% of respondents between ages 25-34 agreeing with the statement compared to 51% of those over 55. With the introduction

[6] Populus poll commissioned by NAPF, conducted between 3rd and 5th June 2011.

of auto-enrolment only a few months away, it is imperative that people, and especially young people, are given a clear message about the importance of saving for retirement, backed by assurance from the Government that saving for themselves will be supported by a strong foundation provided by the state.

Table 1: Options for Reform Compared

Principle	*Option One*	*Option Two*
1. Reform must result in a simpler, more generous system	System would still be comprised of two pensions, each with their own eligibility criteria and up-rating rules.	Combines the Basic State Pension and State Second Pension into one pension set above the means tested benefits level.
2. New system must complement auto-enrolment	System remains complex and eligibility to means tested benefits remains unchanged.	Ensures that it "pays to save" under auto-enrolment.
3. New system must complement programme to "reinvigorate occupational pensions"	Requires no wholesale changes so wider reform would require specific legislation.	The changes can be implemented alongside other deregulatory measures to help occupational pensions.
4. Communicating about saving must be made easier	Incentives to save remain unclear under Option One, making it more difficult to communicate the importance of saving.	The "pays to save" message is clear, making wider communication strategy about the importance of saving easier.
5. New system must remain stable going forward.	Incremental approach and leaves open the possibility for further reform.	Changes can be combined to ensure that further tinkering will not be needed.

NAPF Recommendation 1: The Government should press forward with its plan for radical reform to the UK state pensions system by implementing Option Two – the Single Tier Model.

15. The Single Tier option is the preferred option for reform of the state pension system for the NAPF and its members. However, combining the Basic State Pension and State Second Pension has implications for contracted out pension arrangements and it is important that reform of the state pension is viewed in the context of wider changes to pensions and the Coalition Government's commitment to "reinvigorate occupational pensions". Contracting out for defined contribution (DC) schemes is already set to end in April 2012. However, defined benefit (DB) schemes that are currently contracted out of the State Second Pension and their sponsoring employers are already facing many challenges. Changes to pensions tax relief and the introduction of auto-enrolment from 2012 will add to the administrative burden and cost to running DB schemes. The fact that the majority of contracted out employees work in the public sector further complicates the situation.

16. Although the abolition of contracting out for DB schemes would eventually lead to reduced complexity and administration for schemes, it also means that schemes would no longer receive the contracted out rebate in exchange for the liabilities they take on, adding significant costs to schemes' balance sheets and forcing employers and schemes to rethink their overall benefit structures. In other areas of pensions policy, particularly around auto-enrolment, the Government has demonstrated its willingness to help support existing good quality occupational pensions. The Government must continue with this pragmatic approach and provide easements to prevent levelling down as a result of the ending of contracting out.

17. DB pension systems are extremely costly and complicated to manage. The NAPF Annual Survey 2010 found that on average schemes pay around £350,000 a year in administration, record keeping, and member communications.[7] The rules governing DB schemes are complex, and can vary significantly from scheme to scheme. In thinking about the measures the Government needs to implement in order to make reform of the state pension system successful, the NAPF kept in mind some characteristics of DB schemes which could affect outcomes for scheme members:

    - **Many schemes define pensionable pay using the Basic State Pension as a threshold**. This means that the level of the Basic State Pension is directly linked to the benefits scheme members receive. Schemes can offset benefits in the accrual phase or in the payment phase. In the accrual phase, pensionable pay levels are offset by the various permutations of the Basic State Pension (eg full Basic State Pension, 50% of the Basic State Pension, or 150% of the Basic State Pension). In the payment phase, benefits can be reduced by the value of the Basic State Pension. How a scheme member would be affected by a more generous state pension system would depend on the rules of the individual scheme. We are keen to continue working with the DWP to understand this issue and the variations that exist between schemes.

    - **Schemes operate a triennial valuation cycle and often base major decisions around the valuation**. Valuations are expensive for schemes to complete. We estimate the cost one valuation to be between £50,000 and £100,000 for a small to medium size scheme and up to £200,000 for a large scheme. They require extensive rounds of actuarial calculations and advice. For this reason, any decisions around benefit design which require actuarial work tend to be made in the valuation period. Valuations are also time consuming, usually lasting around a year.

    - **Schemes will have to reconcile Guaranteed Minimum Pensions (GMPs) at once, which is a difficult task in itself.** GMPs have been a persistent source of frustration for schemes. Ending contracting out will require schemes to reconcile all their GMPs at once, to take account of any miscalculations and to provide some certainty around GMP benefits going forward. HMRC will also have to grapple with large numbers of schemes reconciling at the same time.

[7] NAPF Annual Survey 2010.

- **Some DB schemes provide "bridging pensions" which provide higher incomes for scheme members who retire prior to SPA.** Upon reaching SPA, scheme benefits are actuarially reduced to take account of the period. Increasing the generosity of the state pension will affect these calculations and will require schemes to pay higher incomes for members wishing to use bridging pensions.

18. The issues raised above have been identified by NAPF members in initial discussions regarding state pension reform as causing particular difficulties during the process of ending contracting out. In the course of our discussions, NAPF members also identified a number of ways the Government could provide support to schemes to the process easier for schemes to manage. For example, schemes are concerned about the ease at which they will be able to make amendments to their scheme rules. If the Government were to allow schemes to make changes to their rules in an actuarially neutral way with minimal consultation with scheme members, employers will be more likely to keep schemes open for new members or for future accrual. Schemes are also concerned about the length of time they will have to make these changes. We feel schemes need at least 5 years to prepare for the end of contracting out. We have outlined our main recommendations below and have explored them in greater detail in response to question 8.

19. Experience has shown that schemes are subject to various layers of complexity when it comes to changing scheme rules in response to Government action. We therefore urge the Government to consider these issues in greater detail before proceeding further with the abolition of contracting out. The NAPF is committed to working closely with DWP in the coming months and to facilitate discussions with pension schemes about the particular issues they will face.

NAPF recommendation 2: The Government must permit schemes to amend scheme rules in response to the ending of contracting out with minimal consultation with scheme members. Schemes should be granted temporary overriding powers to amend scheme rules, but only if they are adjusting benefits in a broadly actuarially neutral way due to the loss of their National Insurance rebate.

NAPF recommendation 3: The Government must provide schemes with at least five years to prepare for the end of contracting out.

NAPF recommendation 4: The Government must develop ways to make the end of contracting out easy for schemes to administer, in particular around GMP reconciliation.

NAPF recommendation 5: The Government should provide a state pension "reference test" for schemes that calculate benefits using a state pension deduction.

20. In the Coalition Agreement, the Government pledged to "simplify the rules and regulations relating to pensions to help reinvigorate occupational pensions." However, pension schemes in

the UK have already experienced a great deal of change in the past few decades, especially considering the changes to the pensions tax system and the introduction of auto-enrolment. And schemes will experience further pressure in coming years. According to the 2010 NAPF Annual Survey, 40% of schemes currently open to new members are likely to close the scheme over the next five years, while a further one in three are likely to take the final step of closing schemes to future accruals.[8]

21. While the ending of contracting out for DB schemes as implied by the Single Tier option can be viewed as a welcome simplification, schemes will still experience increased administrative burden associated with contracting back in to the state system, as well as the cost of changing benefit structures. In addition, there is the risk that, after spending considerable amounts of time and money implementing these reforms, there will be further announcements that will require similar scheme changes.

22. To help schemes cope with the increased cost and administrative burden associated with the ending of contracting out, we would encourage the Government to explore other deregulatory measures that could be introduced alongside reform of the State Pension system. Last year the NAPF put forward proposals in *Fit for the Future: NAPF's Vision for Pensions* to develop a healthy workplace pensions system offering a mixed economy of provision so employers are free to provide the form of pension that is right for them and their employees, taking into account the Single Tier pension and auto-enrolment.

23. For some employers, this may mean continuing to provide their current pension arrangements. Some may prefer a large scale multi-employer approach. Others might want to adopt a more hands-off approach using NEST. Still others might be content to carry more risk than others. But increasingly the form of provision chosen by employers is being dictated by the regulatory and economic environment. The costs associated with regulation and the desire of scheme sponsors to manage their own pension liabilities and risk exposure means often means when altering their pension arrangements, employers have tended to switch straight from DB to DC provision.

24. To stem this decline, we believe the best way to secure the future of DB would be allow schemes to go "back to basics" and permit scheme sponsors to provide single life, level pensions for benefits accrued in the future. Benefits such as indexation in deferment and in payment and spouses' benefits would no longer be a legal requirement. This would be "core DB".

25. The right for every working person to build up a workplace pension with an employer contribution under automatic enrolment, combined with the higher state pension envisaged under the Single Tier option paid equally to both men and women, reduces the need for these benefits to be paid from employers' DB schemes going forward. Employers would continue to bear investment risk, longevity risk and (in final salary arrangements) salary escalation risk. Employees would take on some inflation and longevity risk.

[8] NAPF Annual Survey, 2010.

26. In the DC space all the risks outlined above are borne by the employee, who is often least well placed to deal with volatility and investment decisions. To help achieve better outcomes and more certainty for DC savers, the Government should encourage the development of large scale, not-for-profit, multi-employer Super Trusts. Super Trusts would be able to operate at lower costs, could access a wider range of investments, and would have more effective and expert governance – all acting in the interest of scheme members.

27. Moving from the current pension system to one that better complements auto-enrolment and the Single Tier pension will require support from the Government. Legislative changes will be necessary and the NAPF is keen to work with the Government to determine where specific changes should be made to help "reinvigorate occupational pensions." This is why we asked Lord McFall of Alcluith, former Chairman of the Treasury Select Committee, to lead an independent commission looking into workplace retirement saving today. The Workplace Retirement Income Commission (WRIC) will be looking at what can be done to increase efficiency and adequacy for the millions of people saving for their retirement through the workplace and will be making recommendations on how the Government can reinvigorate occupational pensions later this year.

NAPF Recommendation 6: In conjunction with the ending of contracting out required by Option Two, the Government should implement a programme of other supportive measures for private sector pension schemes to demonstrate its commitment to "reinvigorate occupational pensions" as outlined in the Coalition Agreement.

28. In order for reform of the state pension system and the ending of contracting out to be implemented successfully, the Government will need to lead a comprehensive and coordinated communication campaign aimed at employers, scheme members, and individual savers affected by the reforms. Because employers will not be making changes to their benefit structures voluntarily but as a result of the loss of the contracted out rebate, the Government must provide assistance to employers and schemes when communicating the change to scheme members by providing guidance and factsheets to help explain the process. Such communications will help employers understand the reforms and should give comfort to scheme members about changes to scheme benefits.

NAPF recommendation 7: The Government should signal early its commitment to providing coordinated support and guidance to employers when communicating to scheme members about reform of the state pension system and the impacts of the abolition of contracting out. HMRC must be adequately resourced to cope with the end of contracting out.

29. Reforms to the State Pension system must be made with a view to ensuring the long term sustainability and affordability of the new system. Trends in longevity mean that the cost of providing the State Pension will rise in the future. We recognise that people are living longer and unless people are encouraged to work longer, people will spend a greater proportion of their lives in retirement. We therefore recognise that further increases in SPA are inevitable, but they

must be done in a fair and reasonable manner that takes account of variations in life expectancy across different parts of the county.

30. The Green Paper suggests two mechanisms for increasing SPA, either by automatically increasing SPA through a formula linked to life expectancy or through conducting a review at regular, pre-determined intervals. The NAPF has long argued for the creation of an independent standing commission that would revise all aspects of retirement saving in the UK, including potential increases in SPA. We believe this mechanism has a number of benefits: it would depoliticise the issue and it would place SPA in context of wider trends in retirement saving. We therefore recommend that the Government extend the remit of the review as proposed in the Green Paper to include all aspects of retirement saving, including increases in SPA.

NAPF recommendation 8: The Government should create an independent standing commission on retirement saving and income issues, which would also consider increases in State Pension Age.

31. Giving people enough time to adjust their plans for retirement to account for increases in SPA will be crucial. Without sufficient notice people may not be able to continue working and this increases the risk that people will fall back in means tested benefits if work is not found. And individuals' ability to plan will become more important as saving in DC pensions increases in prevalence with the introduction of auto-enrolment. Many DC schemes use lifestyling or target date funds to manage risk as individuals approach retirement. Almost 80% of default funds use lifestyling as part of their investment strategy, and with 83% of DC scheme members saving in the default, too fast an increase in SPA could significantly impact their income in retirement. Research conducted by the NAPF and PensionsDCisions in 2009 found that lifestyle strategies start to de-risk from between 3 to 15 years before retirement.[9] We therefore recommend that the notice period for future SPA increases be set somewhere around the average of 10 years.

NAPF recommendation 9: The Government should give people around 10 years notice before increasing the State Pension Age so people have enough time to adjust their retirement saving plans.

32. In the future, increases in SPA will be directly linked to increases in life expectancy. In its final report, Lord Hutton's Independent Public Service Pensions Commission recommended that the Normal Retirement Age for public sector schemes should be linked to increases in SPA. We encourage the Government to explore such a mechanism for private sector schemes to use in regards to future accruals as part of it s commitment to "reinvigorate occupational pensions."

NAPF recommendation 10: Schemes should be able to link their normal retirement ages to the SPA for future accrual.

[9] NAPF and PensionsDCisions, *DC Default funds: Today and Tomorrow,* 2009.

Findings from PPI Research

33. The reforms proposed by the Government in the Green Paper have the potential to radically transform the UK's current state pension system. Each option would require significant changes and would impact individuals in different ways. To help our understanding of the effects the two options for State Pension reform outlined in the Green Paper and to guide our own recommendations on the best option for reform, the NAPF commissioned research from the Pensions Policy Institute (PPI).

34. The PPI provided an independent, evidence based assessment of the two options for reform, examining their impact on:

    a. individuals, in particular who would gain or lose from each of the options.
    b. Government expenditure, focusing on what costs and/or savings might potentially arise from the introduction of the proposed reforms.
    c. pension schemes, looking at the wider consequences of the two options on occupational pensions.

Box 3: Main PPI Findings

PPI modelling suggestions that:

1. **The Single Tier pension would benefit groups of people traditionally underserved by the current system, including women and carers, the self-employed, Jobseekers Allowance claimants, older pensioners, and pensioners who do not claim the means tested benefits they are entitled to**. Redistributing state pension income to lower paid workers is key to boosting incentives to save for this group of people.

2. By 2034, **6.8 million pensioners would benefit from the Single Tier pension** by an average of £23 a week. By 2055, the number of pensioners benefiting from the Single Tier increases to 11 million, gaining an average of £24 a week.

3. The **number of pensioners eligible to means tested benefits in 2055 falls dramatically from 4.4 million pensioners to 0.8 million pensioners because of the Single Tier**.

4. **The Single Tier option would be broadly cost neutral in the long term**, incurring a minor increase in spending of 0.1% of GDP in 2055.

5. Under **Option One, no pensioner would gain extra income**. Some individuals would receive lower incomes from the State compared to the current system. By 2055, 6.7 million pensioners would lose up to £1.50 a week on average.

6. **Option One has a negligible impact on levels of eligibility to means tested benefits**. On current projections, 45% of pensioner households would be eligible to means tested

benefits in 2050.

7. The **Government would save £0.6 billion a year by 2025 under Option One** as a result of reduced expenditure on means tested benefits and State Second Pension. It would also save £3 billion a year in extra National Insurance contributions between 2013 and 2033.

Implications of maintaining the current system

8. As part of its analysis, the PPI looked at the implications of maintaining the current system on individuals and on Government Expenditure as a benchmark for comparison to the reforms proposed in the Green Paper. If the current system were left unchanged, the Basic State Pension would continue to be up-rated in line with the triple guarantee (the higher of earnings, CPI or 2.5%) and the Sate Second Pension (S2P) would become completely flat-rated around 2030.

9. Under the current system, earnings related accrual to S2P will gradually reduce until around 2030. Higher earners will also receive more income from the state system if it were to continue unchanged. In 2034 a higher earning man could expect around £203 a week while a lower earning woman would receive around £143 a week, even with take-up of Pension Credit.

10. Total spending on the Basic State Pension, Pension Credit, Housing Benefit and Council Tax Benefit under the current system reached £76 billion in 2010 or 5.1% of GDP. The triple lock will also add an additional 0.5% of GDP to Government spending on state pensions and other pensioner benefits by 2055.

11. Although PPI analysis suggests that eligibility to means tested benefits is projected to decrease without further changes to the current system, a large percentage of pensioners will still be eligible to means tested benefits in the future. Currently 60% of pensioner households are eligible for means tested benefits. Without any changes to the current system, 45% of pensioner households will be entitled to means tested benefits in 2050.

12. Current plans to flat-rate S2P will also mean that occupational pension schemes will receive less in contracted out rebates as the value of the rebate erodes over time. Although schemes would receive the contracted out rebate at the value of the flat-rate accrual, they would still be obliged to pay actuarially equivalent benefits to members who are entitled to earnings-related amounts of S2P entitlement.

The implications of faster flat-rating of S2P (Option One)

13. The first option proposed in the Green Paper is to bring forward the flat-rating of S2P from 2030 to 2020. In this option, both the Basic State Pension and State Second Pension would remain separate, each with their own eligibility criteria and different up-rating rules.

14. Option One would not require structural change to the current system. Under this option, there would still be two elements to the state system. People would still be able to accrue S2P, schemes would still be able to contract out, and both elements of Pension Credit (Guarantee Credit and Savings Credit) would remain.

15. Although Option One would be simpler to implement because it would not require the ending of contracting out, it could lead to worse outcomes from some groups of pensioners. According to PPI's modelling, people earning between £14,400 (Lower Earnings Threshold) and £40,040 (Upper Accrual Point) between 2013 and 2020 would lose their extra earnings-related entitlement to S2P. The PPI estimates that in 2034 5.3 million pensioners would receive less from the state system under Option One than they would have received under the current system, losing an average of £0.50 a week compared to the current system. By 2055, the number of losers increases to 6.7 million pensioners, who would lose on average around £1.50 a week.

16. PPI analysis also showed that Option One would have little to no impact on future eligibility to means tested benefits. This is because the faster flat rating of S2P is likely to impact those on median to higher incomes, many of whom are already ineligible for means tested benefits. Under the current system, around 60% of pensioners are eligible for means tested benefits in 2010. In 2050, 45% of pensioners are projected to be eligible for means tested benefits. Under Option One, these figures would remain the same.

17. Despite these shortcomings, the Government would make some cost savings of around £0.6 billion a year or 0.1% of GDP each year from 2055 on means tested benefits and expenditure on the S2P by flat-rating S2P at a faster rate as compared to the current system. To keep the spending envelope on pensions broadly the same as under the current system, the Government could make a number of changes to S2P to widen coverage or to make it more generous. However, extending eligibility to S2P or to make S2P more generous by up-rating S2P by the triple lock will only make Option One more similar to Option Two (the Single Tier) while continuing to administer both the BSP and S2P separately.

Implications of Introducing a Single Tier Pension

18. Option Two would combine the BSP and S2P into a single pension worth around £140 a week in 2010 terms, which sits slightly above the threshold for the Guarantee Credit element of Pension Credit. Option Two is very similar to the NAPF's proposal for a Foundation Pension, published in 2010 in *Fit for the Future: NAPF's Vision for Pensions.*

19. Millions of people would benefit from the Single Tier pension, but it also would be broadly cost neutral for Government to implement.

    d. From 2016 to 2019 the Single Tier would cost the same as the current system;
    e. The Single Tier would cost less than the current system by around 0.1% of GPD between 2019 and 2050; and
    f. It would cost marginally more than the current system by 0.1% of GDP by 2055.

20. The introduction of a Single Tier Foundation pension would improve outcomes for many pensioners, especially those with low to median incomes. By 2055, 11 million pensioners would receive an extra £24 a week on average. A male pensioner aged 76 in 2034 who was a lower earner during working life could expect to receive a state pension of around £135 a week from the current system. Under the Single Tier pension, he would receive around £150 a week.

21. Importantly, the Single Tier option could have a significant impact on future eligibility to means tested benefits. Currently around 4.5 million pensioner households are eligible for Pension Credit. Without any reform to the current system, 4.4 million pensioner households would still be eligible for Pension Credit. But under the Single Tier, eligibility to Pension Credit is reduced to only 0.8 million pensioner households, thereby ensuring that it pays to save for retirement.

22. The PPI concluded that the Single Tier option improves the distribution of income across the distribution spectrum by dramatically reducing the number of pensioners living in low income households. Because almost all individuals will qualify for a full Single Tier pension, people would be less reliant on means tested benefits and would be protected against erosion of the value of their pension by the triple lock.

Answers to specific questions

Chapter 1 - The current pension system

1. **Would the current pension system, if left unchanged, meet the Government's principles for reform and provide an effective foundation for saving?**

   The Pensions Commission itself acknowledged that the UK's current state pension system is "the most complex in the world." The state system is itself made up of a "complex combination" of the Basic State Pension, a means tested Pension Credit, and an earnings-related State Second Pension. Looking forward, an individual's state pension entitlement depends on a number of different thresholds (Upper Earnings Limit, Lower Earnings Limit, the Guarantee Credit Level and the Basic State Pension level). This complexity lead the Pensions Commission to declare that it is "close to impossible for individuals to have a clear view idea of what they can in future expect from the state system."[10]

   Recent research conducted by the DWP[11] shows that people often find information and communication on the current State Pension system difficult to understand and engage with. It cannot answer the fundamental questions of "How much will I get from the State Pension?" and "When will I get it?"

   The Pensions Commission estimated that around 12 million people are not saving at all or not saving enough for their retirement.[12] People do not save for their retirement for a variety of reasons: they may not be able to afford it, they may be overwhelmed by the complexity of the pensions system, or they may not understand the value of saving for retirement. In short, people are not sure whether it pays to save under the current system.

   In its 2006 report *Financial Incentives to Save,* the DWP looked at the barriers to saving and what could be done to improve individuals' incentives to save. One conclusion was that improving the incentives is about improving what is called "payback". Payback is what people can expect to receive in return for contributions, interest, and investment growth (after taking inflation into account).

   One of the main factors in determining whether an individual has a strong incentive to save is by measuring what kind of payback he or she can expect in retirement. The DWP found that income-related benefits "may reduce the payback expected from saving and, if they were to spread to a significant majority of pensioners, might affect perceptions of the benefits of saving for retirement which might discourage saving even where potential payback from saving remains high."[13]

[10] Pensions Commission, "Pensions: Challenges and Choices: The First Report of the Pensions Commission," 2004
[11] DWP, "How best to present State Pension information and support retirement planning," 2010.
[12] Pensions Commission, "Pensions: Challenges and Choices: The First Report of the Pensions Commission," 2004.
[13] DWP, Financial Incentives to Save, 2006. p 10.

The DWP went on to say that there are ways to improve actual payback and perceptions of the benefits of saving. "A more generous state pension system that takes more people above the threshold of entitlement to income-related benefits will also increase the expected payback for many people."[14]

With the introduction of auto-enrolment only a few months away, it is imperative that the state pension system is reformed in a radical way to help people understand and appreciate the value of saving for their own retirement and to provide people with a clear message that it "pays to save." The current system falls short of this objective:

- currently around 60% of pensioners are eligible for means tested benefits;
- between 27-38% of pensioners entitled to Pension Credit did not claim it in 2008/9[15], saving the Treasury between £1.6 billion and £2.9 billion in 2008/9[16];
- only 75% of women retiring in 2010 received the full Basic State Pension[17] ; and
- 11% of pensioners retiring in 2009/10 had no other sources of income besides for state benefits[18].

Changes have been made to the contribution criteria for the Basic State Pension and to the crediting arrangements to the State Second Pension, which will help address some of the issues outlined above. But even after the introduction of auto-enrolment the complex interaction between private pension saving and means tested benefits means some people may not experience as great a payback from saving than they would under a Single Tier system.

During the passage of the Pensions Act 2008, the DWP conducted a programme of research around the incentives to save under auto-enrolment in response to stakeholder concerns about the interaction between auto-enrolment and means tested benefits. The 2009 DWP Research Report "Saving for Retirement: implications of pension reform on financial incentives to save for retirement" found that almost all individuals received at least £1 plus inflation in return for every £1 saved. But considering this research did not take into account the effects of employer contributions, payback of £1 plus inflation for every £1 saved under the current system seems a modest trade-off for taking personal responsibility for saving.

Only by combining the Basic State Pension and State Second Pension into a single, more generous Foundation Pension set above the means tested benefits threshold would the Government be able to meet its objectives for reform. A single Foundation Pension would both reduce dependency on means tested benefits in retirement and would provide a clear incentive to save on top of the state system – people would know it would "pay to save". A survey conducted by the NAPF in June 2011 showed how this would work in real life. Respondents said they would

[14] DWP, Financial Incentives to Save, 2006. (p. 10)
[15] DWP, (2010a) table 3.5.1
[16] DWP, *A State Pension System for the 21st Century, 2011.*
[17] DWP Projections.
[18] DWP, Pensioner Income Series 2009/10.

save on average £60 more a month into their own pension if they were guaranteed £140 a week from the State Pension.[19]

Chapter 2 - Options for state pension reform

2. To what extent would faster flat-rating meet the principles for reform and improve savings incentives?

Under current plans, the earnings-related element of the State Second Pension (S2P) is already being withdrawn. From around 2030, S2P will be completely flat-rated. Withdrawing the earnings-related element of S2P at a faster rate will, in essence, make those earning between £14,400 (the Lower Earnigns Threshold) and £40,040 (the Upper Accrual Point) worse off. According to the PPI, around 6.7 million people could be worse off under Option One by around £1.50 a week in 2050[20].

Option One would also add extra cost to schemes, who would receive a smaller contracted out rebate in the period between 2013 and 2020. At the same time, schemes would have to pay actuarially equivalent benefits to members with earnings related S2P entitlements while receiving the contracted out NICs rebate based on a flat-rated accrual seven years sooner than under the current system. This impact on scheme funding levels only adds to the layers of complexity already felt by schemes.

Crucially, accelerating the flat-rating of S2P would have little to no impact on levels of eligibility to means tested benefits nor on the distribution of incomes amongst pensioner households. Under the current system, 45% of pensioners would be eligible for means tested benefits in 2050[21], which remains unchanged under Option One. Without a more generous state pension system, people have fewer incentives to save for their own retirement.

The cost savings of Option One are driven by two factors: reduced Government expenditure on State Second Pension benefits; and reduced expenditure on National Insurance rebates. Option One would save the Treasury around £0.6 billion a year (less then 0.1% GDP) on state pensions and means tested benefits as some individuals would receive less S2P. But in addition to saving money, the Government would also receive increased revenue from paying lower National Insurance rebates to schemes. The PPI calculated that the Government would save around £3bn a year (2011 earnings terms), with £2.5bn coming from unfunded public sector schemes and £0.5bn coming from private sector schemes.[22] Unless the Government were to recycle these savings back into the state pension system, we do not believe Option One meets the Government's objectives of cost neutrality.

Overall, the NAPF does not believe Option One meets the Government's four principles for reform and we do not recommend that the Government moves forward with this option.

[19] Populus poll commissioned by NAPF, conducted between 3rd and 5th June 2011.
[20] PPI, An assessment the Government's options for state pension reform, 2011.
[21] *Ibid*.
[22] PPI, "An assesements of the Government's options for state pension reform," 2011.

3. **What further reforms might be required to the State Second Pension, such as crediting arrangements and uprating of pensions in payment, to better meet the Government's principles, recognising that there is a trade-off between coverage and the potential level of any combined, two-tier flat-rate pension?**

The complexity inherent in the current system stems from the fact that there are two state pensions – the Basic State Pension and the State Second Pension – each with different eligibility criteria and uprating rules. Each system also interacts with means tested benefits in different ways, making it almost impossible for people to know what they will receive from the state.

Changing crediting arrangements or up-rating rules around the Sate Second Pension will only add another layer to the constant tinkering already beleaguering the state pension system. The time for incremental changes to the state pension system is over. Option Two – the Single Tier pension – is the only option going forward.

4. **To what extent would a single-tier pension meet the Government's principles for reform and improve savings incentives?**

The NAPF believes the Single Tier option best meets the Government's objectives for state pension reform. We have outlined our thoughts in the table below:

Table 2: Principles for State Pension Reform

Principles for Reform	Single Tier Option
1. Personal Responsibility	Combining the Basic State Pension and State Second Pension into a single, more generous system would help people predict how much they would receive from the state and make decisions about how much to save on top of it by ensuring it "pays to save" for retirement. This is especially important considering the introduction of automatic enrolment from October 2012. Research conducted by the NAPF shows that on average people would save an extra £60 a month knowing they would receive £140 a week from the State Pension.[23]
2. Fairness	The Single Tier option would improve outcomes for groups of people who have traditionally been disadvantaged by the current system, in particular women and carers. In addition, people who do not claim the means tested benefits to which they are entitled would automatically receive the Single Tier option. Currently 3 to 4.2 million pensioners who are eligible for Pension Credit do not claim the benefits they are entitled to.[24]

[23] Populus poll commissioned by NAPF, conducted between 3rd and 5th June 2011.
[24] Currently between 27-28% of pensioners out of 11.3 million pensioners in 2008/9. DWP (2010b).

3. Simplicity	The Pensions Commission called the current UK state pension system "the most complex in the world". Combining BSP and S2P into a single Foundation pension would be simpler for people to understand. It would also be more cost effective for the Government to administer. 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 Single Tier 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 under the Single Tier Option.
4. Affordability and Sustainability	The Single Tier option is key to ensuring the long term sustainability of the UK pensions system as a whole. From October 2012, people will be automatically enrolled into a workplace pension, many for the first time. The Single Tier pension will help people place value on workplace pension and encourage them to remain opted in to pension saving. In the Green Paper the Government signals its desire to ensure the cost neutrality of state pension reform. In our Foundation Pension proposal, the NAPF suggested ways to keep reform of the state pension system cost neutral. But ultimately decisions on affordability are a political decision.

5. Which of these two options would act as the best complement for automatic enrolment?

We believe the Single Tier option will be the best complement to auto-enrolment. The NAPF is not alone in this view. According to the Making Automatic Enrolment Work Review, the introduction of a Foundation Pension as proposed by the NAPF, would improve individuals' incentives to save under an auto-enrolment system.[25]

In addition to improving individuals' incentives to save, the Single Tier option would also make it easier for employers to make decisions about scheme benefits and contribution levels offered to employees. Anecdotal evidence from NAPF members show that many employers and schemes have made deliberate decisions about contributions and benefit packages because of interaction with means tested benefits. Under a Single Tier system, employers (as well as individuals) could be confident that their contributions made under auto-enrolment would not be eroded away by means tested benefits.

6. Government would be interested in hearing views on other reform options that would meet the Government's principles for reform.

[25] Making Automatic Enrolment Work, DWP, October 2010.

As previously mentioned, last year the NAPF published proposals to combine the Basic State Pension and State Second Pension into a into one, flat-rate Foundation Pension paid to all pensioners on a contributory basis starting in 2017. The NAPF suggested that the Foundation Pension could be paid at a level of £8,000 a year. This is the level an individual with a full National Insurance record would have received from both the BSP and S2P when they retired in 2050. Introducing the Foundation Pension at £8,000 a year would, in an instant, take 2 million people out of means tested benefits.

Under our proposals, the Foundation Pension would be paid to all pensioners, principally to help overcome issues of fairness inherent in the current system. While this would increase the cost of the Foundation Pension, we also proposed a number of measures that could be implemented to ensure that the Foundation Pension could be broadly cost-neutral over the long term. We suggest that, as a trade-off, people work an extra two years (increasing the SPA to 70 by 2046) in exchange for the higher Foundation Pension. Over the long term, this measure would reduce the extra cost of the Foundation Pension to only £3 billion a year.

The Single Tier option outlined in the Green Paper goes a long way towards meeting the NAPF's objectives – and indeed the Government's own four objectives. But we believe that the Foundation Pension would be more conducive to fostering an environment of saving as it would be available for all pensioners. However, we acknowledge that in the current economic environment such a broad approach may not be possible. But a Foundation Pension that would be paid to all pensioners—not just new pensioners—must remain a long term objective for Government as soon as the fiscal climate allows.

7. What would be the impact of ending contracting out, as implied by any single-tier model?

Contracting out is a notoriously complex and difficult area of pension scheme management. Schemes that contract out of the state system take on additional administrative and record-keeping requirements, as well as extra cost and risk which they assume when providing benefits in place of the State Second Pension.

In exchange for taking on the extra cost and risk, schemes are compensated by the contracted out rebate. Employers and employees who contribute to contracted out schemes also pay reduced rates of National Insurance Contributions to reflect the fact that scheme members will not receive benefits from the State Second Pension. Earlier this year the Government confirmed that the value of the contracted out rebate will be reduced from 5.2% to 4.8% in 2012, which means schemes will no longer be adequately compensated for the risk they assume in providing benefits in lieu of the State Second Pension.

Many schemes have already responded to the reduction in the contracting out rebate by choosing to voluntarily contract back in to the State Second Pension. According to the Office of National Statistics' Occupational Pension Scheme Survey, 72% of private sector DB scheme members (2.6m) were contracted out of S2P in 2004. By 2009, the number of contracted-out private sector DB scheme members had reduced to 63% (1.5m). Contracting back in to the State

Second Pension is in itself a form of risk-sharing between schemes and the State as the State assumes some of the longevity risk from the scheme.

That is not to say that the consequences of ending contracting out should be underestimated. For schemes that remain contracted out, especially those that remain open to new members, the loss of the contracted out rebate could increase the amount employers need to contribute to fund the schemes. To minimise the financial implications of the ending of contracting out on balance sheets, schemes and employers could react in many ways. A scheme could choose to adjust contribution levels and/or benefit structures in a broadly actuarially neutral way to account for the increased retirement income people would get from the state pension system. This way, people would receive broadly the same total income from the state and from their occupational pensions, albeit in different proportions.

It is likely that some employers will redesign their benefit structures to new members as a result of the end of contracting out. It will therefore be vitally important for the Government to support employers and schemes during the process of ending contracting out simple and cost-neutral for the employers and schemes. We have outlined the specific details of the easements in Question 8. In addition to specific easements to address the ending of contracting out, the Government should also look at wider deregulatory measures that could be implemented as a package of reforms to help reinvigorate occupational pensions.

8. If the decision is taken to end contracting out, how could the process be best managed so as to minimise any adverse impacts on employers and individuals?

The ending of contracting out for DB schemes is an inevitable part of simplification of the state pension system. But there are a number of ways the Government must help employers and schemes, in order for the transition to transition to the new State Pension system to be successful.

In particular, we believe the Government must:

- **Allow schemes to amend their scheme rules to reflect the ending of contracting out, requiring minimal consultation with scheme members if they are amending rules solely in a broadly actuarially neutral way to adjust for the loss of the National Insurance rebate.** Providing this easement will make it easier and cheaper for employers to amend their schemes, increasing the likelihood that they will remain open. We accept that this overriding power should be temporary and limited only to instances where schemes are amending rules to reflect the ending of contracting out. But as schemes will want to incorporate any changes to their scheme in line with their triennial valuations, we believe schemes should be allowed to make changes to their rules within an appropriate time window. Setting a specific date on which the temporary override is valid would only duplicate administration and expense for schemes. If the Government were to decide to move forward with the ending of contracting out, it must work with schemes and employers to develop this easement further.

- **A legislative fix must found for schemes in former privatised industries, whose scheme rules often prevent re-characterisation of scheme benefits.**

- **Give schemes and employers a sufficient notice period in order to prepare for the end of contracting out.** Schemes will be required to make fundamental changes to the way they provide benefits and many schemes may want to time the changes with their three-yearly valuation cycle to avoid duplicating expensive and time-consuming actuarial calculations. In addition, schemes will need to communicate the changes to scheme members. We believe 5 years is the minimum notice period schemes need. Once the process of ending of contracting out has been completed, any remaining transitional arrangement should be completed in as short a time as possible.

- **Provide certainty for schemes about the details of the reform as soon as they are available.** Many schemes are currently considering the future of the benefits they offer in light of the introduction of auto-enrolment. Some schemes will also be undergoing their triennial valuation this year. Giving schemes more information about reform of the state pension system now will assist them when reviewing their wider benefit package. Schemes also need clarity on how periods of previous contracted out accruals will be treated under a reformed system.

- **Create a "Basic State Pension Reference Test" for schemes that link their definitions of pensionable pay to the Basic State Pension.** Many DB schemes currently define pensionable pay using variations of the Basic State Pension to offset the amount of benefits members receive from the scheme. In many cases, "Basic State Pension" is written into scheme rules. Introducing a Single Tier pension at £140 a week would, in an instant, affect schemes' definitions of pensionable pay and, depending on circumstances, affect scheme members' benefits. To eliminate this anomaly, the Government should create a "Basic State Pension Reference Test" which schemes could continue to use when using the Basic State Pension offset. The reference should continue to be called the "Basic State Pension" and the value of the reference test should be set at the current level of the Basic State Pension, up-rated by the triple lock going forward.

- **Lead a comprehensive and wide-reaching communications campaign in cooperation with employers and schemes,** delivering a coherent and rational message covering issues such as the need to save more for ourselves, the fact that we are all living longer, and that the sate pension age is changing. A clear message that should come out of this communication campaign is that schemes are making changes to benefits because of a Government decision to end contracting out.

- **Streamline the administrative processes associated with the ending of contracting out**. The process of ending contracting out could be made less onerous for schemes if the Government were to grant some flexibility, particularly around Guaranteed Minimum

Pensions (GMPs). HMRC must be adequately equipped to deal with the administration of the ending of contracting out and must engage in an effective communications campaign aimed at employers and schemes.

- **Provide certainty around GMPs**. GMPs are a notoriously complex area of pensions administration. Currently, when a scheme contracts back in to the State Second Pension, they must reconcile all their GMPs to take account of any miscalculations. With the ending of contracting out, some schemes (and HMRC itself) will have to grapple with thousands of GMP calculations all at once. Before ending contracting out, Government must ensure that HMRC is sufficiently resourced to cope with the volume of GMP reconciliations. To help schemes cope with this burden, HMRC should allow schemes to reconcile GMPs at a scheme level. In particular, it would also be helpful if the Government would quantify post-April 1997 Contracted Out Salary Related (COSR) accrual. Finally, the Government must set a date by which all reconciliations will be "locked" with no further changes going forward.

- **Consider how the windfall from National Insurance rebates could be used to reinvigorate occupational pensions** or strengthen the Single Tier pension in the future by increasing its value or widening eligibility or to shorten the transition to the new system.

Each of these measures is integral to a successful transition to the new system following the potential abolition of contracting out. The NAPF has been working closely with the DWP to understand the impacts of the abolition of contracting out on schemes and their members and to explore possible easements for schemes to minimise the effects of abolition. The measures outlined above are the results of initial discussions with our scheme members and will require further work if the DWP were to proceed with the abolition of contracting out. We are committed to continue working with Government to develop how it can support schemes in greater detail by facilitating further discussions with schemes and employers.

Chapter 3 - Means-tested safety net for pensioners

9. In conjunction with the reforms outlined in Chapter 2 are there ways we can change the means-tested system for future pensioners to make it more simple, reduce disincentives and encourage personal responsibility while continuing to help pensioners avoid poverty?

Analysis from the PPI suggests that the introduction of a Single Tier pension would reduce eligibility to Pension Credit to only 5% of pensioners in 2050. Under the Single Tier pension, people would know that whatever they save above the Pension Credit level would not be eroded away by the means test. It will therefore be extremely important that the value of the Single Tier state pension remains above the Pension Credit level going forward. Current uprating arrangements for the Basic State Pension (the triple lock) and Pension Credit (earnings) mean the gap between the state pension system and the means tested benefit threshold will gradually widen over time. However, the Government should signal its early commitment to maintain the value of the Single Tier pension in the future and should take any opportunity to strengthen the value of the Single Tier if the fiscal climate allows.

While the Single Tier option would go some way towards tackling pensioner dependency on Pension Credit (especially in comparison with Option One which has no effect of means tested benefit levels), many pensioners may still find themselves reliant on Housing Benefit and Council Tax Benefit when they reach retirement. Analysis from the PPI estimates that, even after the introduction of a Single Tier pension set at £140 a week in 2011 earnings terms, 15% of pensioners would be eligible for housing benefit and 35% of pensions would be eligible for council tax benefit in 2050.[26]

Given the fact that, under the Single Tier option, the Savings Credit element of Pension Credit would be abolished, it will be important for the Government to consider the impact this would have on eligibility to Housing Benefit and Council Tax Benefit. For example, the Government might want to consider whether the thresholds for eligibility for Housing Benefit and Council Tax Benefit are still appropriate given the wider objective of ensuring that it pays to save for retirement.

Chapter 4 – State Pension age

10. What mechanisms should be used to determine future increases in State Pension age?

The NAPF recognises the need to establish a state pension system which is sustainable in the long term. Trends in longevity mean the costs of providing the state pension will rise in the future. We recognise that people are living longer and unless people are encouraged to work longer, people will spend a greater proportion of their lives in retirement. We therefore recognise that further increases in SPA are inevitable, but they must be done in a fair and reasonable manner that takes account of discrepancies in life expectancy in different parts of the county.

Last year, the Government announced plans to accelerate the increase in SPA to 66 at a faster rate than currently legislated. Under proposals contained in the Pensions Bill 2011, SPA will increase to 66 between 2018 and 2020, giving people only 7 to 9 years to prepare. Around 300,000 men and women will have their SPA increased by up to 2 years and the current outcry against the Government's proposals demonstrates the potential challenges the Government would face when determining any future increases in State Pension age. Women's SPA is currently increasing by six years and it is simply unfair that they haven't been given enough time to prepare. The Government has recently committed to finding ways to better manage the transition for the groups of women most affected by the change but it needs to set out exactly how the transitional arrangements will work as soon as possible.

Therefore, the NAPF believes the best mechanism for determining when to increase SPA and by how much to increase SPA is to establish a permanent and independent commission which would

[26] PPI, "An assessment of the Government's options for state pension reform," 2011.

examine issues around retirement savings and income, including increases in longevity, at regular intervals.

Box 4: A Retirement Savings and Income Commission

The long term nature of pensions requires a long term solution. There is also a need to take the politics out of pensions – and the creation of a permanent, independent Commission would help insulate pensions. A Retirement Savings and Income Commission could have the following characteristics:

- It would assess demographic trends and their impact on pensions – including private and public sector schemes, as well as the state pension system.
- It could identify discrepancies in life expectancy between socio-economic groups and
- It would identify trends in working longer and/or flexible retirement, which might impact the way pensions are designed.
- It would make forecasts on the levels of pension income and pensioner poverty and would assess how the current pensions system provides income in retirement.
- It could also assess levels of financial knowledge and awareness around pensions and make recommendations on communication and financial education.

Increasing longevity impacts not only the state pension system. Pension schemes must also grapple with issues of affordability and sustainability as life expectancy increases for scheme members.

Lord Hutton's Independent Public Service Pensions Commission published its recommendations for reform of public sector pensions earlier this year. In his final report, Lord Hutton recommended that the NRA in public sector schemes should be linked to increases in SPA. We encourage the Government to explore such a mechanism for private sector schemes to use in regards to the accrual of benefits going forward as part of its commitment to reinvigorate occupational pensions contained in the Coalition Agreement.

11. How should the Government respond to the frequent revisions in life expectancy projections while giving individuals sufficient time to prepare?

The decision to increase SPA – no matter if taken by the Government or an independent Commission – will impact different sets of individuals in different ways. While average life expectancy across the UK is rising, the figures hide the fact that people living in the poorest neighbourhoods in England will, on average, live seven years less than people living in the richest neighbourhoods. According to ONS figures, the lowest life expectancy at age 65 in parts of Scotland is 15.7 years. This is almost 10 years lower than life expectancy in wealthy parts of London. As these figures are an average, there will be individuals in some parts of the UK living for only a few years after age 65.[27]

[27] ONS, "Life Expectancy at birth and at age 65 by local areas in the United Kingdom, 2006-2008", October 2009.

The Government must consider the impact a sudden increase in SPA could have on individuals' retirement plans and on their emotional well-being. Phasing the increase in SPA over a period of months or years would give people longer to prepare financially and more time to adjust their retirement plans, therefore resulting in more people working for longer. About 80% of men aged 50-59 and 60% of men aged 60-64 are employed, but this number drops to 20% for men aged 65-69.[28] Some people may find it difficult to cope with increases in SPA, especially if they experience difficulties re-entering the job market.

In the Green Paper, the Government rightly points out that a longer notice period increases the risk that the timetable for increasing SPA becomes out of date by the time the new SPA is reached. But there is something even greater at stake: with too short a notice period, people would be left with insufficient time to plan, increasing the risk they fall back on means tested benefits.

Individuals' ability to plan will become more important as saving in defined contribution (DC) schemes increases in prevalence with the introduction of automatic enrolment scheduled for 2012. Many DC schemes use lifestyling or target date funds to manage risk as individuals approach retirement. In practice, this means investments are moved from riskier asset classes such as equities to less risky assets such as cash or bonds. It is important that individuals (and schemes) are given sufficient notice of changes in their State Pension Age so that their investments are moved at optimal times, especially as 83% of DC scheme members remain in the default fund and 79.4% of default funds use lifestyling[29].

NAPF research shows that, generally, lifestyle funds tend to start adjusting investment strategies between 3 to 15 years before retirement.[30] We therefore recommend that the notice period for changes in SPA be set to reflect this trend in private sector pensions and therefore recommend that the notice period be set around 10 years.

Almost as important as the amount of notice people receive in advance of increases in SPA is the way the increase is communicated. It is vital that the Government implements a comprehensive communications strategy encompassing the increases in state pension age, reforms to the wider state pension system, and the need to save more for retirement. Only with a comprehensive strategy will these changes become part of people's thinking.

[28] PPI briefing note 53, "Could increases in State Pension Age be brought forward?" 2009
[29] NAPF Annual Survey 2010.
[30] NAPF and PensionDCisions, *DC default funds: Today and Tomorrow,* 2009.