NAPF

Securing the future of pensions

Autumn Statement 2012: Building Better Pensions

November 2012

www.napf.co.uk

Contents

Executive Summary 3
Recommendations 5
About the NAPF 5
Recommendations in detail 6
- Building confidence in pensions 6
  - Pensions tax 6
  - Changes to RPI calculation 7
- Easing the burden on funds and sponsors 7
  - DB Funding 7
- Supporting good investment 9
  - Infrastructure 9
  - Gilt issuance 11
- Providing a foundation for saving 12
  - State Pension Reform 12

NAPF

Securing the future of pensions

Executive Summary

The global financial crisis in 2008 and the subsequent downturn have had a profound impact on pension funds and their corporate sponsors.

Pension fund deficits have escalated: first, in response to tumbling equity markets and falling gilt yields in 2009; and, second, as the on-going Eurozone crisis and economic uncertainty caused gilt yields to fall to record low levels as a consequence of the UK's perceived safe haven status and £375bn of Quantitative Easing from the Bank of England. The impact on pension liabilities from falling (and now record low) gilt yields – which have been deliberately depressed as an aim of monetary policy – has seen Defined Benefit (DB) pension fund deficits fluctuate by over £200bn in the last 18 months or so. This problem will have an impact on company balance sheets for years to come as recovery plans are extended and companies are forced to shore up cash or plough profits into the pension fund, rather than into expansion, job creation, or R&D.

More broadly, the challenging economic conditions both in the UK and overseas are making it harder for pension funds to find assets that meet their needs: those that can deliver growth whilst diversifying risks in the case of Defined Contribution (DC) funds; and those that can provide inflation-linked returns over the long run in the case of DB funds. Pension funds have been responding to these difficult conditions, but, in many cases, are subject to conflicting pressures from the Government, the Pensions Regulator and the Bank of England.

At the same time the UK Government has looked to pension funds and savers to help it tackle the shorter term problem of deficit – through changes to pensions tax relief, personal tax allowances and accelerating the rise in State Pension age – and to support the economic recovery by investing in initiatives that will generate growth for the UK economy.

It is important for the Government to realise that using pension fund money as a short-term fix for our current economic problems is not always the answer – especially when it neither on pension funds' terms nor in the interests of their members. Any action of this kind can have long-term consequences that cannot easily be undone and cuts across the Government's wider objective (for which there is a pressing need) of building a long-term retirement savings culture in this country.

It is now widely recognised that the biggest challenge facing the Government's ambitious pension reform agenda is one of trust and stability. Further changes that undermine savers' confidence could be devastating – especially at a time when automatic enrolment is bedding in. The **on-going speculation about further changes to pensions tax relief is incredibly damaging** to pensions,

especially when those changes are aimed at higher earners and end up impacting moderate earners with long service - those trying to do the right thing and save for their retirement.

There are further risks already in the pipeline. For example, the Office for National Statistics' current consultation on RPI could cause huge disruption and confusion for funds trying to secure their long-term funding. The Government should take **full account of any adverse impacts that changes to the calculation to RPI could have** both on savers and on investors in inflation-linked assets.

The Government should also consider how it can support pension funds (and their company sponsors) in the current challenging conditions. The NAPF has called for **explicit acknowledgment of the impact QE is having on DB pension funds and their corporate sponsors**. Our work over the summer and our discussions with employers and trustees indicated that the appropriate response to the current economic conditions and monetary policy interventions from the Bank of England would be to provide short-term respite for companies, rather than a radical change to the funding regime (such as smoothing) that could lead to greater prescription. We estimated that allowing funds to make a modest adjustment to their discount rates could free up £20-£37bn from the FTSE 350 companies that are going through their valuations this year.

Pension funds have been delivering on the Government's objective of increasing investment in growth. We are developing a Pensions Infrastructure Platform and it is critical that the **Government continues to facilitate investment in infrastructure by long-term, low risk investors.** This would involve, for example, re-working the procurement process so as to award higher marks to a lower leveraged capital structure. Failure to do so will mean that investors such as pension funds will always be outbid by other more high-levered investors. Demand from pension funds for long-term, inflation-linked assets will continue to outstrip supply even with an expansion in infrastructure investment and we **urge the Government to issue more index-linked gilts**.

Finally, the Government should **urgently press ahead with its plans to reform the state pension system** into a single flat-rate pension set above the level of means-tested benefits. Clarity and simplicity are needed so that people who save into a pension can do so with confidence. These steps will help to ensure that the auto-enrolment reforms, now finally being implemented, are a success.

NAPF
Securing the future of pensions

Recommendations

Recommendation 1: There should be no further changes to the pension tax system. The relentless upheaval of recent years has imposed huge administrative costs and burdens on businesses and schemes, damaging confidence in pensions as a way to save. The Government should stop tinkering with the system and provide stability so that people can plan and save with confidence.

Recommendation 2: The Government must take full account of any impact on pension schemes, as major holders of gilts, when considering the changes to RPI on which the ONS is now consulting.

Recommendation 3: The Chancellor should explicitly acknowledge the impact QE is having on DB pension scheme funding by using his Autumn Statement to signal a temporary uplift to discount rates that are based on gilt yields (or an alternative discount rate approach) in the light of the current economic conditions.

Recommendation 4: The Government should do more to help facilitate investment in infrastructure by long-term, low risk investors such as pensions funds. This would involve, for example, re-working the procurement process so as to award higher marks to a lower leveraged capital structure..

Recommendation 5: The Government should issue more long-dated and indexed-linked gilts in 2012-13. Regulation and accounting rules have forced pension funds to invest heavily in these instruments and demand for them remains very strong.

Recommendation 6: The Government should urgently press ahead with its plans to reform the state pension system into a single flat-rate pension set above the level of means-tested benefits. Clarity and simplicity are needed so that people who save into a pension can do so with confidence. These steps will help to ensure that the auto-enrolment reforms, now finally being implemented, are a success.

About the NAPF

The National Association of Pension Funds is the leading voice of workplace pension provision in the UK. We represent 1,300 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 16m people and collectively hold assets of around £900bn. Our main objective is to ensure there is a secure and sustainable pensions system in the UK.

Recommendations in detail

Building confidence in pensions

Pensions tax

Recommendation 1: There should be no further changes to the pension tax system. The relentless upheaval of recent years has imposed huge administrative costs and burdens on businesses and schemes, damaging confidence in pensions as a way to save. The Government should stop tinkering with the system and provide stability so that people can plan and save with confidence.

1. The UK tax system is designed to adequately incentivise people to save for their own retirement and for this reason pension contributions are treated as deferred income. The Coalition Government has already introduced restrictions on the Annual Allowance and Lifetime Allowance which are designed to target pensions tax relief on those who need it most. This system is more practicable for both pension schemes and savers than the system of restricting higher rate relief proposed by the previous Government.

2. Changes to the Annual Allowance would not just affect the wealthy. Because of the way AA is calculated, those on moderate earnings in DB schemes could be hit by large, one-off tax bills as a result of modest promotions. Hargreaves Lansdown has calculated that, for a worker with 30 years' service in a 60th final salary scheme, a pay rise of £3,750 in a single year would send them over the limit if the allowance were reduced to £30,000, meaning they would be taxed on pension savings above that amount. Currently a worker in the same pension scheme would not incur tax on their pension contributions until their salary rose by £6,250.

3. Meanwhile those with 20 years' service in a 60th scheme would be taxed on their pension contribution if their wages rose by £5,625 (again assuming a reduction in the Annual Allowance to £30,000), compared to the £9,375 pay rise that they would be able to earn before incurring a tax charge under the current rules.

4. The tax system needs stability. The NAPF continues to call on the Government to abandon any plans to make further changes to the pensions tax regime. With automatic enrolment now being implemented, it is vital that the Government sticks to its commitment to reinvigorate workplace pensions so employers can provide good quality pensions and so employees can save for their future.

5. By restricting higher rate relief or further limiting the amount that individuals can save into a pension, the Government would be fundamentally damaging pension provision. This course of action would cause future generations of employers and individuals to disengage from pension saving.

Changes to RPI calculation

Recommendation 2: Any change in the calculation of RPI which is potentially detrimental to index-linked gilt holders has to be approved by the Chancellor of the Exchequer. The Government must take full account of any impact on pension schemes when considering such a change.

6. The Office for National Statistics (ONS) is undertaking a consultation on four options for the future calculation for RPI, which could have significant implications for pension schemes as major investors in index-linked bonds. The ONS is considering the options from the perspective of statistical methodology and best practice. However, appropriate consideration needs to be given to the potential impacts of such a change upon holders of index-linked gilts.

7. Most DB pension schemes have been de-risking by hedging their liabilities against inflation. Any of the proposed changes would affect schemes with large allocations to index-linked gilts and might lead to pension schemes needing to review their investment strategies. The prospect of change could also cause uncertainty in bond markets, making conditions even more difficult for pension schemes looking to invest in long-dated, inflation-linked assets to hedge their liabilities.

8. Pension schemes are already facing problems caused by the impact that low gilt yields are having on discount rate assumptions, scheme funding deficits and potential recovery plans and sponsor contributions. Continuing uncertainty, especially in the area of inflation-proofing liabilities, is particularly unhelpful to pension schemes and their company sponsors at the current time.

Easing the burden on funds and sponsors

DB Funding

Recommendation 3: The Chancellor should explicitly acknowledge the impact QE (and the deliberate manipulation of the gilt yield) is having on DB pension scheme funding by using his Autumn Statement to signal a temporary uplift to discount rates that are based on gilt yields (or an alternative discount rate approach) in the light of the current economic conditions.

9. The Bank of England recently published analysis identifying the adverse impacts of QE on employers running DB pension schemes, even after the positive impacts of QE on asset values had been taken into account. The current regulatory framework has sufficient flexibility for those running pension schemes to value their liabilities in a way which would mitigate some of the impacts of QE and the UK's safe haven status. However, our members tell us that the way the Pensions Regulator (tPR) behaves in practice is not consistent with this flexibility.

10. Pension funds need more leeway if they are to survive the damaging effects of QE, continue to offer good quality pensions for their members, and free up billions of pounds for businesses to

invest. A report by the NAPF, *DB funding – a call for action*[1], found that even a fairly cautious adjustment to the discount rates being applied to calculate liabilities (with an accompanying adjustment to the assets) could reduce the funding deficits of the FTSE 350 between December 2011 and March 2012 by 40-50%. The report estimated that this would reduce the reported deficits of the tranche of schemes with valuation dates between December 2011 and March 2012 by £20-£37bn.

11. Whilst we welcome the flexibility in the UK's scheme-specific framework, the report argued that trustees, sponsors and actuaries should be given greater assurance by tPR that, in light of the current economic conditions and the Bank of England's Quantitative Easing programme, reviewing the assumptions that feed into the scheme valuation - and making an adjustment where the discount rate is based on gilts - may be appropriate. The report argued that including a temporary mark-up on gilts, for example, was preferable to introducing a new 'smoothing' regime for calculating discount rates (as adopted by the USA, Netherlands, Sweden and Denmark); the temporary mark-up approach would require a more fundamental review of the regulatory framework for DB funding and would lead to much greater prescription in the assumptions used in the scheme valuations and how they are applied.

12. To date tPR has focussed on any offsetting action being taken through the recovery plans. The Regulator concluded in its recent 'flexibility and impact analysis' that 75% of schemes currently going through their valuations would need to extend recovery plans and/or significantly increase their deficit recovery contributions. Some schemes would also need to make assumptions about gilt yield reversion of investment outperformance, whilst around 25% would need to make maximum use of flexibilities in the funding framework because of the affordability challenges for sponsoring employers.

13. Enabling DB pension funds to apply a discount rate that softens the impact of QE and today's very low gilt yields could significantly reduce the pension deficits for those currently going through their triennial scheme valuations without putting the benefits of savers and pensioners at risk. Businesses would not need to hoard so much cash for filling deficits, and could use it for investment, expansion and job creation instead.

14. With many analysts expecting a further round of QE in the coming months, the NAPF is concerned that pension funds will head deeper into the red. Despite TPR's assurances, businesses would feel forced to divert billions of Pounds from investment and growth into filling artificially inflated DB pension deficits.

[1] www.napf.co.uk/PolicyandResearch/DocumentLibrary/0267_DB_funding_a_call_to_action

Supporting good investment

Infrastructure

Recommendation 4: The Government should do more to help facilitate investment in infrastructure by long-term, low risk investors such as pensions funds. This would involve, for example, re-working the procurement process so as to award higher marks to a lower leveraged capital structure.

15. The NAPF and Pension Protection Fund (PPF) announced in October that the Pensions Infrastructure Platform (PIP) had secured the critical mass of Founding Investors needed to move to the next stage of development. A number of the UK's largest pension funds have already agreed to become Founding Investors in the PIP. They include the BAE Systems Pension Funds, BT Pension Scheme, Pension Protection Fund, The Railways Pension Scheme, Strathclyde Pension Fund, the British Airways Pension Scheme and West Midlands Pension Fund. A number of other pension funds are actively considering becoming Founding Investors.

16. With these Founding Investors on board, work will now start on the detailed development of the PIP, and a key next step is the selection of a manager to run the platform. Investment criteria, asset preferences and fee structures will also need to be agreed, and FSA authorisation, if needed, will be sought. Subject to these stages being completed satisfactorily, the Founding Investors will provide investment capital. This ground-breaking platform, which is open to all sizes of pension funds, aims to meet schemes' demand for inflation-linked, long-term investments. The aim is to launch in the first half of 2013.

17. With a target size of £2bn, the PIP is expected to invest in core infrastructure and in projects free of construction risk and on an availability basis so as to avoid excessive GDP risk. It will feature low leverage – no more than 50% per project and across the PIP as a whole. Fees will be low – c.50bpts. Investments will be inflation-linked and the fund is seeking long-term cash returns of RPI +2 to 5%. We believe that this is the right investment structure for UK pension funds, but we also believe it is in the long-term interests of the UK economy for major infrastructure assets to be owned by long-term, stable, investors.

18. However, there are a number of areas where we believe the Government could do more to help facilitate this investment. Current government bidding processes in relation to infrastructure-related projects tends not to place a favourable weighting towards more modest levels of leverage. If long-term, low-risk, investors are to enter the market, we propose that the procurement process should be re-worked so as to award higher marks to a lower leveraged capital structure. Failure to do so would mean that investors such a pension funds would always be outbid by other more high-levered investors, who are effectively subsidised through the tax treatment of debt.

19. Similarly, the Government should seek to modify the approaches adopted by the various regulators which currently incentivise high leverage for the purpose of reducing the after tax costs of capital. Instead, regulators should incentivise long-term stable capital structures. The

current regulations for the UK water sector (in PR09) provide a possible template for how a better acknowledgement of lower leverage could be achieved – it provides a floor on gearing and a base level of debt-related tax allowances.

20. The PIP is being designed to deliver inflation-linked cash returns (with a target of RPI + 2 - 5%). In this way, the PIP will help ensure pension funds can better match their assets to their (inflation-linked) liabilities. Regulated utilities, including those in the energy sector, are likely, therefore, to be an attractive investment for the PIP. However, the European 3rd Energy Directive restricts investment in both the transmission and generation sectors. In practice, this would mean, for example, that the PIP and other investors could not hold assets such as OFTOs (Offshore Transmission Owners, which provide inflation-linked stable cash flows, available on a 20-year concession) and generation assets that can also provide inflation-linked, stable cash flows through renewable energy-linked tariffs. This restriction unnecessarily narrows the range of infrastructure assets that would be attractive to pension funds. The NAPF, therefore, is urging HM Treasury and colleagues at DECC to a) call on the European Commission to clarify this Directive where it applies to long-term investors; and b) urge Ofgem to review its regulations which have implemented this Directive in the UK in a way that is not currently attractive to long-term investors.

21. The NAPF has further concerns that the current review of the IORP Directive could limit the capacity of pension funds to invest in infrastructure. The proposed Solvency Capital Requirement for infrastructure is 49%, as the Commission's proposals view the asset class as high risk simply as it is unlisted. This is not how we see the PIP which will be clearly positioned as part of pensions' de-risking strategies, as reflected in the inflation-linked, low-risk returns we are seeking. We note that the European Commission, as part of its forthcoming Green Paper on Long-term Investment (due in January 2013), has asked EIOPA to examine this part of the IORP review. We urge Government to continue to engage with the Commission and EIOPA on this issue, particularly as it relates to Europe's 2020 growth agenda.

22. Finally, an area of particular concern is the Local Government Pension Scheme (LGPS) investment regulations, which place restrictions around the legal structure of LGPS investments, in particular investments in limited partnerships (LPs) and collective investments. A number of our Local Authority members have told us that they are very close to the 15% limit on LPs, which they say is a hindrance to them investing in infrastructure, including through the Pensions Infrastructure Platform. We therefore welcome the consultation from the Department for Communities and Local Government on options to alter the relegations to allow further infrastructure investment where that is in the pension scheme's best interests. We want to see a swift resolution to this issue so that appropriate investment is not hindered at this critical time.

Gilt issuance

Recommendation 5: The Government should issue more long-dated and indexed-linked gilts in 2012-13. Regulation and accounting rules have forced pension funds to invest heavily in these instruments and demand for them remains very strong.

23. The further rounds of Quantitative Easing (QE) have continued to depress returns on pension schemes' holdings of gilts and on other long-term assets, widening pension fund deficits and reducing the returns that pension funds can get on investment of new money and reinvestment of maturing debt holdings, interest and dividends. Both reduce the affordability of providing decent pensions and undermine the sustainability of occupational pension provision.

24. Pension scheme liabilities are long-term and schemes need assets of the right duration to match liabilities. Over the past five years, DB pension scheme allocations to gilts and fixed income assets have risen from 28% to 40% of total assets (*Purple Book, 2011*). Today, DB pension funds own around £75bn of government fixed-income securities and £140bn of index-linked securities. The continuing trend to de-risking means that schemes will wish to increase their allocations to long-dated, index-linked assets, which better match their liabilities**.**

25. The 2011-2012 remit saw a welcome increase in index-linked issuance, up by 13.6 per cent, but we were disappointed that index-linked and long-term conventional issuance combined was little changed as a proportion of the total from the previous year.

26. We continue to recommend a further sharp increase in long-term – and particularly long-term indexed – issuance in 2012-2013. 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 when interest rates rise.

27. Long-term gilts remain extremely good value for the Government. The yield on conventional long-term gilts remains extremely low, while the real yields on long-term indexed-linked gilts have become negative.

28. It is important that the Government keeps the case for the issuance of CPI-linked gilt issuance under review. With more pension fund liabilities linked to the Consumer Price Index, we are convinced that there will be strong demand for CPI-linked issuance, provided CPI-linked gilts can be issued without undermining the wider inflation-linked gilts market.

Providing a foundation for saving

State Pension Reform

Recommendation 6: The Government should urgently press ahead with its plans to reform the state pension system into a single flat-rate pension set above the level of means-tested benefits. Clarity and simplicity are needed so that people who save into a pension can do so with confidence. These steps will help to ensure that the auto-enrolment reforms, now finally being implemented, are a success.

29. The NAPF has been arguing for a simpler, more generous Foundation Pension for some time. We believe a Foundation Pension, combining the Basic State Pension and State Second Pension set above the means-tested benefits threshold, is absolutely fundamental to changing people's attitudes towards saving for retirement and to making automatic enrolment a success. The introduction of a Foundation Pension would mean that people can save for their retirement with confidence, knowing their savings will not be eroded by means-tested benefits.

30. This is why we were extremely pleased when the Chancellor confirmed the Government's commitment to publish a White Paper in the Budget in March. With the implementation of automatic enrolment now under way, it is even more imperative that people understand what "the deal" is before they make decisions about whether to remain automatically enrolled or whether to opt out. The benefit of a Foundation Pension is that it complements the introduction of auto-enrolment, ensuring that people know it "pays to save" in workplace pensions.

31. We recognised, however, that there will be complex transitional issues, especially for contracted-0ut DB schemes. Ending DB contracting-out as required by the Foundation Pension will have significant implications for employers and schemes. This is why it is vital that the Government provides measures to help employers and schemes cope with the ending of DB contracting out. In particular, the Government must provide employers with a statutory override to help them manage the loss of the contracted-out rebate. We also believe the Government should relax the consultation requirements when employers make changes directly resulting from the ending of DB contracting-out. In combination, these measures will give employers the help they need to make ending DB contracting-out a success.

32. Giving certainty to schemes is one way the Government can help make the process of ending DB contracting-out easier. Schemes will need sufficient time – 5 years post Royal Assent - to prepare for the ending of contracting-out, so we encourage the Government to publish its White Paper as soon as possible.

Further information
For further information please contact:
Darren Philp
Director of Policy
darren.philp@napf.co.uk
020 7601 1700
November 2012