PENSIONS AND
LIFETIME SAVINGS
ASSOCIATION

THE PENSIONS AND LIFETIME SAVINGS ASSOCIATION BUDGET SUBMISSION

TAX REFORM SHOULD HARNESS THE INCENTIVES IN THE SYSTEM NOT REMOVE THEM

29 January 2016

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LIFETIME SAVINGS
ASSOCIATION

ABOUT US

We are the Pensions and Lifetime Savings Association; the national association with a ninety year history of helping pension professionals run better pension schemes. With the support of over 1,300 pension schemes and over 400 supporting businesses, we are the voice for pensions and lifetime savings in Westminster, Whitehall and Brussels.

Our purpose is simple: to help everyone to achieve a better income in retirement. We work to get more money into retirement savings, to get more value out of those savings and to build the confidence and understanding of savers.

SUMMARY

- The pensions system needs stability to realise the benefits of recent reforms.
- Changing the pensions tax system would reduce the incentive to save and threaten future government revenue.
- The pensions freedoms will not work for savers unless trustees have the power to help them.
- Defined benefit schemes need more index-linked gilts to meet their promises.
- Infrastructure projects should be designed for long-term investment.

This year we reach the culmination of a decade of reform to build a pension system fit for the twenty-first century. We now have a system which provides a strong, simple foundation in the form of the new, flat-rate State Pension. Automatic enrolment has reversed years of decline in people saving for their retirement and the new Pension Freedoms have the potential to give savers greater flexibility over how they draw an income throughout their retirement.

This Budget is an opportunity to consolidate the huge potential that now exists in the pensions system. We need to ensure that the existing reforms are implemented successfully, with a clear focus on the long term and the interests of savers.

So we call on the Government to:

PROTECT AND ENHANCE THE STRONG INCENTIVES TO SAVE WHICH ALREADY EXIST THROUGH A COMBINATION OF AUTOMATIC ENROLMENT, EMPLOYER CONTRIBUTIONS AND THE EXISTING PENSIONS TAX REGIME

Having worked through the options in close consultation with Treasury officials we believe no change is the only option which can maintain incentives to save within a sustainable tax framework.

A move to either 'taxed, exempt, exempt' (TEE) or a single rate would be bad news for savers, employers and ultimately Government. Either would reduce the incentive to save for millions of people and their employers and add cost and red tape for employers, threatening the success of automatic enrolment and the prosperity of future pensioners.

The Government should instead undertake a thorough, independent review of tax, pensions and retirement policy so that we can seek sustainable solutions which continue the alignment of Government (both current and future), savers, employers, industry and broader society which has driven the success of automatic enrolment so far.

GIVE TRUSTEES THE POWER TO HELP SAVERS MAKE THE RIGHT DECISION

Most people approaching retirement will not take financial advice, so other sources of help and support will be critical.

Trustees should be given powers to clearly signpost the schemes or products that they (or others) assess to be generally good value and suitable for their membership.

Savers would still be free to choose, while those who are unwilling or unable to make a choice would have their interests safeguarded.

PROVIDE LONG-DATED, INFLATION-LINKED ASSETS TO HELP DB SCHEMES MEET THEIR LIABILITIES

Just under a third of the UK workforce are still accruing benefits in DB schemes with £1 trillion in assets. They need a sufficient supply of long-dated, inflation-linked assets for DB schemes to meet their liabilities, but the supply of index-linked gilts available them will be lower than demand until around 2038.

The objectives of the Debt Management Office should be amended so that it can take into account the impact of insufficient supply of inflation-linked assets, and act accordingly.

MAKE INFRASTRUCTURE WORK FOR LONG-TERM INVESTORS

The National Infrastructure Plan (NIP) 2014, identifies a £410bn pipeline of new UK infrastructure investment projects, two thirds of which will be privately financed.

There are also a great number of operational UK infrastructure assets that would make attractive investments for pension funds.

But the Government needs to engage with pension funds early to design and structure these assets to make them suitable investments. Increasing the number of projects under PF2 would also help. And investors need assurance that contractual terms will not be changed retrospectively.

PENSIONS TAX RELIEF

The Government's '*Strengthening the incentive to save*' consultation document and subsequent Ministerial statements make clear that 'no change' to the system of tax relief remains an option. No change is the option the Government must take to protect the existing and, through automatic enrolment, growing partnership between employers and employees, which is the true source of incentives to save.

We share the Government's desire to strengthen that incentive and **we call on the Government to undertake a thorough, independent review of pensions and retirement policy in the round so that we can seek sustainable solutions which continue the alignment of Government (both current and future), savers, employers, industry and broader society which has driven the success of automatic enrolment so far.**

In our response to the consultation we evaluated the main options for reform and concluded that each would have detrimental effects for schemes, sponsors, savers and the Exchequer.

A move to a **Tax Exempt Exempt** system would:

- leave a hole in future Government finances; our analysis suggests that a system with a 10% upfront incentive (necessary to ensure savers do not lose out) would reduce tax revenues by around 15% over 25 years;
- significantly disrupt the roll-out of automatic enrolment by creating market uncertainty and additional costs for employers and schemes;
- increase administration costs for DC schemes which will feed through into higher charges for members – 63% of our members estimate it would result in a charge increase of at least 10 basis points;
- create payroll conversion costs for all employers estimated by our members as a cost of at least £50,000 per employer;
- lead to the closure of any DB pension scheme which is able to close in order to avoid the cost of completely restructuring benefits around net pay; and
- create a future generation of pensioners who are contributing less and less in terms of income tax while growing as a proportion of the population, making the system unsustainable from the outset.

A move to a **single rate of tax** of 25% (the effects described below would be exacerbated were the rate to be set at 20%) would:

- lead to 4.6 million higher rate taxpayers facing double taxation for saving in a pension: a clear disincentive to save;
- cause employers to restructure their employee benefits packages away from long-term savings in order to protect higher earners from double taxation – half our

members report they would reduce pension contributions and replace with cash or other benefits;

- cause the loss of higher earners and higher contributions from schemes which would lead to a loss of efficiency and cross-subsidy which in turn would lead to higher charges for those who remain; and
- moving to a single rate only delivers more tax revenue to the Exchequer today if the single rate is set at a level below 30% and, even then, delivers very little benefit in net present value terms. The lower the single rate, the less incremental benefit to the basic rate taxpayer and the less attractive the system is for higher rate taxpayers, thereby accelerating their withdrawal from pension schemes and creating problems for later Governments.

Both TEE and single rate would undermine the straightforward messaging which has underpinned employee acceptance of automatic enrolment. It would no longer be the case that all workers get their contributions at least matched through the combination of tax relief and employer contribution. Explaining the benefits of pension saving would become more difficult not simpler. We are not aware of any evidence that either will lead to higher levels of pension saving.

TOWARDS A FUNCTIONING MARKET AT RETIREMENT

The reforms announced in the 2014 Budget have given many new opportunities to savers and have prompted much activity in the pensions sector. There is now a lively debate about how to best meet customer needs and, indeed, what those needs are.

The Pensions and Lifetime Savings Association believes that the “at retirement” market needs to be shaped in order to meet customer needs. As things stand the Association believes that the market is not well placed to meet customer needs. This issue will become more serious as DB winds down and people become more dependent on their DC assets to access the retirement income they say that they want.

We believe that the problem in the “at retirement” market is twofold. First, the demand side seems too weak to drive the kind of product evolution that those reaching retirement need. In the accumulation phase it took concerted policy effort: principally the introduction of automatic enrolment and the Better Workplace Pensions agenda to drive change. Something similar will probably be required in the decumulation phase.

The second issue is that the mechanism for accessing retirement products is weak. Current policy places too much emphasis on the ability of individuals to make choices in a market, either on their own using perfect information or through accessing financial advice. Our analysis, which we set out in our response to the Financial

Advice Market Review Call for Input, shows that most people reaching retirement do not take financial advice[1]. This approach was found wanting in the annuity market and the decisions being asked of retirees are now significantly more complex than the annuity purchase decision.

Our research[2] shows that when making financial decisions a range of sources are often consulted. For those reaching retirement with sufficiently large pots, or where their employer provides advice, then financial advice is likely to be welcome and utilised. However for the vast majority this is unlikely to be the case and the cost of advice can be a barrier. Therefore for the majority, other sources of help and support will be critical.

A solution is needed that allows people to access the freedoms but makes the line of least resistance the right thing for most people most of the time. In designing this it will be important to learn the lessons of the accumulation phase, while at the same time realising that the default approach in the accumulation phase cannot simply be ported over to decumulation. That would not allow savers sufficient freedom and would risk people being placed in a retirement product before they had thought through the consequences. We set out our more detailed analysis of the at-retirement market in the Association's response to the FCA's CP15/30 consultation[3].

We believe that the right answer would be to allow trustees to clearly signpost to schemes or products that they (or others) assess to be generally good value and suitable for their membership as a whole but that preserve future choices for those choosing to use them. This would preserve savers' abilities to choose while ensuring those who are unwilling or unable to make a choice would have their interests safeguarded. The Pension Quality Mark Board are currently considering responses to their recent consultation[4] on launching a quality standard for in retirement products.

[1] 31% of those aged 55-70 who had started to think about accessing their pension savings between April and September 2015 had paid for or planned to pay for independent financial advice: http://plsa.co.uk/PolicyandResearch/DocumentLibrary/~/media/Policy/Documents/0559-Financial-Advice-Market-Review-Call-For-Input.pdf

[2] Pensions and Lifetime Savings Association, *Pension Freedoms: No More Normal*, January 2016

[3] http://www.plsa.co.uk/PolicyandResearch/DocumentLibrary/0560-CP15-30-Consultation-Response-By-The-Pensions-And-Lifetime-Savings-Association.aspx

[4] http://www.pensionqualitymark.org.uk/documents/31_rqm-consultation-paper-on-developing-a-retirement-quality-mark-november-2015.pdf

INFLATION-LINKED ASSETS

Despite the decline of DB pension schemes in the private sector in recent years (just 13% remain open in 2015, with 34% closed to future accrual[5]) DB pension provision remains an important part of the retirement landscape and will do so for years to come. Just under one-third of the workforce are still accruing benefits in a DB scheme, with schemes themselves managing around £1trillion worth of assets. It is therefore crucial that employers sponsoring DB schemes can meet their obligations to scheme members without facing undue impact on their ability to invest and grow their own businesses.

To meet their liabilities, DB schemes need to invest in assets which return an inflation-linked stream of income for decades to come – particularly as they mature and close to future accrual. Demand for liability-matching investments has been increasing over recent years – 50% of the Association's fund members responding to our 2015 Annual Survey stated that their appetite for this sort of investment had, once again, increased over the previous 12 months[6].

Historically, schemes have met this demand through investing in index-linked gilts. However, research by the Association undertaken in 2014 showed there is a significant shortfall in the funds required to meet future demand. In order to fully hedge schemes liabilities, pension schemes would need access to an inflation-linked market of approximately £1 trillion. The total market value of current index-linked issuance was £495 billion at September 2015[7]. According to our projections, the supply of the index-linked gilt market available to pension schemes will be lower than demand until around 2038[8].

This persistent gap between supply and demand results in pension schemes bidding up the price of index-linked gilts, making pension promises more expensive for sponsoring employers than they otherwise would be, and thereby diverting corporate investment away from other areas of the economy.

To address this, and to ensure a sufficient increase in supply to enable sponsors both to meet their promises and invest in growth, **we call upon the Government to amend the strategic objectives of the Debt Management Office so that, in**

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[5] PPF, Purple Book 2015,
[6] Pensions and Lifetime Savings Association , Annual Survey, December 2015
[7] DMO quarterly review, September 2015, http://www.dmo.gov.uk/documentview.aspx?docname=publications/quarterly/jul-sep15.pdf&page=Quarterly_Review
[8] DB run-off, NAPF, 2014, http://www.napf.co.uk/PressCentre/NAPFbuzz/~/media/Policy/Documents/0389_NAPF_DB_run_off_report_June_2014_DOCUMENT.pdf

its role advising on managing government debt, it can also take into account the impact of insufficient supply of inflation-linked assets.

INFRASTRUCTURE

If structured correctly to provide long term, low risk, inflation linked cashflows, infrastructure investment can play a valuable role in enabling DB schemes to match their liabilities. Increasing the scale of institutional investment into UK infrastructure would also be highly beneficial to the economy.

The Pensions Infrastructure Platform (PiP) has already helped mobilise over £1bn of investment into UK infrastructure projects ranging from hospitals and schools PPP/PFI projects, renewable energy and the Thames Tideway Tunnel "super sewer". PiP became a fully authorised AIFM in January 2015 and will shortly launch a directly managed multi-strategy fund.

From the work done to produce the most recent last National Infrastructure Plan (NIP) in 2014, the Treasury has identified a £410bn pipeline of new UK infrastructure investment projects, two thirds of which will be privately financed. There are also a great number of operational UK infrastructure assets that would make attractive investments for pension funds. Three principal issues are, however, continuing to prevent realisation of the potential for pension funds to make significant investments in this market.

The first is that the NIP has not traditionally gone beyond identifying projects to the next level of indicating which new assets will be structured in a way to make them attractive to long term investors. Pension schemes are reluctant to commit to building in-house expertise and collective solutions such as the PiP cannot realise their full potential to invest in primary (new) assets, on the basis of the generic list of assets that the NIP has historically contained.

The Government must work with its newly established National Infrastructure Commission (NIC) to develop a clear pipeline of suitable assets, with appropriate structures and investment characteristics, and make them available to long-term investors. Increased and much earlier consultation with pension schemes about projects the Government is seeking to fund would help achieve appropriate deal structuring to attract pension scheme investment capital.

The PF2 regime for PPP investments was intended to attract pension fund investment to primary PPP assets by making equity funding easier and implementing structures that suit long-term investors. However, take-up of PF2 has been relatively slow and the new project PPP market is shrinking as a result.

This lack of movement in the primary market is increasing competition – and hence prices – for secondary PPP assets. High prices tend to favour short-term investors who structure their purchase with high levels of debt. Pension schemes want long-term, low-risk investments with inflation-linked returns, but this market does not work for them. **Government should significantly increase the number of projects being brought forward under the PF2 initiative.**

The third issue concerns the stability of the UK's legal, regulatory and subsidy regimes. The infrastructure assets that appeal to pension scheme investors are by their very nature long term. To help pension schemes to make long term, 20-25 year, investment decisions it is important that there is confidence in the regimes under which these assets will operate for their foreseeable lives. The perceived stability of the UK legal and regulatory regimes is one of our key advantages in attracting long term capital for infrastructure investment.

To preserve and enhance this advantage, **the Government should reconfirm it will never retrospectively legislate to change the contractual terms of infrastructure assets which are already operating.** The Government should also implement long term, transparent and predictable evolution of subsidy regimes that apply to long term projects. Recent unpredictable changes in the area of renewable energy (significant reductions in solar PV feed-in tariffs and the cancellation of the White Rose carbon capture and storage project for example) have begun to erode the confidence of developers and investors that it is worth taking on the long term development and construction of assets.

Finally, it is imperative that all potential participants, especially those in major new infrastructure developments, can be confident that the critical political decisions will be taken to enable projects to progress. Where timetables are provided they must be adhered to. Major infrastructure projects will inevitably affect many individuals and businesses. Some will benefit, some will be disadvantaged. In the age of social media there will also inevitably be pressure groups opposing projects and supporting them.

It will always be easy to delay a decision to allow for more research or consultation. Major projects need courageous decision making to make them happen. If the Government is serious about wanting to attract UK pension fund investment into UK infrastructure (as the Chancellor said in his autumn statement in 2012 and more recently in relation to investment by local authority pension funds) it must be prepared to take bold decisions with a focus on the long term, not short term political expediency.

The funding, financing and construction skills are all available in the UK to deliver major projects. The critical constraint on delivery is political decision making.