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Green Paper on Demographic Change
DG EMPL/E1
J-27 01/122
European Commission
B1049 Brussels
Belgium

Our Ref: JM/CS/4.23

26th July 2005

Dear Sirs,

EUROPEAN COMMISSION GREEN PAPER "CONFRONTING DEMOGRAPHIC CHANGE: A NEW SOLIDARITY BETWEEN THE GENERATIONS"

We have considered with interest the above green paper.

Our specialisation is in employer sponsored pension arrangements in the UK and it is therefore not within our competence to prepare a detailed response spanning all EU member states, or even to comment in detail on the demographic situation in the UK.

We did, however, prepare a paper for the Pensions Commission in the UK, which is considering in very broad terms the future of pension provision in this country, which is clearly a major factor in any discussion of the effect of demographic factors in this country.

I am pleased to enclose a copy of our paper. If you would like to discuss any part of it in more detail, please let me know.

Yours sincerely

John Mortimer
Secretary

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SPC'S RESPONSE TO THE FIRST REPORT OF THE PENSIONS COMMISSION

(1) INTRODUCTION TO SPC

SPC is the representative body for the providers of advice and services needed to establish and operate occupational and personal pension schemes and related benefit provision. SPC's Members include accounting firms, solicitors, life offices, investment houses, investment performance measurers, consultants and actuaries, independent trustees and external pension administrators. Slightly more than half the Members are consultants and actuaries. SPC is the only body to focus on the whole range of pension related functions across the whole range of non-State provision, through such a wide spread of providers of advice and services.

The overwhelming majority of the 500 largest UK pension funds use the services of one or more of SPC's Members, as of course do many thousands of smaller ones. SPC's growing membership collectively employs some 14,000 people providing pension-related advice and services.

(2) SPC COMMENT IN RESPONSE TO THE FIRST REPORT OF THE PENSIONS COMMISSION

Factual Accuracy and the Commission's Judgements About Key Variables

1) As far as we can ascertain, there are no areas where the first report is factually wrong or where the Commission has failed to take into account relevant information sources.

2) We consider that the Commission's judgements about key variables are broadly reasonable overall (but see paragraph 21). The assumed equity risk premium is arguably slightly too high, but this is counter-balanced by an assumption on implicit costs which is also possibly slightly too high. However, in a money purchase environment short-run deviations from assumptions which are reasonable in the long-term can have a significant impact, for better or worse, on benefit outcomes for individuals.

The Role of Government in Pension Provision

3) The government should provide a contributory or credit-based flat rate non-means tested first tier pension at a level which aims to ensure that nobody who has worked, undertaken unpaid caring duties during their working life, or has for some other good reason undertaken little or no paid work, should be faced with absolute poverty in retirement. Participation should be compulsory for both employees and self-employed.

4) Should the government do more than this? Or should it be for individuals, employers and product providers to organise any provision above this basic level? We are not convinced that the government's role should be restricted to just providing the first tier needed to escape poverty. Pension provision is very difficult for most people – visualising old age is difficult, as is making the sacrifices to provide for it, and the necessary investment decisions. Employers can do much to ensure proper provision, but a significant proportion of the population do not have, and will never have, an employer sponsored pension. We see a legitimate role for government, in providing a second tier of pension in which participation by employees and the self-employed would also be compulsory unless they had equivalent provision by another route. Financially attractive and simple contracting-out arrangements would make an important contribution to encouraging equivalent provision by another route.

5) Whatever the government's role, however, it is essential that people understand what it is. When SERPS was introduced, the government communicated that it was looking after pensions for most people. This was a reasonable message – everything was earnings linked, the State Pension was around 20% of average earnings, and SERPS provided 25% of relevant earnings. So for a single person on average earnings the two would give around 40% of gross pre-retirement income. When State pensions were cut back, firstly through changes to indexation and then through the SERPS changes, there was not such a strong message that under the new system people needed to provide for themselves if they wanted a decent retirement income. That message has broadly been communicated now, but far too late. A key role for an ongoing Pensions Commission could be honest communication about the State benefits. Whoever carries out the communication, State provision must be properly and clearly explained to the general public.

6) The government's role in pension provision should also cover assisting in dealing with failure of the market, if it arises, to deliver what is necessary for adequate retirement provision; facilitating well informed choice by individuals; legislating to provide an appropriate level of security for contributions and for any benefit promises; and supporting provision above the level needed to avoid absolute poverty, either by offering it directly or by encouraging private provision by employers and individuals, to replace it through durable tax reliefs, which clearly reward long term saving and through simple and financially attractive contracting-out arrangements. The government should recognise that its involvement in determining the shape of private provision is likely to be unhelpful.

7) An example of where the government might help with market failures would be in addressing current fears that the market alone will not be able to provide sufficient capacity to meet coming demand for annuities as money purchase replaces defined benefits.

8) Individuals, employers and providers will only maximise their potential to organise provision if they can be confident that the costs they incur in doing so will not simply reduce entitlement to first tier pension provided by the state. It is therefore essential that pension provided by the State is not means-tested. They also need to have justified confidence that what the State provides will change only as a result of a fundamental need for change, and not as a result of shifts in political vision on a change of Secretary of State, government or governing party.

Dealing with Current Problems

9) Considering the options set out by the Commission, we do not consider that pensioners becoming poorer relative to the rest of society is a realistic option for addressing the current problems in UK pension provision. The aim should be to ensure that as far as possible higher average retirement ages make the greatest

contribution to the challenges described in the Commission's report. The contributions earmarked for retirement also need to rise and to be paid for longer.

Trends in the UK Pension System

10) Predicting the future must to some extent involve an attempt to learn from the accumulated experience of the past. Inevitably, some of the experience from which we seek to learn will be irrelevant to the future. We broadly agree, however, with the Commission's description of trends in the UK pension system. We consider, however, that the Commission understates the post-retirement inflation risk borne by individuals in defined benefits schemes, given that such schemes are required to provide only limited price indexation. The report therefore overstates the transfer of inflation risk to individuals on a move from defined benefit to money purchase.

11) The Commission also understates the extent to which the security of the pension promise in a defined benefit scheme depends upon the covenant of the employer as well as the adequacy of scheme assets.

12) The Commission's analysis also fails to recognise the strains which regulatory creep has imposed on defined benefit schemes. Very few employers are capable of delivering the guarantees now imposed on defined benefit schemes, and in particular the risks on winding up of a scheme.

Defining Adequacy of Provision

13) We consider that the Commission's bench-mark definition of "adequate" income replacement represents sensible aspirations, but ones which will not always be met, sometimes as a result of conscious individual choice. In some cases individual needs for income replacement will be significantly affected by whether or not they own the property in which they live and on other income in a household. The government can play a key role in helping individuals to make well informed choices about what is adequate for them.

14) We believe that the Commission's analysis of the groups of people likely to be inadequately provided for, and those likely to be well provided for, is accurate. There is however one further category of people who are at risk of joining the category of inadequate provision. These are individuals who are currently accruing benefits in defined benefit schemes which will cease future accrual (having already been closed to new members). If these individuals' period of defined benefit accrual was brief, and future accrual is money purchase with lower contributions levels, their overall provision might well prove to be inadequate.

The Commission's Macro Model

15) The information available to us suggests that the Commission's macro model of likely future pension contributions and pension incomes is on average reasonable for the purposes to which it is put in framing the Commission's report. But in a money purchase scheme an individual does not get the average – he or she gets a specific return which can be a lot less. The use of average returns in projecting money purchase benefits can mislead people into believing that the return (or something close to it) is assured. This can lead to them taking on commitments as though their projected income were certain.

16) We view the investment return assumptions as more crucial, however. These are the same as those used elsewhere in the report and we have already indicated that these seem broadly reasonable.

17) We note that the model assumes 60% investment in equities throughout the accumulation phase. There is no quantitative statement of the risk involved in this level of equity investment and this is important, given our understanding that the model, rightly, assumes that pension outcomes are money purchase. It needs to be properly understood that at times, based on past experience, the state of the equity market will result in poor outcomes for those converting accumulated funds into benefits.

The Role of Non-Pension Financial Assets

18) We consider that non-pension financial assets could play a bigger role in pension provision in future, for example through the sale of a business or a house. But the availability of non-pension financial assets will be patchy and their purchasing power in terms of pension will be unpredictable. We therefore agree with the Commission, that they cannot be relied upon to play a major part in overall pension provision.

19) Housing wealth in particular, especially via inheritance, could play a significant role in pension provision on average and overall, but, as the Commission suggests, it does not provide a sufficient solution because of the pattern of distribution of pension rights and housing assets.

20) The overall emphasis must remain on encouraging the build up of financial assets specifically intended for pension provision.

The Viability of a Voluntary System

21) We believe that a voluntary system can work at lower income levels, but probably through provision made through employers, rather than products sold by providers directly to individuals (we view lower income levels ending nearer to £20,000 p.a., rather than the £30,000 implied in the Commission's report). In this context, the distinction between employer based and retail provision is probably as significant as that between State and non-State provision. The Commission's judgement about key variables arguably omits one of the important influences on the variables, which is whether the pension is work based or retail. This does not just affect costs, it also affects contribution rates – the average contribution rate to a work based pension is higher than to a retail pension, especially for the lower paid. Pension provision through an employer, who accesses potential members, collects contributions and passes them on to a provider, can already be extremely cost effective. It is not administration costs which inhibit employer sponsored provision but an unwillingness to engage with administrative complexity and a fear among advisers of negating entitlement to State means tested benefits. It is essential that voluntary saving at lower income levels supplements benefits provided by the State, rather than replaces it.

22) The Commission asks whether there is a segment of the market, comprising lower income, lower premium savers, which cannot be served profitably by the financial services industry on a voluntary basis, except at a reduction in yield which makes saving unattractive to the saver. There undoubtedly is such a segment, but its size could be reduced by minimising the regulatory complexity involved in serving that area of the market and by removing the risk that saving by people on low incomes and paying low contributions will reduce their entitlement from the State under a means tested system. Means testing represents a large dis-incentive to save or to advise people to save.

The Position of Women

23) As a long term aim, we support the principle that all individuals, men and women, should accrue pensions in their own right.

24) We must, however, avoid the temptation to place over reliance on the pension system to solve the difficulties which women can face in retirement.

25) Women's pensions are often lower because they have shorter periods in work in which to accumulate pension savings (because they usually carry the main burden of caring responsibilities within a family) and because, while they are in work, they earn less than men.

26) A proper recognition of the unpaid caring responsibilities carried by women, in terms of pension entitlement, should be given with through the eligibility conditions for pension provided directly by the State.

27) There is evidence that the position of women is improving, so that we can come closer to the aim of having a system in which all individuals accrue pensions in their own right. Pay inequalities have not yet been eradicated but many more women can now expect to have working lives as long as those of men and more are now likely to be members of pension schemes than previously. Pension sharing on divorce will improve the position of divorced women. A facility for one person to make pension contributions on behalf of another would make it easier to transfer resources within a household to enable women to build up their own pension rights.

28) For the time being, however, the provision of spouses' benefits in occupational pension schemes must be accepted as a valid option for ensuring satisfactory provision for women.

Compulsory Private Saving

29) The case for compulsory private savings, over and above any first or second tier provision compelled by the State, is extremely weak. Because of the variability of outcome in money purchase provision, which will relatively soon become the dominant component of private sector pension provision, compulsory private saving cannot be relied upon to provide the predictable basic level of pension needed as the foundation of any durable and robust pension system. Only the State has the capacity to meet this need.

30) The effect of compulsory contributions for employers, on top of existing compulsory contributions to the State (national insurance) would vary. Some employers might consider that the introduction of compulsory minimum contributions provided an acceptable reason to reduce existing contributions, over and above those to national insurance, to the minimum compulsory level. Others would be faced with a substantial increase in employment costs which they would have to address by reducing costs elsewhere in the business or by employing fewer people than they would otherwise employ and/or paying them less. Experience in Australia provides evidence that companies reduce pension contributions to the compulsory minimum.

Design Features of a Compulsory System

31) The Commission asks, if compulsion was introduced, what design features would be required to ensure an appropriate balance between individual choice, guidance on sensible investment approaches and low cost administration.

32) Given that we oppose compulsory third tier private savings as a policy option, we see limited value in commenting on how to smooth a journey down the wrong path.

33) We suggest, however, that, if compulsion was introduced, the move to the ultimate level of compulsory employer/employee contributions would have to be phased in, to reduce the immediate impact on both parties of the new financial requirements on them.

34) There would need to be a change of attitude on pay. Pay and pensions would need to be seen as part of a single package and it would need to be accepted that higher pension contributions could be at the expense of lower current disposable income. Such a change of attitude would be difficult to achieve.

35) There would need to be very simple arrangements for bringing individuals into membership of schemes. To minimise complexity for employers, the only way for employees to obtain the compulsory employer contribution, would have to be to join the scheme offered by the employer. Employees should not have the option to require employers to direct the employer contribution to a scheme of their choice. If employees wished to make their own arrangements they would have to meet whatever minimum contribution was required entirely from their own pocket.

36) There would need to be no doubt that employees could automatically be enrolled into scheme membership without having to give explicit consent. This is arguably not currently possible in the case of employer sponsored non-occupational schemes.

37) A suitable default investment strategy would need to be in place to cater for the likelihood that many of those paying compulsory contributions would exercise no choice of their own on how the contributions were invested.

38) If compulsion was introduced against the backdrop of current means tested State benefits, contribution levels would need to be set high enough to give a reasonable likelihood that they would produce benefits at levels which did not simply cancel out entitlement to the State benefits.

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