'Where next for pension reform? How can we encourage people to save?'

ILC Policy Paper and notes of Dinner debate (22 February 2010) supported by Aviva

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International Longevity Centre – UK

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'Where next for pension reform? How can we encourage people to save?'

On Monday 22nd February, the International Longevity Centre, UK (ILC-UK) invited a number of stakeholders interested in pensions issues, to a dinner debate, sponsored by Aviva to discuss pension reform and saving.

Throughout the dinner debate, participants considered:

* Should we see further increases to the state pension age (beyond that which is currently happening)?
* What can we learn from behavioural economics in terms of encouraging people to save?
* What is the role for NEST and how can we support its introduction?
* Where next for Pension reform?
* What are the challenges and opportunities for a new Government?

Paul Goodwin of Aviva and Lawrence Churchill (ILC-UK Trustee and Chair Elect of NEST) introduced the debate before Baroness Greengross introduced and chaired the dinner debate. The dinner debate did not take place under the Chatham House Rule and the notes below represent an ILC-UK perspective on the debate. They do not necessarily represent the views of the participants.

The Policy Context

This year marks the 101st anniversary of the first state pension payment. To qualify for the state pension in 1909 you needed to reach 70 to receive up to five shillings a week. The pension was provided after a number of tests including a residency test.

Only half a million people received a pension in 1909 but with us all living longer and the pension age falling, there are now over 12 million pensioners. In 2009/10 more than 700,000 people reached State Pension Age. The basic pension is £95 per week. Some may receive less than this due to gaps in contribution record, others more due to the additional state pension. Those with limited overall incomes may qualify to have their income topped up and Pension Credit provides a single person with a minimum income of £130.

13 years ago Nat West Bank produced a report called “A changing Nation” which called for a new Beveridge report on pensions, and an increase in the State Pension Age to 67 (at Income Support Level).

In 2005 the Independent Pensions Commission chaired by Adair Turner published the report "A New Pension Settlement for the Twenty-First Century". The report talked of four options. Either we would have to work longer, save more, pay more tax or we would see poorer pensioners.

The Turner Commission resulted in long-term changes in pension policy including plans for an increased state pension age alongside a committment to increase in the annual pension by earnings (not inflation) and a reduction in the number of National Insurance Contribution (NIC) years. That said, we still have a situation where the

basic state pension alone is an inadequate source of income for people to live on free from poverty.

Following the Pension Commission report the Government's White Paper, published in May 2006 (and followed by the Pensions Act 2007) focused on reforming the state pensions system.

A second White Paper, Personal Accounts: a new way to save, published in December 2006, contained further proposals, with an emphasis on encouraging private saving. These measures were legislated for in the Pensions Act 2008, which became law in November 2008.

Despite the progress made over the past 10 years, it is clear that pensions policy is likely to develop further over the course of the next Parliament. Lord Turner, for example. has already conceded that 70 rather than 68 may have been a better aim in terms of current plans for increasing the State Pension Age.

The next couple of years will see the introduction of auto-enrollment and the National Employer Savings Trust (NEST – previously called personal accounts).

Participants at the ILC-UK debate considered the case for an independent pension authority between Government, the employer, the individual and the industry. Such a body could help take the politics out of some pensions decisions. Whilst there was some sympathy for the creation of such a body, it was argued however that because pensions amounts for such a huge proportion of government spending, politicians will inevitably find it a difficult decision to willingly lose control over some of these aspects of the state budget.

It was clear from our debate that there is a general consensus on the direction of travel needed in terms of pension reform. That said, the detail is important and there are significantly different viewpoints on this detail. What is important however, is that future reform of the state and private pension system is not kicked into the long grass. There is an appetite for more urgent reform and Government must not shy away from this challenge.

The State Pension Age

We live in an ageing society, one where not only are we living longer, but we are retiring earlier. Had Government increased the state pension age commensurate to average life expectancy (since 1907), the current age of eligibility would be 72.

However a relatively rapid increase in the state pension age to 72 would be unattractive and would have a disproportinately negatively impact on the lower social classes[1] (those unskilled or working in manual/routine jobs) who are likely to live fewer years than the richest people in society. It would also be very unfair to those close to retirement who may find it difficult to make alternative arrangements.

[1] As indeed does any any single State Pension Age. The current State Pension Age discriminates against those in lower social classes.

If we are to see such a change, we will also need to see major structural change in the employment market with jobs widely available for those in their 60s and new attitudes to employing older workers.

Furthermore, an increasing State Pension Age makes the Default Retirement Age even less defendable.

Employer bodies argue that the current system works in that around one third request flexible working at the DRA and that eight in ten of these are accepted. ILC-UK is not however convinced that the Default Retirement Age is an essential performance management tool. Any practical implications to the end of a DRA should not be major barriers to its removal.

One participant argued that the "concept of the Default Retirement Age will go. It is history. In the future it will seem as outdated as women not being given voting rights".

That said average retirement age is currently under 65 (but is a combination of both voluntary or involuntary 'retirement'). However, younger generations seem to be more likely to have an attitude that they don't believe they will ever be able to afford to retire.

Any further increase in the State Pension Age will also make it vital that the DWP (and other Government bodies) ensure that there are initiatives to help keep/support the older (60 plus) workforce.

At the same time there seems to be (perhaps unsurprising) political consensus that a more generous state pension should be the medium term objective of Government. A rise in State Pension Age could help enable the Government to deliver a 'decent' income and would allow people to build on this through private saving. A 'decent' universal state pension could also provide a trade off against a faster increase in State Pension Age

That said, whilst there is consensus in terms of the objective, there is very real debate as to the means of achieving this. Some argue strongly that a universal (or near universal) Citizens pension could be afforded partly through the earlier capping (or scrapping) of the State Second Pension.

Poverty in old age – The role of Saving

The majority of the population does not save enough money to ensure that they have an adequate income in retirement. As a result we have 2.4 million people living in poverty later in life (before housing costs)

A survey published last year revealed that half of adults between the age of 20 and 60 are not saving for their pensions. The under 30s were least likely to be saving with only about 36% of these contributing towards a pension scheme. The Wealth & Assets Survey shows that 76% of the employed (between 35 and 64) has some pension wealth but only 24% of the unemployed has pension wealth. The difference

between men and women is marked but less distinct when looking at men and women in employment.

A springboard to saving would be one where the consumer knew that every penny they saved would result in them being wealthier later in life[2].

At the moment however, means testing means that this is not a reality for those saving small amounts. For these people, saving may actually be simply pulling themselves out of eligibility for the means tested benefits. This makes it difficult to advise people on low incomes to save for their retirement.

Money advisers often say that as a rough estimate you should take the age you start paying your pension and halve it, and put this percentage of your salary aside each year until you retire. Using this formula, someone starting to save for a pension at 32 would need to save 16% of their salary for the rest of their life. But if you start at 20 you would need to put just 10% of your salary into a pension. Most people fall well short of this target.

Incentives to Save: It could be argued that there are few rational reasons for deferring expenditure for up to 40 years and that incentives to save could be larger. Even for those who fear being poor in retirement face a challenge that it is difficult to act rationally over such a long timescale. And there remains debate over what the most rational form of behaviour actually is!

Yet there is a myth that people on low incomes cannot or will not save. Low income individuals do save and e.g. Christmas savings clubs continue to be very popular[3]. That said, one very real barrier to saving is the current levels of indebtedness in the country. The Consumer Credit Counseling Services attracts over 300,000 calls to its helpline each year. And for some their budget dictates that they have more going out than coming in. For many it makes more economic sense to pay of debt rather than to save.

At the same time, pensions tax relief is arguably inefficient and poorly targeted. Just 1.5% of the population claim about 25% of tax incentives. There is a case for pension tax relief to have be restricted further, beyond the restrcitions on higher rate relief planned for 2011-12. Further reducing the proportion of tax relief going to a small proportion of the wealthiest savers could provide funding to support the goal of a universal decent state pension.

Over recent years the Government has piloted, with success, the Savings Gateway, which allows for working age lower income individuals to save small amounts and receive a matched contribution from Government. There is a case to explore whether further matching could better incentivise pension saving than current initiatives. In addition to tax relief, the Australian Government does offer a matching scheme for pension savings for low and middle income earners.

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[2] Although it must be noted that surveys don't tend to support the argument that means testing is a barrier to saving.And people don't tend to know how much they are likely to receive in retirement.
[3] And the Savings Gateway, see below, has proved effective.

The application of behavioral economics could help encourage people to save more. If we design the pension and savings system to capitalises on inertia we could see much higher savings rates. And auto-enrolment is a good example of the sort of nudge which can help push people in the right direction.

In some ways, easy access to consumer credit creates an “anti-nudge”. It is much easier to get a loan/credit than it is to save. Perhaps we need to make saving as easy as borrowing.

There remain major issues facing women in relation to pensions policy. Care of children, divorce and elder care all impact heavily on the ability of women to provide for themselves in retirement.

One policy change which could benefit women (and men) would be a move towards more flexible pension pots. Some argue that pensions are not flexible enough to meet income needs across the lifecourse. There is a case for Government to consider the case to incentivise and support the financial services industry in producing products which help people draw down against long term savings at the point the most need it.

A final observation made by one participant was that society needs to find a way of making saving during the lifecourse a social norm again. Research highlights that many younger people do believe that saving is a good thing but have negative stereotypes that those who have saved are the ‘misers’, living austere lives. Another part of the problem is the negative image many younger people have of old age; there is frequently a perception that old age is a boring and bleak time and not worth thinking about.

The role of information and advice

Complexity in the pension and benefits system creates a barrier to saving and makes it difficult to provide advice. A key aim of Government policy should be to deliver a pension system which is simpler and less complex than the current one. It is not just means testing, but issues such as the State Second Pension, which add to the complexity faced by individuals when undertaking retirement planning. And at the same time, understanding of annuities is very low. Many people in retirement don’t shop around for the best annuity

If consumers are to make the right savings decisions across the lifecourse, it is vital that they have access to information to aid that decision. At the moment people receive their state pension forecast 4 months before retirement. This is too late for individuals to make alternative plans. It is now possible to get a state pension forecast earlier (you need to apply online, by post or by phone) but this requires and individual to choose to seek out this forecast. It is important to get this information to more people and earlier.

It is also important to help free the hands of companies and reduce the barriers to them talking to their employees about long term saving. Employers should be free to talk about pension savings, but not be seen as giving advice.

The voluntary sector advice sector has a key (and relatively trusted) role to play in both helping tackle indebtedness and in delivering support to help people move from debt to saving. Financial advice can act as an important nudge to behaviour.

Options for Decumulation

We currently have large numbers of people who have multiple (but often small) pension saving pots. This is an issue of concern when it comes to ensuring retirees can make the most of their savings. As a result of job mobility and the end of defined benefit pension schemes, this is a problem which could become even more pressing.

Age UK have made recommendations to amend annuities regulation so as to make life easier for people with small pension pots. They have argued that tax legislation should be amended so that

- pension savings that are too small to annuitise can always be drawn in cash without penalty, regardless of the type of pension scheme they are in;
- the lump sum from drawing a very small pension fund in cash ('trivial commutation') is taxed no more heavily than either a lump sum from deferring state pension or a cash payout from a very large fund;
- the 'trivial commutation' limit is not linked to the lifetime allowance for pension savings, which is being frozen from 2011. The trivial commutation limit should be set independently so that it can reflect the needs of small savers.

ILC-UK support these recommendations and would also advocate for more support to make annuities more attractive and make it easier for all annuitants to make use of the open market to ensure they get the best return on their savings. We would also support initiatives to facilitate consolidation of multiple small pots before retirement.

Some participants argued that pensions and annuity legislation constrains the industry from developing alternative retirement income products (e.g. variable annuities) whilst others argued that new retirement income products should be looked at carefully to ensure that they do not expose individuals to inappropriate or poorly understood risks.

Others pointed out that Solvency II could have a very negative impact on the attractiveness of annuities. Age UK has, for example, called for a review of annuity funding.

Some participants expressed concern about proposals which would mean an end to compulsory annuitisation. It was felt is a very real risk that this an end to compulsory annuitisation could result in people running out of money unless there are controls to avoid this – which will effectively means that such a policy would benefit only the better-off. An end to compulsory annuitisation could send the wrong message about a product which is a good product and remove an importtant 'nudge' which ensures that people have some security of income in retirement.

A high proportion of wealth is held by parts of the older population (particularly 50 to 64 year olds) is in the form of housing wealth. These assets could help support a decent income later in life yet liquidating or using these assets in other ways is not

always easy. It is important that housing wealth is considered in the mix when examining ways to generate an income in retirement.

Priorities for the Next Government

ILC-UK believes that, in the context of pension reform, the next Government (alongside the financial services industry) should seek to prioritise the following over the next five years:

- End pensioner poverty
- Do more to help us to save
- Ensure we have the right policy making environment
- Deliver an environment which supports successful decumulation
- Implement solutions which work for all generations

End pensioner poverty

Poverty in later life: all stakeholders must work together to attack the continuing problem of pensioner poverty. Pension policy should contirbute towards this goal.

Do more to help us to save

ILC-UK believes that Government and the financial serivices industry must do much more to support increased levels of long term saving.

Incentivise saving: We must find new ways of improving the incentives for those on low incomes to save. ILC-UK believes that Government should explore the case for extending matched saving either as an addition to or replacement for tax relief (up to a certain limit).

A 'decent' State Pension: A 'decent' universal state pension would provide a basic income and ensure that a high proportion of additional savings would result in a higher income. Means testing remains a barrier to saving and Government should seek to reduce the numbers and proportions of older people who find themselves on means tested benefits.

Advice and Information: Individuals must have access to impartial and accurate information and advice. Money Guidance could help alongside further Government and private sector initiatives to promote financial literacy. It is important for people to better understand how much money they are likely to have to live on in their old age. Government should move towards automatically informing people of their State Pension Forecast regularly through their life course. Individuals should not be expected to seek this information out. At the same time, more should be done to help people understand how private and public provision works together.

State Pension Age: Many argue that the projected increase in the State Pension Age to 68 in 2046 is too little, too late. ILC-UK believes that future Governments are likely to return to the issue of State Pension Age..

Adequate forewarning of any increase in the State Pension Age is necessary however, and any increases in the State Pension Age must go alongside initiatives to ensure a decent universal state pension and further and mroe significant stepsw tackle health inequalities. Government must ensure there are no discriminatory barriers to us working longer.

ILC-UK believes that an Independent Commission should determine the state pension and that such a body would help take some of the politics out of pension reform.

Supporting older workers: Government should abolish the Default Retirement Age so as to remove a barrier to older people working longer. They should also work to ensure that Government policy actively supports older people in the workplace for longer.

The role of employers: There is much to do to support employers in providing advice to employees. And Government must continue to support the employers to help them, help their staff make the right decisions. In the context of NEST, Government must be clearer about their expectations of employers in terms of advice and support.

Ensuring we have the right policy making environment:

The policy making environment must better facilitate long term pensions policy and we need to ensure that we have the best pension architecture. The effectiveness of auto-enrollment in increasing saving, the Suitability of 8% contribution?, the incidence of levelling down by employers must all be kept under review and requirements tightened if necessary.

Drive Consensus: The consensus created as a result of the Turner report has been useful for savers, older people and the insurance industry. It is of course important that we debate the options for reform. But a process which leads to consensus is more likely to be successful in the long term. This could help ensure a nurturing environment exists to support an active private sector.

Create a permanent Independent Pensions Commission: It is important for a new Government to make bold decisions and not put off difficult policy in relation to pensions reform and savings. Pension reform is often delayed by the problem of short term political imperiatives. At the same time, there has been a relatively high turnover of Pensions Minister within Government. Pensions reform is not aided by instability at the top.

ILC-UK believes that an Independent Commission could help take some of the short term political imperitavies out of pension reform. The Commission would sit permanently like the Monetary Policy Committee. Such a body would make recommendations to Ministers about pension policy (including State Pension Age)

Learn from Behavioural Economics: The emerging theories of behavioural economics could help encourage people to save more. If we design the pension and savings system to capitalise on inertia we could see much higher savings rates. Whilst this has begun with NEST, for example, more can be done in this area (e.g. using behavoral economic theories to promote the open market option for annuities).

An environment which supports successful decumulation

Annuities: Government should consider changing the regulatory and tax regime for annuities so as to tackle some of the problems related to, for example, people with small pension pots. ILC-UK do not believe that an end to compulsory annuitisation would be in the interests of older people.

Decumulation strategy: Government and the private sector should work together to find ways of helping people monetarise housing wealth. They should also seek to find ways to tackle the problems associated with timing risk in relation to annuities.

Flexible pension pots. Government should also looking at barriers to flexible use of savings in retirement. More flexible long term savings should not however be a replacement to a pension, and care should be taken to ensure taht these are not seen as an alternative. Whilst more flexible pension pots could in theory benefit women, most women's pension pots are too small to be used across the lifecourse and there is a risk if people draw down pension savings early it will eat into their standard of living in retirement.

A solution for all generations

Pensions policy should not result in intergenerational unfairness. An environment which supports long term savings and an adequate income in retirement should be an issue of concern to all generations. That said, there is a very real risk that over the next few years, pensions will become a weapon for intergenerational debate and disagreement. Clearly any changes to the pension regime should not discriminate unfairly against future generations. But we do need to look to the long term if we are to deliver a pensions system which works well for all.

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