The Pensions Institute

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Philip Moon Esq
Clerk of the Committee
House of Commons Work & Pensions Committee
7 Millbank
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Dear Sir

Pensions Inquiry: Response to the DWP's Green Paper and Inland Revenue Review

In summary, the DWP Green Paper and Inland Revenue Review propose, within the context of a 'voluntarist' approach to pension planning, to:

- simplify the tax regime for pensions;
- help people make better informed choices about their retirement;
- reaffirm the role and responsibilities of employers in the pensions partnership, improving saving through the workplace, and providing greater protection for members of occupational schemes;
- encourage simple and flexible savings products, broadening access to the financial services industry; and
- introduce measures to extend working lives.

These proposals are all very desirable and some, indeed, are highly imaginative, such as the proposal to recognise the life-time nature of pension planning and to have life-time limits on tax relief rather than annual limits. But to be effective in a voluntarist context, they require the following:

- well-informed consumers with the skills needed to make rational life-time financial planning decisions and capable of understanding and responding to the tax incentives offered;

- enlightened employers willing to accept responsibility for making adequate contributions to the pension arrangements of their employees in direct proportion to the time that these employees worked for them;

- an efficient and innovative financial services industry willing to design and sell life-cycle investment products at low cost.

It is hard to accept that these conditions hold in the UK at this time. I therefore have the following problems with the proposals:

- They remain voluntary. Even with the welcome simplifications proposed, pension planning will still be too complex for many people and as a consequence the necessary increase in pension savings that the government desires might not materialise. A voluntarist approach is valid if people bear the consequences of their own decisions. If people, given the incentives to make long-term savings decisions, choose not to do so, then they face poverty in retirement. However, if they can then claim means-tested benefits from the state, there is a major moral hazard problem arising from these voluntary arrangements. In short, why should people bother to save if they do not have to and can still end up with an adequate pension in retirement from the state?

- The illustrative calculations in the Green Paper showing the ‘modest’ level of saving needed to achieve a pension of a particular size in future are based on very high future real returns and make no allowance for the risks involved in achieving those returns, no allowance for inflation in retirement and no allowance for mortality improvements. To illustrate this, I reproduce Figure 2.8 (p. 28) which presents savings amounts and rates required to retire on half and two-thirds of final salary in 2050, taking account of both state and private income:

Gross replacement rate		Gross weekly earnings over working life			
		£300	£400	£500	£600
Half	Savings amount	£5	£30	£55	£70
	Savings rate	1%	7%	11%	12%
Two-thirds	Savings amount	£30	£60	£85	£110
	Savings rate	10%	15%	17%	18%
Assumptions: Certain real returns of 4% p.a. during the accumulation phase, level annuities (with no allowance for inflation) during the decumulation phase with mortality based on 2002 data and with no mortality improvements assumed.					

- The weakening of the reference scheme test for DB schemes to contract out of S2P together with scheme-specific transfer values (rather than a national standard for transfer values as there was with the Minimum Funding Requirement) makes DB schemes considerably less attractive to scheme members, but probably does little to save them from extinction in the long term.

- Substantial complexity still remains, particularly in respect of the contracting out arrangements for defined benefit schemes and the transfer arrangements between defined benefit schemes. Considerably greater simplification can be achieved with defined contribution schemes.

- There is no discussion of the reluctance of the financial services industry to promote stakeholder pensions (a very good product from the consumer's point of view) on account of their low costs and the pressure by the financial services industry to have these costs raised (e.g., by charging for advice)

I remain of the view that:

- greater compulsion will sooner or later be necessary;

- defined benefit schemes are still too complex and risky for many private-sector employers to operate even with the weakening of the reference scheme test;

- the only real future for private sector employees is well-designed and well-funded defined contribution schemes (designed as commoditised products requiring generic but not specific advice) along the lines proposed in the Pensionmetrics research at the Pensions Institute: see David Blake, Andrew Cairns and Kevin Dowd (2001) <u>Pensionmetrics: Stochastic Pension Plan Design and Value-at-Risk during the Accumulation Phase</u> (http://www.pensions-institute.org/wp/wp0102.pdf) and David Blake, Andrew Cairns and Kevin Dowd (2002) Pensionmetrics 2: Stochastic Pension Plan Design During the Decumulation Phase (http://www.pensions-institute.org/wp/wp0103.pdf).

Yours faithfully

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