Britain’s Pension Reforms: a new departure?

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Outline of presentation

• The UK pension scheme: structure and logic
• Pensions Commission Reports (2004-5) and their implementation: recent reforms
  – The state pension - Tier 1
  – Private pensions - Tier 2 (and 3):
    • Auto-enrolment (NEST)
    • Pension Freedom (the death of annuities?)
• Continuing issues
  • Pension inequalities
  • Governance problems
Preface: UK: a short history

Since 1946, policy aims to foster private pensions, to supplement basic state pension (BSP)

– Tier 1: BSP: NIC funded, flat-rate, subsistence level (lower)
  • Supplemented by public assistance (Pension Credit)

– Tier 2: occupational pensions
  • Private (employer-based DB) funded schemes: cover peaks in 1967 at 50% working population
  • State Earnings-Related Pension (SERPS, 1978 – S2P from 2002): a deviation from earlier policy: for those with no employer scheme

– Since 1986: consistent policy to extract state from earnings-related pensions and restore original flat-rate BSP

– In 2016, this will be achieved (against all the odds).
Summary chart of UK pension development

- Tier 1
  - 1940s: State basic pension
  - 1950s: State graduated pension
  - 1960s: State 2nd Pension
  - 1970s: SERPS
  - 1980s: Personal Pensions
  - 1990s: Stakeholder pension
  - 2000s: Additional Voluntary Contributions
  - Free-standing AVCs
Promoting voluntary action: ‘contracting out’

• 1959: firms ‘contract out’ of higher state pension
  – employers with funded DB schemes pay lower NICs (plus corporation tax gives more incentives)
  – Conditional on Tier 2 pension meeting pre-defined levels
  – [1978 SERPS / S2P for those excluded from Tier 2 scheme]

• 1986: Individuals can ‘contract out’ of Tier 2 schemes

• Post 2000: ageing, financial crises, FRS 17 (etc)
  – Employers convert schemes from DB to DC.
  – Employers ‘contract back in’: state liability rises
  – 2013: only 840 of 45,000+ DB schemes stay open
Second and third tier pension cover and contracting out.

Men and Women with second tier pension provision by principal type of cover during the tax year

- State Earnings Related Pension (SERPS) / State Second Pension (S2P)
- Contracted Out Salary Related (Public Sector)
- Contracted Out Salary Related (Private Sector)
- Contracted Out Money Purchase and Mixed Benefit (aggregated data)
- Appropriate Personal Pension+ Appropriate Personal Pension Stakeholder (aggregated data)
The Pensions Commission (2004-6)

• Critique: UK pensions too complex:
  – Planning retirement impossible
  – Administration is too complex & expensive
  – BSP too low: Pension Credit penalises small savers
  – Private pensions cover too few: S2P is poor value

• Recommended (general principles accepted)
  – BSP at subsistence level: remove Pension Credit
  – Abolish SERPS / SP2: savings to fund new BSP
  – Universal Tier 2 pension: National Pension Scheme
Reforming the BSP: Tier 1

• ‘Contracting out’ & mandatory retirement ages abolished
• State Pension Age (SPA) raised
  – Women reach parity with men (65 years) in 2018
  – For all, raised to 66 (2020): 67 years (2028): thereafter in line with life expectancy
• Full BSP requires 35 NIC years (2012)
  – Child care credits up to age 12 years: credits for sick, unemployed etc.
  – Abolition of survivor’s pension from 2016
• From 2016 BSP = c. £155 per week (for those who never ‘contracted out’ and meet NIC requirements)
• Cameron’s ‘triple lock’: BSP will match inflation rate, cost of living index or 2.5% - whichever is highest.
Reforming private pensions: Tier 2 Auto-enrolment - NEST

• Employers must auto-enrol all employees (2012-18)
  – Who pay income tax (now £10k pa) & employed 3 months
  – Min 8% contribution to DC pension (3% employer, 1% state, 4% worker) by 2018.
  – Roll-out by employer size (largest first)
  – Opt-out rights for workers (but opted in every 3 years)

• NEST : statutory, elective, low-cost, private pension provider
  – Max contributions: £4,200 p.a. per contributor

• April 2015: Decumulation reform - ‘Pension Freedom’
  – Annuities no longer required (had been mandatory at 75)
  – Access to Tier 2 pension savings at 55 years
Results and limitations

• BSP: a higher basic rate, favouring poor & women, but:
  – not available for those reaching SPA before April 2016
  – lower pension rates for those previously ‘contracted out’
• Auto-enrolment and NEST: extends Tier 2, but:
  – employers use current pension provider (ignore low cost alternatives)
  – 8% p.a.: sufficient to create good pension income for low paid?
• ‘Pension Freedom’ welcome (annuities unpopular), but:
  – already ‘trivial commutation’ (<£18k in pension pot) and retired with £20k p.a. income were exempt. New policy for the remaining elderly.
  – stimulates resistance / exit penalties from providers (earlier access).
  – lump sum withdrawals are taxed at marginal rates
  – mandatory ‘guidance’ for all with pension pots above £30k
Continuing problems (next slides)

• Pension inequalities and gaps
  – Inequalities in wealth
  – Inequalities by gender
  – Inequalities between generations

• Governance (supplementary pensions)
  – Failures of competition
  – Portability and persistence issues
  – Management (AMC) costs
Context: voluntarism & impact of 2007/8 GFC.

• Crash 2007/8 & After: savers’ problems
  – Lower pension fund balances/ interest rates
    • 2014 report: average DC saver loses 0.7% p.a. 2000-13
  – Jobs: growth part-time / temp. / self-employed and in-work poverty – especially young workers
  – More household debt (rising housing costs)

• Pre-2012: falling numbers covered by Tier 2

• Widening dispersal household pension wealth
  – Professionals marry professionals
Aggregate household private pension wealth (only those with any private pension): deciles 2008 /10

Source: ONS 2012 Part II ch. 4. Note that 24 per cent of UK retired households have no private pension wealth and are not included.
Gender issues
(and loss of survivor’s benefit from 2016)

• Pension calculation: 40+ years full-time work
  – Female work patterns differ (high child care costs)
    • Professional women comply with male working life
    • Poorer women: part-time jobs to suit domestic duties.

• Rising SPA creates confusion over BSP access

• Irregular job = part-time (or no) Tier 2 pension
  – Tax threshold of £10k for auto-enrolment
  – 2008-10 female DC pension savings = 50% male (average)
  – Scottish Widows: 17% pension loss for rearing one child
Average gender-derived pension gaps in EU member states

Source: Bettio et al. 2013: 34
Intergenerational inequality

- 40+ years to accumulate a Tier 2 pension
  - Loss of compound interest in early years not compensated by later year contributions
- Younger workers bore brunt of GFC.
  - Zero-hours contracts, unpaid internships etc.
  - Student debt rising (undergrad. fees = £9k p.a.)
  - Rents in south (esp. London) have rocketed
- Question: can this generation sustain £5 trillion cost of public sector + BSP in future?
Governance problems 1: Failure of competition

- Failures past and present due to low financial literacy
  - Annuities: many providers, anti-social products
    - Highest pension income for risk-taking behaviour
    - Retired do not get ‘best value’: 66% buy single life from current provider (not index linked, no widow’s pension)
  - Employers, auto-enrolment: extend own scheme
    - Low charge alternatives (NEST) neglected in favour of providers who do more administrative work
    - DC charges on savers, not employers (low paid hit hard)

- Result: regulation and ‘nudging’ to secure behavioural changes create higher compliance costs
Governance problems 2: labour market mobility

• Portability and persistence: problems of time
  – Workers change jobs, leave work (childbirth), change names (marriage): stop saving (GFC)
  – Firms amalgamate / go bust / lose records
  – Accrual multiple ‘pots’ per individual: personal responsibility to trace on retirement
  – Auto-enrolment: more smaller ‘pots’: higher costs

• Result: £3 billion ‘orphan’ (lost) pensions

• More regulation: obligatory transfer small pension savings (<£10k) but incurs charges and raises costs
## Governance problems 3: AMCs

**Figure 1** Comparative value of hypothetical funds built up from Initial lump sum of £10k (assumes seven per cent nominal growth over 25 years)

<table>
<thead>
<tr>
<th>Provider</th>
<th>Protected fund value after 25 years (£)</th>
<th>Proportion of fund lost in fees (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>HSBC Life</td>
<td>32,172</td>
<td>41</td>
</tr>
<tr>
<td>Friends Provident stakeholder</td>
<td>40,209</td>
<td>26</td>
</tr>
<tr>
<td>“Low-cost” stakeholder *</td>
<td>42,215</td>
<td>22</td>
</tr>
<tr>
<td>“New” stakeholder **</td>
<td>40,131</td>
<td>26</td>
</tr>
<tr>
<td>NEST basic ***</td>
<td>48,123</td>
<td>11</td>
</tr>
<tr>
<td>Pension fund with no fees at all</td>
<td>54,274</td>
<td>0</td>
</tr>
</tbody>
</table>

* assumes charges of 1.0 per cent of assets under management.

** assumes charges of 1.5 per cent of assets under management and 1.0 per cent thereafter.

*** assuming charges of circa 0.48 per cent of assets under management.

**Source**: Financial Times Money Supplement, 13 Feb 2011, and own calculations.
‘Where there is money there are sharks’: explaining higher charges

- State regulation: marketing, fraud, fiscal changes, consumer guidance: fund transfers ..
  - Compliance costs have accrued post 2012
- Structure of industry: 45,000+ private funds (down 50% since 2008)
  - Run by trusts, insurance companies, employers
  - 75% of funds cover c. 15% of contributors
  - No economies of scale: duplication of personnel, premises, legal and financial consultancies etc.
Where charges go ...

BARELY ENOUGH TO FEED ME, LET ALONE THE CAT.

YEH, AND I STILL WANT MY BONUS.
Public view of private pension manager
Conclusions: UK pensions as constant work in progress

• Opaque policy-making. Treasury consults industry, specialist financiers, legal firms etc., no public debate
  – Citizen transformed into consumer of products
  – Loss of public confidence and trust in providers and state

• Short-term policy-making
  – Future costs of social care of elderly untouched
  – Predictions of means-testing BSP as cost of this plus public sector pensions to next generation is unsustainable

• Recent reforms reproduce existing insider-outsider problems, with new generational twist.
The future is not looking bright ...

Open the tunnel... here comes the choo choo