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PENSIONS COMMISSION COMES IN FROM THE COLD

1 INTRODUCTION

Rarely has pensions been such an overtly political issue. On 30 November 2005, after weeks of speculation on – and allegedly objections to – its contents, the Pensions Commission's Second Report finally came in from the cold. A copy of the Report can be found at:

<http://www.dwp.gov.uk/publications/dwp/2005/pensionscommreport/annrep-index.asp>

2 KEY RECOMMENDATIONS

- Reform the state pension system to underpin private saving.
- Provide a state pension which is less means-tested and which rises in line with average wages and not prices.
- Increase state pension age, possibly to 66 by 2030, 67 by 2040 and 68 by 2050 (variations on this theme are also put forward). The clear idea is to link state pension age to increasing life expectancy.
- Establish a National Pension Savings Scheme to boost pension savings, with automatic enrolment (subject to the ability to opt-out) for those individuals "not covered by other adequate pension arrangements".
- Employers who do not operate a work-based pension scheme would face 3% compulsory contributions to the above scheme.
- Contracting-out should be phased out gradually.

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3 REMIT

The Pensions Commission, headed by Lord Turner, is an independent body set up in the wake of the Pensions Green Paper to keep under review the system of private pensions and long-term savings in the UK.

Its First Report was published on 12 October 2004 with the aim of “stimulating debate” on dealing with the challenge of providing pensions for an ageing population¹. It identified four possibilities – including:

- Lifting taxes to pay for state pensions;
- Raising saving levels;
- Increasing retirement ages;
- Accepting that the number of poorer pensioners will grow.

4 KEY OBJECTIVES

Recognising that “major reform of the UK pension system is needed to create a new settlement for the 21st century”, the key objectives underlying the Pensions Commission’s Second Report include the need to:

- “Overcome the barriers of inertia and high cost which deter voluntary private pension provision;
- Maintain employer involvement in good quality pension provision;

¹ See our Sackers Extra Alert “Pensions Commission publishes report” dated 12 October 2004, available from the client area of our website www.sackers.com or from your usual contact.

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- Prevent the spread of means-testing which would occur if present indexation arrangements continued indefinitely;
- Be sustainable in the face of rising longevity and of uncertainty over how fast that rise is occurring;
- Be less complex and more understandable;
- But maintain the improvements in the relative standard of living of the poorest pensioners which the present means-tested approach has achieved.”

Set against this backdrop, it is not altogether surprising that the Pensions Commission's key recommendations focus on a fairly radical shake-up of state pension provision and the establishment of a National Pension Savings Scheme (NPSS).

5 STATE PENSION PROPOSALS

The Commission's preferred way forward for dealing with the state pension system is to gradually change the existing arrangement of the basic state pension (BSP) and S2P, the state second pension based on an individual's earnings and contributions. Its reforms centre on the creation of two flat-rate pensions, with the value of BSP linked to the growth in average earnings (and not, as now, to the increase in prices) and S2P becoming flat-rate over time.

The advantages of this approach from the Commission's perspective include the ability to make future accrual of BSP individual (in the sense of not being linked to a spouse's entitlement) and universal (i.e. based on residency). The latter will help to ensure that all UK residents, even those with interrupted work patterns, can look forward to a "significant floor" of state pension.

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In terms of increasing state pension age, although the Report canvasses the possibility of state pension age increasing to 66 by 2030, 67 by 2040 and 68 by 2050, it does so for the purposes of modelling the cost impact. It therefore seems to stop short of a concrete recommendation. Because of “uncertainties around future projections of life expectancy, changes in SPA required can only be indicative and need to be determined over time in the light of latest life expectancy estimates”.

But the Report does go on to state that the Government should consider “the option, post 2020, of having a two-tier pension age, higher for the State Second Pension and lower for the BSP”.

6 NPSS

Although the details of its design would need to be fleshed out, the idea is that NPSS would operate automatic enrolment (subject to the employee’s ability to opt-out) at a national level wherever an employee is not covered by other adequate pension arrangements.

The base-line for contributions would be pitched at around 8% of earnings above the “Primary Threshold” (the level of income at which tax and NI contributions become payable). The contributions would comprise a mixture of employee contributions (4% of post-tax pay), tax relief (1%), and employer compulsory contributions of 3%. The Commission also recommends that voluntary contributions over and above the default level be allowed, subject to a cap.

7 OTHER RECOMMENDATIONS

- Contracting-out should be phased out gradually. Although the option to contract-out should be maintained for defined benefit (DB) schemes for now, it should disappear “at the latest” by about 2030. Contracted-out rebates for both occupational and personal defined contribution pension schemes should be abolished, “with all employees not covered by [DB] Schemes becoming members of the State Second

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Pension for future accrual”.

- The Government should work towards easing capacity strains in the annuity market, for example, by raising over time the first and last possible ages at which annuities can be bought.
- Further consideration should be given to measures to facilitate later working and flexible retirement. For example, the Report suggests that there should be no default retirement age “beyond which the provisions of the Age Discrimination legislation do not apply” (the draft age discrimination legislation, which is due to come into force on 1 October 2006, currently anticipates a default retirement age for employment purposes of 65).
- The Government should establish a successor body to the Pensions Commission “charged with presenting every 3-4 years a report” setting out, amongst other things, the latest trends in private pension saving, life expectancy and the “implications for the long-term public expenditure / State Pension Age trade-off”.

8 THE GREAT PENSIONS DEBATE

The Report recommends an essential public pensions debate “over the public expenditure versus pension age trade-off”. It remains to be seen, however, how the Government will ultimately take things forward. But one thing seems clear, it will entail challenges and trade-offs on all sides.