PICKERING REPORT COMMENTS

After a year of looking at the UK pensions landscape, it is a great shame that this Report only scratches the surface of the problems. There are so many areas which are not addressed, or only cursorily dealt with.

The main thrust of the Report seems to be:

‘we must save final salary (DB) schemes at all costs. We must save them because the alternative is that companies will close them down and move to defined contribution (DC) schemes, with lower contributions.’

So what is the solution?

The Report says the solution is to make it cheaper and easier for employers to keep running DB schemes.

And how should we do this?

Easy...we must make them pay much lower benefits. Yes, the answer to the problems of companies closing DB schemes is to keep them going, but allow them to provide much worse pensions, take away cover for spouses, take away life assurance and sickness benefits, and take away inflation protection! As long as DB schemes are saved, it apparently shouldn’t matter that they no longer provide decent pensions and insurance cover. We should just be thankful that they keep going!

Of course, the idea that this effectively means lower contributions into DB (lower costs, mean less for employers to pay in) is not spelled out. And why it is better to have lower contributions into DB than moving to lower contributions in a DC scheme is also not explained. Worsening benefits of DB makes these schemes worse, and – unless there is some kind of solvency insurance or other restriction to prevent companies reneging on the promises – I do not believe that they are better than DC.

What a missed opportunity. Instead of seeking to make DC work better (this is, after all, the way pensions of the future will be provided, whether we like it or not!) the Report concentrates on lowering costs of DB. How can we seriously say that it is acceptable to cut out life cover and spouse’s benefits from schemes? This will be a net loss to so many people and will mean higher numbers falling into poverty and on state benefits. How can Government endorse a message that we do not need to worry about protecting pensions against inflation? Even on the Bank of England’s official 2.5% target, the real value of a pension will fall by more than half over 30 years. We cannot lull people into a false sense of security on this. It would be outrageous to accept that no index-linking is fine. There are so many important elements missing from this report. A quick summary is as follows:

1. **Costs of DB could be cut by discouraging early retirement and moving to more part-time work at older ages.** The best way to cut costs of running a DB scheme for employers is to make them pay the pensions for shorter periods of time. The trend to early retirement must stop, members should be encouraged to work for longer (hopefully with a system of ‘gradual retirement’ being introduced by enlightened employers). This is not dealt with seriously in the Report at all. It could

have suggested using 'best 5 years average' instead of final salary, for example. It would be much better to keep good benefits and pay them for less time, than to pay much worse benefits for long periods.

2. **<u>Need to address workings of DC – it could and should work much better.</u>** The Report does not deal with how to get DC working better. Making companies be more honest about how much they are reducing contributions when changing pension arrangements, so that unions and workers can demand the cuts are made up, or plan to contribute more themselves.
3. **<u>How can we provide better incentives for pension savings?</u>** How can we get people putting more money into DC? For example with more generous fiscal incentives, moving away from tax relief perhaps.
4. **<u>We need to simplify pensions – get just one regime for DC, roll all the different schemes into one basic type.</u>** The Report does not suggest how we can simplify the workings of DC. It discusses the need to do this, but not the means to achieve it. There are so many different DC regimes and products – AVC's, FSAVC's, SIPP's, SSAS's, Stakeholder etc and all have different regimes, tax treatment, investment restrictions and benefit rules. Why not just have ONE DC regime. Everyone can get 25% tax free lump sum and the rest is used to buy a pension. Any DC scheme can have the same investment restrictions and contribution limits. This would be so much simpler and could be achieved.
5. **<u>Government's Pension Credit policy must be changed, otherwise many people should not be in a pension at all.</u>** The Report does not point out that current government policy needs to be changed. The Pension Credit is a major disincentive to people putting money into a pension and the statement that 'it always pays to save' is just not true. For many people, a pension will not be suitable, because Pension Credit will mean they lose the first part of their pension completely and the rest is taxed at 40%. The Report just tows Government line, rather than analysing the situation properly. Many people would be much better advised to put money into an ISA, not a pension. Forcing them to pay into their employers' scheme will be the equivalent of Government mis-selling of pensions!
6. **<u>Need to consider insurance cover to protect members DB schemes.</u>** No mention is made of providing insurance protection for schemes, to ensure all members receive at least some minimum level of pension, if the scheme winds up or the employer becomes insolvent. At the moment, workers may receive nothing at all and others will not know how much they will get for some time after wind-up.
7. **<u>Need to simplify rules for stakeholder pensions.</u>** No mention is made of the very complicated 'non-relevance' requirements of stakeholder pensions. There are ridiculous rules and limits on which employers need to provide stakeholder. The system could and should have been simple, the idea was great, but the rules attached to it have been a classic example of how the authorities seem unable to really make pensions easy to understand.
8. **<u>Why not have one regulator for all pensions, not separate one for occupational schemes?</u>** The Report suggests the taxpayer should fund a regulator for occupational schemes, separate from the FSA. Surely, it would be better for a regulator to cover all pension types, to try to get some sort of 'joined up' regulation for a change.
9. **<u>No mention of annuities.</u>** The Report does not deal with the problems of annuities. Helping people to get better value annuities, offering money-back guarantees and simplifying the legislation would be of great help to improving pensions.

10. **<u>Get moving on reform now!</u>** The Report, sadly, encourages Government not to rush into making changes or give in to pressure from 'misguided lobby groups'. This is a dangerous message. Things need to be done now. Pension provision is crumbling and it would be much better to identify some short term measures which would be useful, before more major reforms are announced.
11. **<u>Why not have just ONE regulator for pensions?</u>** Changing OPRA to EPRA will not solve anything. And why should the taxpayer fund it anyway – less than half the workforce is in occupational schemes, so why should they not fund the regulator directly?
12. **<u>Would be great to suggest having just one single 'personal retirement account' for everyone who is transferred out of a company scheme.</u>** All old pension entitlements could be kept in this kind of 'safe harbour' system, but in one place. The Report does not suggest this, but it could really help many people to keep track of all their old pension entitlements in one account.

Overview:

The Pickering Report does not really go the whole way in identifying all the inconsistencies and complications of the UK pensions landscape. There are many more areas that need to be highlighted, but the Report has not mentioned them, or has left them to other Reviews.

The Report is really focussed on reducing costs and regulations surrounding DB schemes. In trying to protect DB pensions, however, it has avoided tackling some of the issues around DC schemes which need to be addressed. It recommends that employers should be allowed to reduce the value of the final salary pensions and to cease providing some of the standard benefits, such as life assurance, spouse's pensions or indexation. This represents a significant potential deterioration in pension and insurance coverage for a large section of the population. It is not clear from the analysis of the Report – or from other evidence – that this course of action is better for people than addressing the problems of the current system of DC pension provision in the UK. If we could make DC work better, this might be preferable in the long run, for many people, to worsening the benefits provided by a DB scheme.

The issues of DC that need to be addressed include raising contribution levels and reducing the regulatory complexity:

How can we ensure higher levels of contributions into these schemes?

For example, offering tax incentives for employers who contribute more than a certain percentage; requiring a minimum notice period of, say, 12 months before changing pension provision; preventing employers keeping their DB scheme open for Directors if they close it for other staff; or compelling employers to be honest with their workforce about exactly how much contributions are being reduced when moving from DB to DC. This is a huge effective pay cut and needs to be explained more honestly. At least then, workers would be better able to exert pressure on employers to make up the loss of 'deferred pay' and also to help them to know how much extra they might need to contribute to their pension to make up for what is being lost.

How can we get a more streamlined and simple regulatory regime?

The Report does not address the possibility of how to achieve one DC regime and merging all the various DC products into one type, with standard features on contributions, investment, tax free lump sum and pension benefit. Given that it introduces the idea of being able NOT to fully guarantee the same benefits between one scheme and another, the Report might have gone further to suggest that all old entitlements are converted into the new type of regime, with standard features and – at the moment – no-one would lose out, because Retirement Annuity Policies (RAP's) are currently entitled to less than the 25% tax free lump sum and would benefit from a standard 25% payout. If we could merge stakeholder, personal pensions, AVC's, FSAVC's, SIPP's and SSAS's, it would be a great benefit. The Report strongly supports the idea that 'a pension is a pension is a pension' but leaves the current myriad types of pension, with all their different rules, to someone else to simplify. The Sandler Review suggests just one regime for all pensions, which is pretty sensible, although we are likely to find it very difficult to have less than two (one occupational and one personal, <u>or</u> one DB and one DC perhaps).

There are, however, some recommendations which have questionable value. There are also areas which are not fully explored, which would have been useful to consider.

<u>Weaknesses of recommendations and analysis:</u>

1. No real mention is made of the need to encourage people to work longer, (and stopping early retirement) so that pensions do not need to be paid for so many years. This is, surely, a much better way of cutting the costs of providing a DB scheme. One of the big increases in cost for pension schemes is the need to support people for far longer in retirement than used to be the case. Administrative and regulatory burdens have risen, too, but a major benefit to the cost of running a DB scheme would come from trying to ensure people will be contributing for more years and not retiring early. These are really fundamental points which affect the costs of pension schemes and would be much more beneficial to future pensions than allowing employers to cut benefits.
2. The Review does not focus on how to get DC scheme contributions to rise. It is mostly concerned with saving final salary schemes, but many have already gone and improving the workings of DC is a very important area for the future of UK pension coverage.
3. The Review is not bold enough in places – for example, not recommending the abolition of AVC's, FSAVC's, distinctions between SIPP's and SSAS's etc. People are too confused by the enormous number of different, yet similar, types of scheme and it would be much better if they could be standardised into one type.
4. Pickering says there is no rush to introduce new legislation and Government should take its time, not be pressured by well-meaning or misguided lobby groups. This could lull Government into a false sense of security. There is a rush to close schemes, which will have far-reaching consequences in years to come. UK pension provision is crumbling and Government needs to act urgently and radically, otherwise it will be blamed for overseeing the demise of the UK's superior retirement savings culture. We are just fiddling while pension provision burns! This has been going on for several years and nothing has been done.
   It would be useful to identify what could be done in the shorter term to help improve the pension situation. Addressing contributions in DC, addressing the ease with

which companies can just close their DB scheme, ensuring all people have access to advice, improving the pensions people obtain when they buy an annuity and so on, would be very useful in the short term.

5. No direct consideration of annuities. This is another disappointment and is actually in parts a 'stand-alone' area of pensions that could and should be changed as soon as possible. For example, allowing moneyback guarantees could happen quickly, could improve the perception of money purchase pensions and could win some positive comment for a change! Also, ensuring basic advice for everyone buying an annuity, on the grounds that this is a special case (Government forces you to buy one and you can't change it, you're locked in for the rest of your life) could help everyone to get a much higher pension by using the Open Market Option. This point has been a bit forgotten, but it means real extra money for so many pensioners, who will be retiring this week, next month or whenever. If annuity reform has to wait a year or two, this will be such a shame.
6. The Report recommends that worsening DB benefits is preferable to switching to DC. There is an underlying assumption that a lowering of DB benefits is still better than a switch to DC – but this case is not proven at all. Effectively, the recommendations amount to contribution reductions in DB schemes (lower costs for employers mean lower contributions to the scheme!) If benefits are reduced, it is not clear that it will always better to have a DB scheme than a DC one. In fact, I would argue that, if both schemes have the same lower level of contributions, a DC scheme may be safer, because DB schemes depend on the employer staying in business and keeping the scheme open. On wind-up, unless there is better protection for active members, a DB scheme may provide nothing for the current workforce – not even a return of their contributions! At least with DC, there will be a pot of money for each member, even if the employer fails.
7. The Report recommends introducing much lower minimum 'standard' benefits for contracting out and for final salary schemes generally. The danger is that such a minimum may become a new standard, with employers deciding there is little merit in providing a scheme which offers higher benefits than the required minimum.
8. The suggestion of tolerating cuts in the benefits provided by DB schemes (removing indexation, spouse cover, life and sickness insurance etc.) will, obviously, reduce costs for employers running final salary schemes, but is not clear that this will necessarily be the best thing for members in the long run.
9. I think it will be dangerous for Government to be seen to endorse a message that it is fine for pension schemes to stop providing life and sickness insurance for members. At the moment, the ability to get this cover is a big benefit, makes it much cheaper for the cover to be obtained and, without it, many more people will not have such protection and will, therefore, be forced to rely on state benefits if they become ill or die young.
10. Likewise, removing indexation requirements may help to reduce costs in the short term but, over the long term, even The Bank of England's official target of 2.5% inflation will erode benefits substantially over a period of 20 or 30 years. The real value of a pension will decline by 40% or so after 20 years and will be worth less than half its original value after 30 years. There may also be consequences for index linked gilt prices to consider. A message which suggests that people do not need to worry about protecting the real value of their retirement income is not sensible in the longer term, especially if inflation picks up again in coming years. This Government could then be blamed for lulling people into a false sense of security about the need to protect the real value of their pensions.

11. The Report does not recognise that Pension Credit is still a disincentive to save and can still mean 100% marginal tax rates for those with less than full BSP. It actually seems to endorse the Pension Credit, even though this is one of the major disincentives to lower/middle income groups' contributing to a pension.
12. An alternative way of cutting costs for final salary schemes would be to consider using career average earnings, rather than final pay, as the basis for pension calculations. If everyone's pension was based on 'average' earnings, rather than final earnings, the system could reduce costs for many schemes but could have other social benefits. Such a system could help to 'modernise' DB schemes and make them more suitable to the likely work patterns of the future. If we are going to move into an environment where people can stay at work longer, but gradually retire, their last salary will not be the highest. This is probably inevitable over the coming years, but is being inhibited for many people by the requirements of taking a final salary pension. If they can stay on at work with the same company, but at reduced pay, and not risk a much lower pension than if they moved company, there could be benefits to them and to the employer (who will retain staff with firm-specific skills).
13. The Report does not explore the possibility of providing some insurance protection for members of DB schemes – to ensure that they at least can obtain some minimum amount if their scheme collapses. There is no guarantee that members will even get their contributions back.
14. No mention is made of the complicated 'non-relevance' requirements of stakeholder pensions and the need to simplify these.
15. The Report recommends establishing a new regulator, with an advisory role, called EPRA. It says this should be funded by the taxpayer, rather than a scheme levy by which OPRA is funded. The new regulator for occupational pensions is also supposed to be separate from FSA. However, there is little evidence to justify why taxpayers should fund an occupational pension regulator (less than half the workforce is in an occupational pension) and does not really explain why it should be separate from the FSA. It would make more sense, perhaps, to have a regulator within the FSA, to help co-ordinate regulation and why not have a regulator who is responsible for ALL pensions – why are occupational schemes so special? We need joined up regulation and this would surely be helped by regulating all occupational and personal pensions under one regime.
16. I would suggest that there is a need to consider having all old pension entitlements held together in one retirement account, rather than transferring to a series of 'safe harbour' products or leaving pension rights accruing in old schemes. This is not considered in the Report. Deferred members in old DC schemes and people with small amounts in other schemes which are transferred under the 'de minimis' rules, should be able to set up one single 'retirement account' to hold their pensions from all previous work.
17. The Report recommends that deferred members of schemes which wind up should not have to be bought out with deferred annuities, which are very expensive, unless they are within 10 years of retirement age. It is not clear why we need the added complication of not covering those within 10 years of retirement age. I think that everyone should have the same option – to either have a deferred annuity, or transfer into an alternative 'safe harbour' or other scheme. This is fairer, less arbitrary and simpler to operate.
18. The Report suggests that illustrations of expected levels of pension need not be set out on a standard basis, but could differ from scheme to scheme, with different assumptions underlying growth etc. I am not sure about this. This may be an occasion when it would actually be helpful for people to be able to compare pension

forecasts from one scheme to another on a consistent basis. If the assumptions were not the same, this would be impossible. For example, someone trying to assess whether a scheme from one company was better than a scheme from another company, might be unable to do so.

There are, nevertheless, a number sensible recommendations in the Report. It highlights many of the problems which have built up over the years in UK occupational pension provision. The thorough analysis and many of the recommendations would represent a significant improvement on the current position.

Strengths of Recommendations

1. Reducing number of pension products and generic types will help people better understand pensions – make them friendly, not frightening
2. Review suggests that the need to fully replicate and guarantee pension equivalence is excessive – if one can just replace existing rules with an ‘expectation’ of equivalence, it might be possible to streamline old pension arrangements into standardised new types of scheme.
3. Immediate vesting - sensible to increase pension coverage
4. Transfer of small amounts of pension entitlement to a ‘safe harbour’ product – will help schemes reduce costs, by not having to track small entitlements for many years
5. Abolition of distinction between protected rights and non-protected rights - will help simplify the process of buying an annuity
6. Simpler, less prescriptive, unified legislation - would be very helpful
7. All communication requirements should be set out in one place. FSA and DWP disclosure requirements should be made consistent. There may be a beneficial effect from the focus attention on asking why so many Government departments are involved in different bits of pensions. If we can get pensions under ‘joined up’ responsibility, it will be easier to sort out the mess
8. Suggestion to end contracting out, or at least radically simplify it and assertion that contracting out rebates are not enough to make contracting out attractive are helpful in the debate about simplifying pensions. This will focus attention on one of the most complicated areas of UK pension provision and hopefully lead to more sensible arrangements than we have at present.
9. Making it easier for firms to establish multi-employer schemes – this could help prevent smaller schemes closing their DB arrangement, because they would be able to pool the costs of administration, investment management and governance, thus benefiting from economies of scale.

10. Encourage using plain English and clearer forms for communication with members and simplification of grievance procedures will be helpful.