Pension Reform

Response from Scottish Life
DWP Consultation Paper:
A state pension for
the 21st century

June 2011

Introduction

Scottish Life, a division of Royal London, is pleased to respond to this DWP consultation paper ‘A state pension for the 21st century’.

About Scottish Life

Scottish Life was founded in 1881 in Edinburgh as a proprietary company before becoming a mutual company in 1968.

On 1 July 2001 Scottish Life demutualised and transferred its business to The Royal London Mutual Insurance Society Limited. Scottish Life is the specialist pension business of the Royal London Group, providing individual and group pensions to the market through intermediaries. This includes acting for approximately 250 defined benefit schemes operated by SME employers.

Scottish Life and Royal London’s other intermediary businesses are based mainly in Edinburgh where 1,050 staff are employed, with 770 working in other parts of the UK and overseas. (Information as at 31 March 2011)

About Royal London Group

Royal London Group is a specialist financial services provider. Its businesses focus on those sectors of the market which value quality propositions, operating through a number of brands:

- Scottish Life – UK pensions market
- Bright Grey – UK protection market
- Scottish Provident – UK protection market
- Royal London 360° – offshore investment markets
- RLAM – fund management
- Royal London Plus – life and pensions administration
- Ascentric/IFDL – Wrap Platform.

Royal London also distributes life and pensions products through Santander’s UK branch networks.

Royal London is the largest mutual life and pension company in the UK with funds under management of £42.4 billion. The businesses serve around 3 million customers and employ 2,700 people. (Information as at 31 March 2011)

Our response

Our response is made up of two parts:

1. Our general view

2. Responses to the questions posed in the consultation paper.

1. Our general view

Scottish Life has long held the view that for workplace pensions to be distributed more effectively, the benefits provided by the state need to be fairer, simpler and clearer. We have consistently voiced our concerns as to how means-testing, in particular the savings credit, acts as a barrier to the effective distribution of workplace pensions. Our view is that the value of each £1 saved in a pension should be worth at least the value of that £1 saved in additional benefit.

We are delighted the Government is looking at reforming the state pension system. A state pension that acts as a solid foundation to income in retirement is long overdue. With millions of workers due to be automatically enrolled into workplace pensions, it's essential that the extra money they save is available to buy additional income in retirement, and is not offset against state benefits they would have otherwise received if they hadn't saved. It should pay to save. This will encourage personal responsibility, one of the Government's key principles of reform.

We favour a single-tier pension as this removes the savings credit for future pensioners. The removal of contracting out for defined benefit schemes will undoubtedly lead to financial challenges for those employers who still operate these schemes and employees who pay into them. Without underestimating these challenges, our view is that the removal of means-testing is fundamental to the success of automatic enrolment.

It is right that state second pension benefits already given up by being contracted out are taken into account when deciding what flat rate pension will be given. Although this retains some complexity, it is right in the interests of fairness.

We favour regular reviews of state pension age by an independent commission with oversight, as opposed to increases by a set formula.

2. Responses to the questions

Question 1 - Would the current state pension, if left unchanged, meet the Government's principles for reform and provide an effective foundation for saving?

The current state pension system does not meet the Government's principles for reform.

Means-testing in the form of the savings credit does not encourage personal responsibility, nor is it fair to those who have saved. Providing couples with a benefit that is less than two times the benefit a single person would receive is not fair either.

It is clear by the reaction to possible state pension reforms from those who currently receive the state pension, the system isn't simple - it's anything but. The proposed reforms will retain some of the complexity of the existing system and there is still a challenge for Government to clearly communicate the benefits offered by the state pension system and other forms of saving for retirement. Only when individuals understand what they will receive from the state can they make informed decisions about any additional saving they need to make. A campaign to raise awareness of pension benefits provided by the state is required.

Although we understand that based on the reforms already announced by the Government the state pension system is affordable and sustainable, many of these reforms have not yet been fully put in place and therefore have not been fully established. As such, we believe further reforms beyond those announced or subject to current consultation may be necessary in the future.

Question 2 - To what extent would faster flat rating meet the principles for reform and improve savings incentives?

Faster flat rating would in the main not meet the principles for reform.

It would involve extra complexity for individuals in the short-term with less complexity thereafter. For individuals close to retirement or those within the period of convergence, the reduced simplicity could reduce savings due to a "planning blight" effect.

It would encourage more personal responsibility, although as mentioned in our answer to question 1, we feel this will only be achieved by a campaign to raise awareness of state pension benefits and other forms of saving for retirement. The retention of means-testing, in particular the savings credit, keeps the unfairness prevalent in the current system that it might not pay to save. A lot of the complexity of the current system will still exist, making it difficult for individuals to understand and make informed decisions.

Question 3 - What further reforms might be required to the State Second Pension, such as crediting arrangements and uprating of pensions in payment, to better meet the Government's principles, recognising that there is a trade-off between coverage and the potential level of any combined, two-tier flat-rate pension?

The GMP component of the state second pension currently over inflates for inflation for those member's who withdrew from a contracted out scheme prior to 2000, compared to benefits accrued since 1997. This revaluation anomaly should be corrected.

Widening the scope of the state second pension to also include individuals who are self-employed or in receipt of jobseekers allowance could assist in meeting the Government's principles.

Question 4 - To what extent would a single-tier pension meet the Government's principles for reform and improve savings incentives?

A single-tier pension is our preferred option as the savings credit would be abolished, making private pension saving suitable for the vast majority. Savings credit is a real barrier to saving, particularly in the distribution of workplace pensions, and we have consistently campaigned against it. The removal of savings credit would undoubtedly improve the incentive to save, even more so if there was a campaign to raise awareness as already mentioned.

A single-tier pension is simpler to understand than retaining a two tier system. It is more inclusive, so in general fairer to those who really need it. We welcome the inclusion of the self-employed and those on job seekers allowance, and the fact that the majority of women and the low paid would get better pensions.

Care needs to be taken to explain the 30 year cap on credits. As the state pension age increases and individuals work for longer, the gap between how many years individuals pay contributions and the number of credits they have for state pension widens. Many may view this as unfair.

The continuation of the contracting out offset would however keep some of the current complexity and require existing contracted out systems to be maintained for many years.

We are assuming that the single-tier pension will be set at a level that is both affordable and sustainable in the long term.

Question 5 - Which of these two options would act as the best complement for automatic enrolment?

The single-tier pension best complements automatic enrolment as it is simpler to explain and removes means-testing, making saving in the workplace pension scheme suitable for the vast majority. Also see our response to question 4.

Question 6 - Government would be interested in hearing views on other reform options that would meet the Government's principles for reform.

The only other option we can think of is a citizen's pension based on residency.

Question 7 - What would be the impact of ending contracting out, as implied by any single-tier model?

(a) The loss of NI rebates could lead to more defined benefit schemes closing to future accrual, or where it is possible to do so future benefits being reduced, on cost grounds. This reduction may be difficult to make in practice unless there is overriding legislation. In addition, any attempt to alter benefit structures in respect of future accrual would increase administration costs as historical benefit structures would remain in place.

(b) Depending upon how the legislation is worded and how defined benefit scheme rules are written many individuals could receive lower pensions if the pension scheme was still required to provide the contracting out offset. Many contracted out schemes provide a pension benefit designed to provide a pension after 40 years, of 40/60ths less the basic state pension (BSP). If the BSP is increased to £140 per week (£7280 p.a.) then the overall pension provided by the scheme would reduce. However the state pension received would not increase as the additional state pension would not be paid by the government. For example; consider an individual with 40 years service on a final salary of £18,000 p.a.:

Current pension = (40/60 x 18,000) – (97.65 x 52) =	6922.20
State pension	5077.80
Total	£12,000.00 p.a.
Future pension = (40/60 x 18,000) – (140 x 52) =	4720.00
State pension (after contracting out offset)	5077.80
Total	£9,797.80 p.a.

Conversely, if a new name is given to the combined state pension and the term "Basic State Pension" is not used then members could receive a significant increase in their benefits. Employers could find it extremely difficult to fund such a change. Using the same example, if the basic state pension no longer exists then

Future pension = 40/60 x 18,000 – 0 =	12,000.00
State pension	5,077.80
Total	£17,077.80 p.a.

These examples illustrate how important it will be to liaise closely with pensions experts prior to any legislation being drafted.

Question 8 - If the decision is taken to end contracting out, how could the process be best managed so as to minimise any adverse impacts on employers and individuals?

The removal of contracting out for defined benefit schemes will involve an immediate increase to the employer's cost of providing the scheme. The cash-flow consequences are therefore different from the removal of contracting out on defined contribution schemes where any employer rebate is in addition to their base contributions.

If contracting out is abolished then simplification in respect of existing rights, particularly GMPs should be considered. At present many accrued GMPs revalue at fixed rates which depend upon when the member left the scheme e.g. at 7% for leavers in 1996, but at 6.25% for leavers in 1998 and at 4% for leavers in 2010. Contracted out rights accrued since 1997 are revalued in line with other scheme benefits i.e. RPI/CPI up to a maximum of 5%, or 2.5%, over the period. Average RPI since 1978 has been less than the fixed rates above, and hence schemes are being required to over-inflation proof these historical benefits. Altering the regulations to require accrued GMPs to revalue in line with other scheme benefits would simplify scheme administration.

Overriding legislation would allow employers to change their schemes with less cost. If this isn't on the agenda, and whilst appreciating that the reforms have to be affordable, we do feel that employers and individuals should be given as much notice as possible of the removal of defined benefit contracting out. This would give time for the impact to be properly assessed by employers and individuals, and if changes to scheme benefits or individual retirement plans are required, to consult on and implement these.

Question 9 - In conjunction with the reforms outlined in Chapter 2 are there ways we can change the means-testing system for future pensioners to make it more simple, reduce disincentives and encourage personal responsibility while continuing to help pensioners avoid poverty?

We can't see any easy way of changing the means-testing system that wouldn't involve a fundamental overhaul of the benefits system.

Question 10 - What mechanism should be used to determine future increases in State Pension age?

The future is unknown. In particular neither actuarial nor medical science knows whether life spans will continue to increase in the future nor the pace at which any changes will occur. Existing projections of longevity are based upon trends which may or may not occur. For example, life spans actually reduced in Russia after the break up of the Soviet Union. Increased obesity could cause a similar trend in the UK. Similarly, the ability of the state to finance future pension commitments is unknown.

Given this, we believe that future increases in state pension age should be determined through regular reviews carried out by an independent commission made up of medical and actuarial experts with Government oversight say every 5 years. The independence of the committee is crucial to avoid potential accusations of political bias. To aid political objectivity, it might be helpful if the regular reviews were carried out in the year after a general election.

The review should take into account the latest life expectancy projections and an agreed range of factors. There would be an underlying principle on the proportion (say 30%) of adult life to be spent in retirement.

Question 11 - How should the Government respond to the frequent revisions in life expectancy projections while giving individuals sufficient time to prepare?

Revisions in life expectancy projections should be picked up and reflected in any increase to state pension age as part of the regular review (see response to question 10 above). Government should ensure that individuals are always given fair notice of an increase to the state pension age. We'd suggest individuals have at least 10 years notice of a change to their state pension age. This is fair to affected individual as it allows a bit of time for them to plan for this change. This message should be communicated by Government so that individuals understand that if the state pension age has to rise they will have fair notice.

We think that Government should ensure allowance is made for how long people live a 'healthy' life as well as general life expectancy when considering increasing the state pension age. If this isn't taken into account an earlier state pension may well be replaced with other state benefits until individuals are entitled to receive their state pension.

The Government could consider, as they are doing for the current public sector reforms, allowing individuals to have part of their state pension at an earlier age and part at a later age. For example, accrued entitlement stays at current state pension age with future entitlement at a later age. This solution does add complexity and cost, but is fairer than a straight change to another age.