

Universal Protected Pension – A framework for building consensus

Background

The Universal Protected Pension (UPP) is a concept based on some core objectives and principles. The purpose of this paper is not to reiterate the need for pension reform; rather:

- To reiterate the essentials of the UPP; and
- To show how the UPP could accommodate others' views and, thereby, provide an attractive framework around which to build consensus.

The Pensions Reform Group (PRG) welcomes comments.

Objectives

The PRG suggests that the Government has two fundamental duties in this area: to prevent poverty and to provide people with an environment in which they, as individuals, can easily take sensible decisions about their personal savings. To achieve these objectives we suggest that any new pension scheme must have the following three key features:

- **Sufficiency** – it must give people a sufficient pension off which to live such that those who receive it require no other retirement support; over time, this will remove the need for the pension credit and will assure that everybody has the incentive to save;
- **Simplicity** – pensions are a complex and, to some, frightening subject, even for the relatively sophisticated. Whatever is put in place must be simple for the individual to understand (and appreciate); and
- **Survivability** – Providing pensions is a long term business and an efficient pensions policy must be seen by the population as being a long term solution. This means minimising the risk of political change such that the electorate takes ownership of that new pension reform. The governance of the reform must be put beyond the easy reach of politicians – it must be capable of surviving indefinitely.

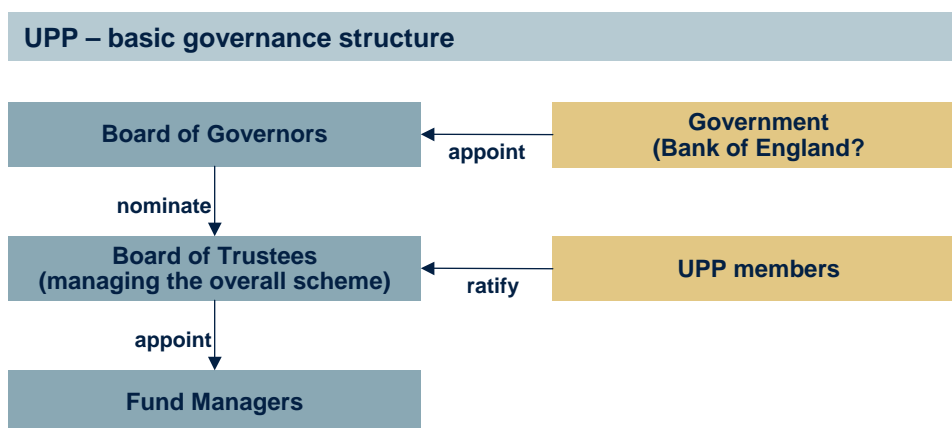
It is only by providing a scheme which is simple and survivable that the Government will create the right environment for personal savings. With a pension set just above poverty levels, personal savings are particularly important.

Principles ...

We reiterate that the UPP proposed core scheme is merely a proposal for others to adapt. However, we have established five principles which, in our view, define its strength and which should be immutable:

- **Guaranteed pension** based on a fixed minimum percentage of national average earnings for all who contribute to society including carers and job-seekers. The payment would come in part from the existing price indexed basic state pension (to which the Government would have to make a contractual commitment) plus a centrally but independently administered fund to top it up to achieve that minimum national average earnings-related pension; this fund would use the Contracted Out Rebate (COR) as part contribution to the scheme. The key is that the pension should be set at such a level that the Government can, with absolute confidence, announce the phasing out of Pension Credit.
- **No new compulsion:** the scheme would be compulsory for all in work, but there would be no new compulsion. Contributions to the fund would be collected through the NIC system by the Contributions Agency. Compulsion is essential in a scheme which is redistributive (see below).

- **Redistributive:** this scheme is as redistributive as the basic state pension scheme – over the relevant National Insurance bands, everyone puts in the same percentage of income for the same monetary pension at the end. This meets the key tests of fairness (“something for something”) and the more practicable one of affordability. PRG does not see how one can establish an incentive scheme which can honestly address the needs of those who most need to cover their old age but cannot afford to do so or that can guarantee take up by those who need it most – hence the need for redistribution.
- **Funded:** it is a critical element of the proposal that the scheme should be funded – to distance it from Government – “it is our/my money; they cannot fiddle with or expropriate it”. The fund would be administered by independent trustees who would select private sector professional fund managers to manage the money. The fund would be invested in a range of assets around the world to diversity the investment risk.
- **Independent:** It is critical, to our minds, that there should be a governance structure that puts significant distance between the scheme and politicians. The trustees would be appointed by Governors (who might, themselves, be selected by the Bank of England). The trustees would be ratified by the present and future pensioners. Apart from administering the fund (subcontracting day to day administration to private sector managers), the trustees would determine the fixed minimum pension level and the level of contributions.



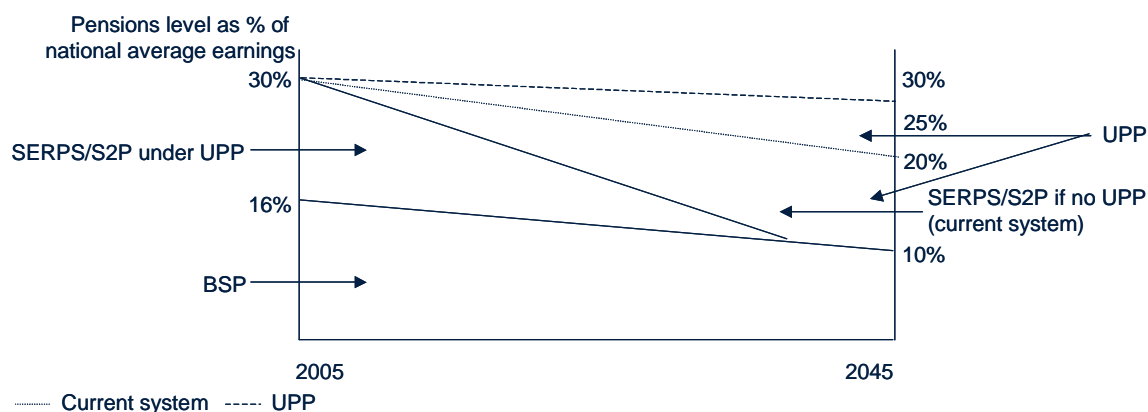
These principles are listed separately but, in reality, they are intimately inter-related.

... and specifics

PRG has scaled what it believes the more detailed terms could be:

- **Level of pension:** it is suggested that the trustees should set the pension rate at 25-30% of national average earnings; in other words, that the trustees should be obligated to set a contribution rate that is robust (it should not fluctuate significantly – in any event this is not in the nature of pension contribution rates) and should target with confidence (ie based on prudent assumptions) a distribution rate of 25% of average earnings. If there should be sufficient headroom in the scheme, they should be capable of distributing more up to a level of 30%, above which they should reduce the contribution rate.

Current and project value of contracted in pension benefits for lifetime median earnings at point of retirement



Note: This graph illustrates the position of an individual AT retirement who has had median lifetime earnings. The earnings-indexation of the UPP will further improve the position relative to the current system *THROUGHOUT* retirement.

- **The “double payment” problem:** we suggest that members of the UPP would not accrue any further State Second Pension benefits (S2P). However, because of the need to pay all existing accrued SERPS/S2P benefits under the PAYG system, there will inevitably arise the possibility of “double payment” whereby younger workers pay for the benefits of older retired pensioners, but do not accrue similar benefits themselves. This is common to any change from PAYG to funded and, to some extent, this already exists under the existing system. We suggest there are several ways in which double payment can be mitigated under the UPP:
 - Because the Basic State Pension remains in place, double payment only applies to SERPS/S2P and means-tested retirement benefits:
 - By adjusting the indexation of the Basic State Pension itself for members of the UPP only – perhaps making it earnings related so that it comprises a constant percentage of the overall UPP guarantee,
 - As S2P and then UPP mature there will be reduced expenditure on means-tested benefits. This could be directed towards those who have been penalised through some double payment..
 - Because no further accruals of S2P will be made for those in the UPP, once UPP benefits come into payment, S2P expenditure will be much lower than is currently projected. At some point National Insurance reductions might be possible – and could be directed towards those who have suffered double payment.
- **Including life insurance?:** we have also suggested that, for those who don’t make it to retirement, there could be a £100,000 life insurance element to the scheme.

Others’ perspectives

In discussing our core proposal, however, we have encountered many different views as to how the pension provision should be reformed. What follows, therefore, is our attempt to analyse how the core UPP proposal could be adapted, if others wished, to some of those alternative ideas. We do not particularly sponsor or argue for any of these variations:

- **Non funded?:** some suggest that one should create a similar model without independent funding. We fundamentally oppose this:

- Who would trust this to last; without that trust half the benefit of a guaranteed liveable pension is lost. PRG strongly believes that funding brings ‘property rights’ that engender confidence and trust; and
- We also believe that funding offers a better and, where linked to the basic unfunded state pension, a balanced return. The Pensions Commission has recognised that “provided that selling, administration and fund management costs are not too high [therefore], individuals should on average be better off in funded schemes” (*page 25 of Appendix B, First Report*).

It must also be remembered that the fund only represents an add-on to the PAYG basic state pension – the UPP provides a **partially funded** collective pension that would take us further towards (and may even meet) the Government’s overall objective of moving pension provision from 40 to 60% funded basis.

By providing a pension that is part PAYG and part funded, the UPP diversifies risk between the labour and capital markets.

- **Non compulsory?:** Equally, others suggest that individuals should not be compelled to save but rather should be incentivised to build up their own funds; we have six essential problems with this:
 - How do you provide sufficient incentive to get those who most need to do something (often the lowest earners in life and retirement) to do it? Even the stakeholder pension, with its relatively simple structure, worksite availability and price-cap, has not achieved that.
 - How do you convince people that the incentives are robust for the long term and cannot be chopped and changed at political whim?
 - Do those who need the help have the knowledge to decide what to do ...
 - ... and, the collection and marketing costs (which for the UPP are negligible) cut a significant hole in the income from the savings accumulated in this manner.
 - Encouraging them into their own pension funds also introduces the annuity risk. It is not clear that in these circumstances, selling a scheme to low earners would be defensible.
 - There is also cost – historically the tax treatment of pensions has been generous but still has not been attractive to a significant proportion of the population. The likely cost of incentives will be high, have a big deadweight cost and still not be wholly effective.

It is, in our view, wishful thinking – it would be nice if the world worked that way but it doesn’t. UPP envisages giving everyone a good ‘starter pension’ and then anything else saved on top is a bonus for the individual (which they keep) - the best incentive!

We note that others suggest that **auto-enrolment** might be the optimal method of incentivising people but, assuming it only applied to occupational schemes, then it would at best only apply to around half the population in full-time employment. Moreover, under EU law, there is doubt about the degree of coercion implied in such arrangements. Because so many are likely to fall through the net with auto-enrolment, the need for means-tested benefits would remain relatively acute.

- **Inflating pensions with prices?:** One option might be to offer a pension that, prior to payment, is linked to increases in earnings but which, once in payment, is indexed to price inflation (as with SERPS and the S2P). To change the UPP to a similar structure and allow pensioners only increases in line with inflation rather than earnings might be an option which would reduce the cost but was not proposed originally by PRG because it would fail to provide an adequate pension for older pensioners and create differences between cohorts of the population (the recently retired would get more than the long-term retired).

- **How will the private sector adjust?** People have asked, reasonably, how private sector schemes would adjust their provision to take into account the loss of the COR (in return for a higher combined state-sponsored pension); we make a number of points:
 - This is only really a problem for defined benefit (DB) schemes that are contracted out (for contracted out money purchase schemes projected future benefits will automatically adjust with a lower contribution rate).
 - Only about 30% of the working population are in contracted out occupational schemes and, of this figure nearly two-thirds are in the public sector which could make its own adjustments; a much smaller number are entering DB schemes as they enter employment or move jobs (but this proportion is in rapid decline).
 - The DB schemes would have an obvious adjustment to make – they could offer a reduced accrual rate (eg in terms of percentage of final salary) after the commencement of such a UPP scheme.
 - Although almost all DB schemes remain contracted out, the NAPF has recently argued that many schemes regard contracting-out as a significant complexity and that there is a case for abolition.
 - A problem for occupational schemes and private pension providers alike is that the level of rebate has become inadequate, and the even if adjusted in the imminent GAD review of rebate levels, will still at best only aim to replace the benefits foregone. This is considered by many to be an inadequate reward for the risk taken on when contracting-out.
 - Other schemes, such as Citizens Pension, also envisage spending the COR on benefits immediately – at least, under the UPP the rebate (and more) is retained as funded savings.

This is not a trivial issue but it can be accommodated. If, as others have suggested, it increases the closure of DB schemes, then this may be only a marginal acceleration beyond what is already underway. Arguably, such an acceleration of DB closures would be at least compensated for by the overall growth in savings under the UPP.

- **One of the major risks is life expectancy – the nation cannot afford it – this risk must be borne up to “retirement” by the working population.** A key to the UPP scheme is that all risks (including the economic risks) are borne by the contributors (the contribution rate) and by pensioners (a pension between, say, 25-30% of average earnings). This includes the mortality risk. The PRG has not sought to pass judgement on when the retirement age should be (beyond pointing out that it should be reviewed as part of any pension reform). It, even, questions the use of that term, “retirement” – people can decide under the UPP to retire when they want (by saving sufficient to retire before the UPP benefits become payable or to defer retirement by getting a higher percentage pension by deferring its receipt).

The UPP could, however, accommodate a change in pensionable age by requiring the trustees (who have to have regard to mortality anyway) to vary this according to life expectancy (to target an average pension period of, say, 15 years). This could be reviewed by the Governors every, say, five years and would significantly derisk the scheme.

For example: if average life expectancy at 65 (males and females combined) is currently around 18 years, then the pension age for those at 55 (ie an appreciable planning distance from state (or UPP) pension age) would be fixed at 68 (65+18-15). This would not change for that cohort, thereby allowing time to plan the later stages of work and the move into retirement. Five yearly reviews would give younger cohorts their retirement age as they approached 55.

- **Other national schemes are based on (or moving towards) providing replacement incomes?** The UPP is not designed to give (or to be able to give) everyone a pension based on INDIVIDUAL’S final or lifetime average earnings. But, the UPP could let people “buy” additional units of NATIONAL average

earnings at an actuarially neutral rate – I could choose to add to my NIC contributions to “buy” an additional 5% (say) of average earnings; this might be quite attractive and accessible to a lot of people but it would be voluntary and it would not give them a personal salary-linked benefit. Alternatively, a parallel fund could be established on a more conventional unit based system. Any move in this direction reduces potentially the inherent simplicity of the core proposition (but any earnings-related state system is bound to be complicated).

- **Affordable?:** PRG does not have the resources to calculate the costs of all the permutations to the scheme; the core UPP proposal is currently being re-costed by the Government Actuary. However,
 - The cost will fundamentally be determined by the level at which the guarantee is set, the period over which one has to earn to get to full entitlement and the age at which that guarantee can be drawn.
 - However, there are other areas in which cost can be reduced: by rebasing the Government commitment to the basic state pension (to make it earnings linked, for example – this reduces the immediate cost but increases long term cost) or by redefining the commitment of the UPP (see “Inflating pensions with prices” above).

However, despite these details, all our calculations to date have suggested that, beyond the need to give property rights to contributors, running a single scheme will be cheaper than a multiplicity of schemes and the single scheme offers a better spreading of risks across nations, capital institutions and over time.

In summary, the UPP comes out cheaper than other schemes (including PAYG) offering comparable benefits.

- **Gradual build up.** The crucial step for the Government in pension reform is to bring voters alongside who will lock the scheme into a consensus which the contributors enforce. We have interpreted others’ views that there might be significant advantages in building steps to this objective by establishing the UPP and having it up and running in this parliament with only the COR paid into the fund. Voters will, therefore, know what the scheme is, how it operates and that it “works” before, at a predetermined second stage, the Government opens discussions, possibly in the next parliament, with the trustees and Governors as to the level of guarantee that is appropriate and at what cost such that the scheme is funded adequately to meet that agreed guaranteed level.

Conclusion

The UPP is not a final proposal. It does, however, contain both the principles and their practical application which will have to be enshrined in any reform which meets the test of time as did Beveridge’s original proposals.

Pensions Reform Group
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