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UK – on course for an innovative pension system

The UK may have one of the most mature occupational pension markets in Europe, yet seven million people do not save enough to meet their minimum retirement income.[1] This holds especially true for low income earners. One reason is a relatively low gross replacement rate of the public pension, only 30.8% in 2009, and substantially less than the OECD average of 45.7%.[2] In 2006, the government called upon a pension commission to analyze its pension system in order to address this deficit. Apart from increasing the state pension, the commission suggested auto-enrolment and a low-cost savings scheme which now comes into being as the National Employment Savings Trust (NEST). This paper reviews the current system in the UK, introduces the pension acts that resulted from the commission's proposals and discusses the current status of implementation.

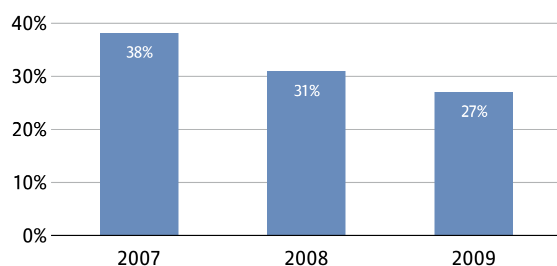
Current System

The pension system consists of three pillars: the base pension as provided by the state, the occupational pension orchestrated by employer and employee and the private pension initiated by individuals. The state pension is further divided into a Basic State Pension (BSP) and a State Second Pension (S2P). Only the BSP is currently mandatory and organized as a pay-as-you-go system with fixed pension benefits. Individuals can contract out of the S2P if they join an occupational or private pension scheme. The S2P is earnings related. To qualify for either type, individuals need to accumulate a minimum number of working years and reach the state pension age. The number of qualifying years as well as the state pension age is increasing across birth cohorts.

The second pillar of the UK pension system is related to individuals' occupation. Typically, occupational pension plans are run by pension funds or insurance companies. Companies with more than five employees must offer access to a company pension plan or a Stakeholder Pension, a private scheme, yet employees'

1 NEST Corporation 2010: Key facts and myth buster
2 OECD Pension Database 2009: Pensions at a Glance

Graph 1: DB Plans open to new members



Source: Pension Regulator, 2010: Annual Reports and Accounts

participation is not mandatory. In 2005/6, only 42% of working age men and 37% women respectively accrued non-state pension entitlements.[3] Traditionally, the occupational pension plans were of the defined benefit (DB) type, in which employees and employers make contributions to a plan and retirement benefits are proportional to the employee's salary. The percentage of DB plans open to new members has decreased as Graph 1 demonstrates. Today, most open schemes are of the defined contribution (DC) type, in which employees (and employers) make contributions to a plan, invest them and receive benefits upon retirement dependent on the rate of return of the accumulated assets. The current legislation foresees mandatory annuitization at age 75 to secure old age income.[4]

There are two main types of pension plans in the third pillar of the UK pension system: Personal Pension Plans and Stakeholder Pensions. Both are DC in nature and originally dependent on individuals' (employees') contributions. Today, however, they are often used instead of occupational pension plans because they are more flexible with regard to labour mobility and thereby reduce costs. The Stakeholder Pension is special as it is designed to encourage savings, especially among low income earners. The employer chooses the Stakeholder Pension provider, which must adhere to certain standards. Stakeholder pensions must, for instance, accept flexible contributions and low minimum payments and keep fees low (max 1.5% (1% after

3 www.pensionspolicyinstitute.org.uk/default.asp?p=81

4 George Osborne announced that the government will legislate a new rule in 2011 that enforces annuitization only for those individuals that cannot prove to have a minimum lifetime income of £20,000 per year. (www.guardian.co.uk)

5 The Pension Bill 2011 foresees a faster increase in the state pension age.

The State Pension System in Detail

In order to receive a Basic State Pension (BSP) upon retirement, people have to acquire a sufficient number of qualifying years and reach the state pension age. The Pension Act in 2007 made these requirements more complex by adding a cohort dependent component to the eligibility rules during a transition phase. Previously, male and female cohorts attained a state pension at age 65 and 60 respectively. The state pension age for females increases from 60 to 65 for those born between April 6th, 1950 and April 5th, 1955. The male and female state pension age increases from 65 to 68 starting with birth cohorts 1959.[5] Also, the required years to qualify currently varies across cohorts. To receive the full BSP, men and women born prior to April 6th, 1945 require 44 and 39 qualifying years respectively. People born after April 5th, 1945 need 30 qualifying years to be eligible to the full BSP. To receive any pension, people born before April 6th, 1945 require at least 25% of the regular number of qualifying years. The equivalent for people born after April 5th, 1945 is one qualifying year. People can acquire qualifying years by earning more than the lower earnings limit of £5,044 (2010/2011) or through special circumstances. These include caring for severely disabled people more than 20 hours a week, receiving unemployment or sickness benefits. Upon retirement at the state pension age, the full BSP is a flat rate £97.65 (2010/2011) per week. It is altered proportional to the number of attained versus regular qualifying years. There are some additional rewards for late retirement.

Contrary to the BSP, the State Second Pension (S2P) is currently earnings related. All employees earning more than the lower earnings limit may contribute. People earning less than the low earnings threshold of £14,100 (2010/2011), but more than the lower earnings limit of £5,044 (2010/2011), receive a S2P as if they earned £14,100. The accrual rate for people earning more than the low earnings threshold is proportional to their income. However, the accrual rate increases more slowly the more one earns. The S2P benefit during retirement is then determined by the accruals and by the proportion of actual versus potential working life. The potential working life refers to the number of years between state pension age and age 16. The working life of people born prior to April 6th, 1962 is calculated as the time between April 6h, 1978 and their state pension age. As in case of the BSP, the S2P becomes available when the applicable state pension age is reached.

10 years of membership) of fund value per year). Since the implementation of the Finance Act 2004 on April 6th, 2006, all pension schemes are subject to the same taxation. The act sets an overall lifetime allowance of £1.8million (2010/2011) and restricts annual tax-favoured contributions to £255,000 (2010/2011) at most. While the new system is simple, the transition from the old to the new system is complex.

Pension Reforming Acts

After analyzing the pension system in 2006 and realising many future pensioners will live below their targeted standard of living, the government levied two pension acts, one in 2007 and one in 2008. The major aims are

- 2007: raise state pension benefits and state pension coverage
- 2008: encourage more people to save and provide incentives to save in non-state pension schemes

Many elements of the Pension Act 2007 have already been implemented. The cohort dependent state pension age and number of qualifying years, elements of the Pension Act 2007, were implemented on April 6th, 2010. Also, easier access to the BSP for caregivers, parents and sick people via the minimum number of qualifying years has been implemented. Since April 6th, 2010, it is also easier for them to qualify for S2P. Two aspects are still to be implemented. As of April 2011, the indexation of the BSP will change from prices to earnings which should increase state pension benefits. And as of April 2012, it will no longer be possible to contract out of the S2P. It will then be mandatory for all employees, caregivers and parents with children younger than 12 years old. This implies that previously contracted out individuals will have to contribute to the S2P (again) and build up entitlements. In addition, the S2P will eventually become a flat rate benefit.

The main goal of the 2008 Pension Act is to increase private savings by, first, increasing the number of savers and, second, providing financial incentives to save more. Its content will become effective as of 2012. The key measure is to automatically enrol eligible workers into a qualifying occupational scheme. Automatic enrolment applies to anyone:

- Aged between 22 years and the applicable state pension age
- Works full- or part-time
- Earns equal to or more than the lower earnings limit from a single job[6]
- Not already in a qualified occupational scheme

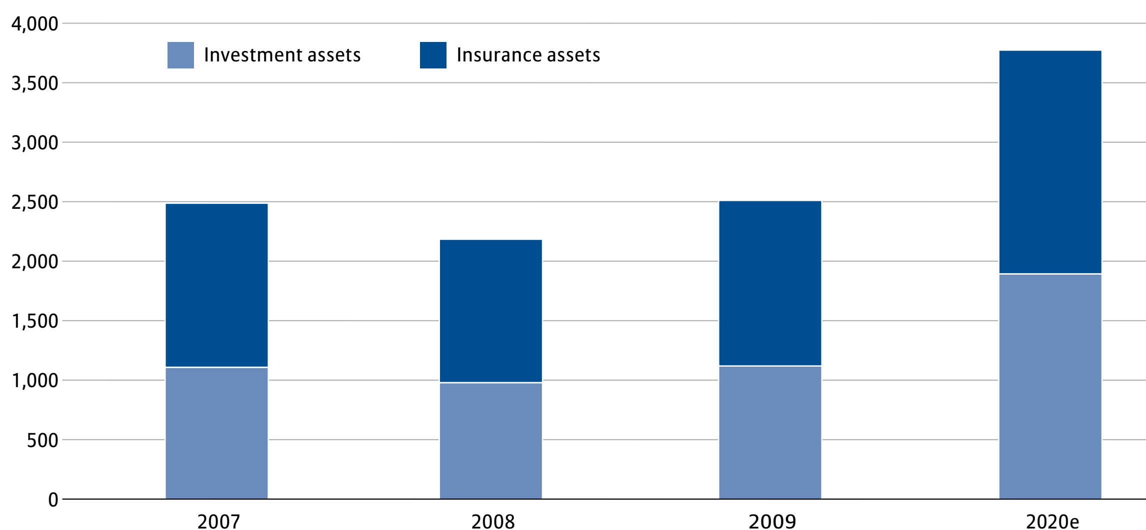
To reduce administrative costs for employers, the Department for Work and Pensions suggests in the Pension Bill 2011 that employees need only be enrolled three months after their start of work. Employers will have to contribute at least 1% of employees' earnings in the first four years after implementation. This percentage will increase to 3% until 2017. One percent will be added by the government in the form of tax relief. When fully phased in, total contributions on behalf of an employee should amount to at least 8% of his salary. One of the qualified occupational schemes is going to be NEST.

Another key ingredient of the Pension Act 2008 was the establishment of personal accounts through a newly created public body, the Personal Accounts Delivery Authority. Together with the Department for Work and Pensions and the Pension Regulator, it designed NEST. NEST is going to be a low-cost, not-for-profit personal savings vehicle that is to meet the requirements as laid out by the Pension Act 2008 to qualify for auto-enrolment. It is meant to facilitate savings, especially for low income earners. In the long run, its fees are expected to be around 0.3% of members' funds under management. To keep costs low, it will place an emphasis on e-services to make information and investing available online in an easy-to-understand manner.[7] The Personal Accounts Delivery Authority set up the infrastructure and the concept for the investment strategy. The latter has to be in line with members' characteristics such as their job types and expected investment horizons. To avoid cutting into already existing savings schemes, the Personal Accounts Delivery Authority decided on an upper limit of contributions on behalf of an individual of £4,300 (2010) per annum. This limit does not interfere with

6 The Pension Bill 2011 foresees a threshold of £ 7475 (2011) in line with the income tax threshold.

7 In fact, NEST published a phrasebook in January 2011, which explains pension terms in a simple manner, and put up a plain-speaking forum to encourage continuous conversations about pension terms.

Graph 2: Historical and expected market development



Source: Allianz Global Investors, International Pensions 2010

This graph plots investment assets in billions of Euro (defined as assets from autonomous pension funds as given by the OECD and other non-insurance type occupational pension funds) and life-insurance assets in billions of Euro (defined as assets under management of European life insurance companies). The pound/euro exchange rate is from December 2009. Expected numbers are based on savings, return and GDP growth assumptions.

the intention to be a saving vehicle for low income earners. In addition, given median earnings of £25,100 (2005) and assuming a contribution rate of 8% of total earnings (£2,008), there is still much room to save more. Since July 5th, 2010 the trustee corporation (NEST) is responsible for the management of the accounts and the investment decisions.

What will the future bring?

The establishment of NEST is already well under way. Its orders and rules have been published and come into effect. Despite the UK's significant state deficit and massive austerity measures, the government plans to launch NEST in October 2012. To swiftly repay the debt NEST assumed to be able to initiate the fund, members are charged 2% of their contributions until the debt is paid off.

Despite general acknowledgement that pensions used to be too low for a significant share of the population, there is no consensus that the reforms will increase individuals' welfare. Most importantly, auto-enrolment will lead to low income earners postponing their expenses where possible. Rather than spending when they actually need to (on children's education, for instance), they will defer expenses to retirement and thus might spend their money on what might be less essential. Moreover, the state pension by itself may already replace 70% of their previous earnings.[8,9] It is also pointed out that the upper limit on contributions as well as the mandatory contributions of 3% on behalf of the employer may send the wrong message about the adequate amount of contributions and lead to lower contributions than initially planned.

However, the government expects the vast majority of pensioners to be financially better off after the Pension Act 2007 and 2008. Due to the change in indexation, the benefits from the first pension pillar should increase for everyone. Even though high income earners may be negatively affected by the change of the S2P from an earnings-related to a flat-rate pension, the change in indexation should dominate the conversion from earnings related to flat rate and lead to an overall increase of state pension pay.[10]

8 Global Pensions 04/2010: Building a NEST

9 Johnson,P., Yeandle, D. and Boulding, A., 10/2010: Making auto-enrolment work – A Review for the Department for Work and Pensions.

10 Pension Policy Institute, 2009: Retirement income and assets: how can pensions and financial assets support retirement?

The effects of the Pension Act 2008 on retirement income, mainly the auto-enrolment, are less clear. Reasons include uncertainty surrounding previous contribution rates of employers compared to a now mandatory minimum of 3% (as of 2017) and substitution effects that may result from simply reallocating savings.[11] Behavioural finance has shown that auto-enrolment is generally a good method to increase the number of savers.[12] And the government expects the number of savers to increase from three to four million people.

Looking at the different types of income earners, the Department for Work and Pensions expects low to medium income earners to build up larger non-state pensions after the reforms. The effects are somewhat ambiguous for high income earners. Nevertheless, the Department for Work and Pension estimates 95% of the population will receive at least as much back as they contributed in real terms; most of them at least three times more.[13] The degree of improvement increases with birth cohorts. The only type of saver the Department for Work and Pension found not to benefit from the reforms were elderly people who pay rent.

Graph 2 illustrates expected pensions assets for 2020 and historical pension assets as provided by financial flow statistics. It distinguishes pension investment assets from life insurance assets, while the former refer mainly to the pension funds and the latter to the assets under management from life insurance companies. Total assets decreased by 11% from 2007 to 2008, predominantly due to the financial crisis, but regained strength in 2009. Assuming moderate GDP growth and financial market performance and taking the potential substitution effects associated with the Pension Act 2008 into account, Allianz Global Investors projects total assets to increase 50% by 2020. The ratio of pension investment to life insurance assets has historically been approximately 8:10 with insurance assets having the larger share. In the future, this ratio is expected to level out as auto-enrolment (into NEST) will increase pension investment assets for most savers.

Summary

To increase retirement income, particularly for low income groups, the UK government has simplified the system and increased state pension benefits. In order to make the pension system sustainable though, it also increased the SPA in line with increasing life expectancy. The government wants to push occupational and private savings further. It has therefore mandated auto-enrolment for the vast majority of workers and provided a low-cost savings vehicle as one possible pension scheme (NEST). The UK has thus further strengthened its pension system, yet whether this is enough, specifically whether people do not opt-out after having been auto-enrolled and whether they adhere to the targeted minimum contribution of 8% of their earnings is to be seen in the future.

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11 Pension Policy Institute, 2009: Retirement income and assets: how can pensions and financial assets support retirement?

12 Madrian, B.C. and Shea, D.F. 2003: The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior. *Quarterly Journal of Economics* 116: 1149-1225.

13 Department for Work and Pension, 2009: Saving for Retirement: Implications of pension reforms on financial incentives to save for retirement.

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