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IS THERE A RETIREMENT SAVINGS CRISIS? WHITHER PENSION REFORM?

A Discussion Meeting

[Held by the Institute of Actuaries, 23 May 2005]

Introduction

As the national debate hots up, this Sessional Meeting is being devoted to the following important topics, which affect life, pensions and investment actuaries:
- What should be the role of the State as pension provider — safety net or income replacement?
- Should the State Pension Age be raised? If so, when and by how much?
- Should the United Kingdom adopt a Citizen's Pension and scrap the State Second Pension and contracting out?
- Should there be more compulsory savings for retirement? If not, how can a voluntarist system be made to work better?
- What is the role for equity release?
- How can consumers become better educated in financial matters, and what role can actuaries play in helping to achieve improved levels of financial literacy?

These, and many other, challenging questions will be discussed.

Useful Reference Sources

Presidential Address, by Michael Pomery (Sections 1 and 2).
http://www.actuaries.org.uk/files/pdf/library/inst_add_2004.pdf

Pensions: Challenges and Choices — The First Report of the Pensions Commission.
http://www.pensionscommission.org.uk/publications/2004/annrep/index.asp

Response by the Actuarial Profession to the Pensions Commission's Report.
http://www.actuaries.org.uk/files/pdf/social_policy/pens_com_resp.pdf

Equity Release Working Party paper.
http://www.actuaries.org.uk/files/pdf/equity_release/
equityreleaserepjan05V1:pdf (Volume 1 — Main Report)

http://www.actuaries.org.uk/files/pdf/equity_release/
equityreleaserepjan05V2.pdf (Volume 2 — Technical Supplement)

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Pensions Policy Institute response (Part 2) to the Pensions Commission's Report.
http://www.pensionspolicyinstitute.org.uk/uploadeddocuments/PPI_Pensions_Commission_Response_January_2005.pdf

ABSTRACT OF THE DISCUSSION

The President (Mr M. A. Pomery, F.I.A.): I am particularly delighted to hold this discussion on the future of the United Kingdom pension system, as it is a matter of national importance and impinges on many of the areas in which actuaries work.

After the recent General Election, David Blunkett was appointed as Secretary of State for Work and Pensions. This indicates the importance which the Government attaches to these issues. He has already made it clear that he intends to press ahead with reforms to the U.K. pension system.

The Pensions Commission, under Adair Turner, will report in autumn 2005. This will represent a huge opportunity, coming early in a new Parliament, for difficult decisions to be taken. The next few months could see the shape of the U.K. pension system being set for the next generation.

I have some scene setting comments. First, it is not the role of the Actuarial Profession to be party political, although individual members can be, and often are. Our role is to spell out the implications of different policy proposals, and we should not be afraid to let our voices be heard.

The starting point for any consideration of pensions reform has to be the demographic changes which are happening here, as in most other developing countries. We have increasing longevity, a falling birth rate, plus a baby boom generation about to retire — in short, a rapidly ageing population.

We could muddle through on the pensions front, as Adair Turner has explained. Individuals would probably adapt their behaviour, working longer, saving more, but probably only in the last few years of work as the harsh realities struck home, and, overall, settling for a poorer retirement than they had hoped.

What would be the social implications of this muddling through approach? Each generation expects to be better off than the previous one as a result of economic growth. If this does not happen, they are likely to be bitter and resentful, and they are a powerful voting group.

However, the current generation of younger retired have been described as a golden generation, millions are enjoying, or will shortly enjoy, generous final salary occupational pensions, especially those in the public sector. SERPS has waxed and waned, but the biggest winners are those who reached state pension age around 1998. Many workers have retired in their fifties, not always from choice, but on enhanced pension terms. The problem flowing from the ageing population is that it will be very much harder for the next generation to be significantly better off in retirement than the current one. Inevitably, the average age at which people retire will creep up, particularly as early retirement before age 60 or even age 65 becomes a thing of the past. The advent of defined contribution (DC) schemes will encourage and accelerate this trend.

It is often said that we need to encourage higher savings for retirement, but there are no simple solutions to this problem. There are so many factors to take into account. For instance, personal debt is immense and continuing to grow. There are alternative ways of saving. Just think of owner-managed small businesses. Investing in the business with a view to selling it on when you no longer want to work is a genuine form of retirement saving. Also, what will be the impact of inheritance, as the new generation of house owners pass on their assets, just as their children are themselves reaching retirement age? Equity release has an important role to play as part of the overall solution to retirement income. The profession is doing good work in this field, and has published two reports in recent years, with further ongoing work.

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Work-based pensions will be key components of any solution. There is survey evidence that people trust their employer more than anyone else when it comes to dealing with financial services. Occupational schemes are also more cost effective than individual pensions. There are new risk-sharing designs spanning the spectrum between final salary and pure DC, which point the way forward.

On the choice between greater compulsion or increased encouragement for voluntary savings, there is a major need for the proponents of a compulsory system to spell out just how it might operate. Our role, as actuaries, will be to point out the implications. For instance, would there be strong pressure from the public for guaranteed outcomes to their compulsory savings, and would that then lead to risk free or minimum risk investment strategies, and, if so, why is that better than expanding the state pay-as-you-go system?

There are also challenges for actuaries in the product design area. How do we provide low cost products in a low interest rate environment? I believe that the time is right for a radical rethink on annuities. They are much maligned in the media, but provide an important protection against outliving your resources in old age. I would suggest that they are no longer suitable for 50 and 60-year-olds. They could do their job much better if they were not bought until, say, age 75, or even age 80. That would leave the way open for savings institutions to design new products for people during their sixties and seventies.

The problems are challenging and multifaceted; the solutions are likely to be highly contentious, and also multifaceted.

Our opener is Ms Alison O'Connell, Director of the Pensions Policy Institute, which is doing much good work in analysing these issues and publishing the results.

Ms A. C. O'Connell, F.I.A. (opening the discussion)**:** In the last 3½ years or so, as the Pensions Policy Institute (PPI) has been operating, it has been quite striking how at the start we thought that pension reform was some time off, as we had had some major reforms. Now, it seems almost a certainty that there will be further major reforms, if not in this Parliament, then in the next.

I shall pick out what, I think, are the most important parts from the extensive reading list.

There are a number of concerns in U.K. pensions:

(1) There is the complexity of the state system, which provides for the basic state pension, the state second pension (S2P), guarantee credit, savings credit and contracting out — five different state products, each with its own different rules. This is before you get to the complexity of occupational and personal pensions. It is complex enough that, even though individuals might have trouble understanding it, pensions experts cannot possibly be expected to know all the elements of the system, which makes even talking about pension reform very difficult.

(2) There is the inadequacy of the state pension system. There is pensioner poverty, although it is much less than when the Government came to power in 1997 and instigated pension credit. That is because the basic state pension is so low and does not operate well for all groups of people. We are increasingly reliant on means-tested benefits. The take-up of guarantee credit is now around 80%. The take-up of savings credit, where that is just claimed as a single benefit, is less than 50%, which means that there are a lot of people who are not getting the benefits to which they are entitled.

(3) There are inequalities in the system. There are inequalities in income before retirement, and, therefore, you would expect to see inequalities in income in retirement, because occupational personal pensions have to replicate that, they cannot redistribute. The problem which we have is that the state pension system also has inequalities in it, so that it leverages the disadvantage for certain groups of people, in particular females and the oldest pensioners. Fifty per cent of women are not entitled to a full basic state pension in their own right. Even going 20 years further out, the average woman will have a basic state pension 15% less than the average man. These figures are important, because it is a big problem today, which is not going to go away by just letting the system pan out. May I remind you that there are more women than men — they are not a minority interest group. The oldest pensioners are particularly hard hit, not just because there is a cohort effect,

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but also because of the indexation of the basic state pension. We also have the disabled, the self-employed, and other groups, which may actually add up to be more than 50% of our population disadvantaged in some way.

(4) There is the unsustainability of the pensions system. Projections of the cost of the current state pension system, using government assumptions, gives a fairly level percentage of GDP over the next 50 years. These projections make assumptions as to how much people are saving and what the return on those savings will be, how much pension credit people will be eligible for, and how much will be taken up. If you make plausibly different assumptions, possibly more realistic than those from the Government, then the cost of the state pension system will be much higher in future. The risk is all on the upside. A flat spend on state pensions going forward for 50 years, whilst the number of people over state pension age increases by 50%, means, on average, that people will receive less. A growing proportion of the electorate will not be happy about that! The political pressure is for state pensions to increase and for the cost of state pensions to go up. So, for those, and for other reasons, the current framework for state pensions is not sustainable, and we have to think about some kind of reform.

(5) Further, private pensions are not filling the 'gap' — the gap created by declining state pensions and the gap created because we need to put more money in, as we all live longer. This is the concern which is normally addressed in the pensions debate about the retirement savings crisis and attracts most 'air time'.

Considering point (5) in more detail, the size of the retirement savings gap, based on the Pensions Commission's estimated numbers, can be defined by what we need to have in order to maintain the living standards of pensioners through to 2050, on average. By 2050, we should be transferring nearly 14% of GDP to people over state pension age. This compares with the state pension, estimated to then be providing 6.9% of GDP, although there might be reasons why that would go up by the time we reach 2050.

You have to make some more assumptions as to what the transfer from private pensions might be expected to be by that time. The assumptions which the Pensions Commission made for its central estimate were that there would be a fall in contributions made to occupational and personal pension plans (reflecting a fall from the current level in occupational pensions), because, today, much of the money is not going towards paying for accrued pensions for today's employees, but making up for the pension contribution holidays in the past. The central estimate of the Pensions Commission is that there will be a fall in pension contributions of around one third over the next 15 years. It also assumed, for this estimate, that there is no increase in non-pension saving through savings vehicles such as property for equity release, ISAs, and so on. You will come to your own opinion as to whether or not that is realistic.

What the projections mean is that the transfer to pensioners which will come from private pensions in 50 years' time is not much different than it is at the moment, around 4% of GDP. This means that there is a gap of around 3% of GDP which needs to be filled somehow. One way in which it could be filled is by people working longer. The Pensions Commission assumed, in their central assumption, that the average retirement age of women will go up, as a consequence of the state pension age for women going up from 60 to 65, but only as far as the current average age for men, which is 63.8, and that there is no further increase in either the male or the female average retirement age. You will come to your own views as to whether or not that is realistic.

It is not really a retirement savings gap, but a gap potentially caused if state pensions, pensions saving, non-pensions saving and working later work out in such a way as this. It might be that things work out differently, and that the gap is closed. The Pensions Commission was set up to look at ways of closing that gap. The PPI has also looked at a number of scenarios and ways to fill the gap. If state pensions are not to be improved, we need to be considering both saving more and working longer. There is a complicated second order consideration, which is that, if people do save more, they might be tempted to retire earlier.

In order to consider what the right way forward is for pensions, we have to start with the

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benefit which everybody pays for and benefits from — the state pension system. We have to understand how much is going to come from the basic state pension in 50 years' time, so that we have a firm underpin for whatever non-state scenarios we want to consider.

Reform to a better first-tier state pension has to come first. When reforming the state pension system, it is not just because we have identified the savings gap as being an issue, but because we have identified five issues: the inequalities, the complexities, the inadequacies, the unsustainability, and the lack of private provision.

There is great disparity in savings amongst the U.K. working age population, reflected in income. Over 9 million people are not working, and most of these are not accruing a private pension. They will most likely be very dependent, if not totally dependent, on the state pension. Next, nearly 7 million people earn less than £10,000 p.a., the majority of whom are again accruing no private pension at all. Then, the majority of people earn between £10,000 and £20,000 p.a., and, of these, about 50% have an occupational personal pension. It is only when earnings exceed £20,000 p.a. that the majority of people actually accrue a private pension.

In summary — of 35 million working age people, 20 million people are not accruing any kind of private pension, but 15 million are. Therefore, for most people the state pension will be, if not of total relevance, then of great significance in their retirement income. Therefore, state pensions should be looked at first.

Many of the submissions made in response to the Pensions Commission's first report on long-term savings talk about reform of the state first-tier pension. There has been much talk in the press about whether or not there is consensus about what reforms should actually take place, but we believe that there is.

The Pensions Policy Institute analysed 30 major organisations making submissions to the Pensions Commission and other policy proposals. Of those, nearly all want the state first-tier, or basic, pension to be indexed to earnings, which is a reversal of the linkage to prices which happened some years ago, and which is the main reason why the basic state pension is so low now. Nearly all organisations want the basic tier to be at least at the level of the guarantee credit, the means-tested income, of £109 per week. There is less consensus about how the overall pension should be designed, and limited knowledge about the choices. Whilst 14 organisations, out of our sample of 30, said that they would propose that the pension be on a citizenship, or universal, basis, five wanted to keep the contributory principle, and the remainder just did not know, or suggested that it should be reviewed. Half of that sample said that the state second pension should be scrapped in the interests of simplicity, so that the first tier of basic pension is the only one, but at a higher level. Then, everything is simplified for occupational and personal saving on top. Other organisations wanted to keep some kind of state second tier, even if they wanted the first tier improved.

One thing which is particularly noticeable about many of the proposals is that the organisations making them just do not have the available information to work out what they would cost, so that they are, to some extent, wish lists. The debate really needs to start about what we can practically afford to have.

I will take you through some examples for higher benefits, so that you can see the kinds of trade-offs possible, either through taxes or through other means, like raising the state pension age.

If we roll forward the current system for the next 50 years, the Government estimates that the cost will remain level, even though there is an increasing number of pensioners. This is shown on Figure D.1, which also shows a dotted line, which is our estimate of what the upside risk might be on some fairly plausible assumptions for people not saving as much as the Government assumes, and therefore falling back onto pension credit (a greater number than the Government is assuming). So, there is a fairly large funnel of doubt for what the current system might cost. In the middle of that funnel of doubt sits the policy option which we were asked to cost for the National Association of Pension Funds (NAPF), the citizen's pension at £109 per week.

Even if you had a basic state pension on the contributory system at £109 a week, it is going to look very similar to that cost in the long term, although, in the short term it will be more

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A better first tier will cost more…

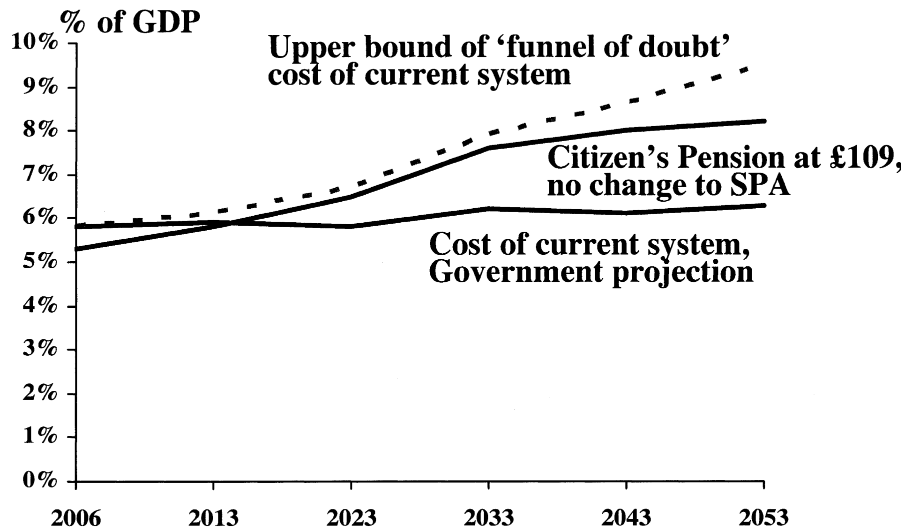

Figure D.1

expensive. The short-term cost of the citizen pension is actually below that of the current system, because of the transition method, and I recommend the NAPF publication for the details.

The figures shown in Figure D.2 illustrate that, in order to get a better state pension in line with what most organisations want, pensions will be more expensive than those which the Government expects to pay in 50 years' time by about two percentage points of GDP. That money will have to come from somewhere, if it is not from an increase in taxes. Two percentage points of GDP is 20% of the budget for health services and 40% of the budget for education, so it is not easy to switch from one pot to another. Some of it is going to have to come from increasing the state pension age.

Figure D.2 also shows the cost of the current system and the possible upside cost for a citizen's pension at £109 per week, but with an increase in the state pension age to 70. It runs along the cost of the current system, but an increase to a state pension age of 70, even by 2030, is going to be very difficult to achieve. Therefore, we will be looking at some combination of state pension age going up and increased taxes. The other line on the graph shows the same proposal in the long term, keeping the basic state pension at the higher level of £109 a week, but also retaining the state second pension. This results in a further one percentage point or so of GDP. If you want a better first-tier basic state pension along the lines shown, and then have compulsion on top, by some kind of private savings, then that will cost extra money as well. Instead of the extra cost, the extra 1% of GDP, going on taxes and being redistributed by the state, it will go into individuals' savings pots. Still extra money has to be found for better state pensions.

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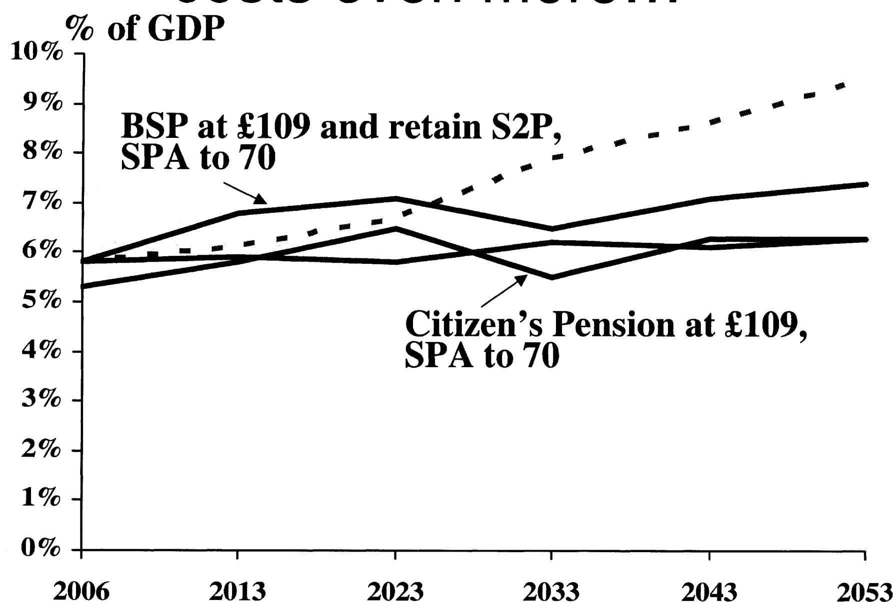

Figure D.2

There are some real trade-offs between the options to see how good we want the pension from the state to be, how much we are prepared to pay for it, and how much we want additional earnings-related state pensions on top.

To show that conceptually, Figure D.3 tries to crystallise the point which the debate has now reached. What the figure shows along the horizontal axis is people arranged according to their incomes, and taking them cumulatively. So, you can see where half the population falls. The horizontal line is what the state would deliver through a better state pension at the first tier. I have put that at 22% of national average earnings, which is the guarantee credit level, but, obviously, there is a choice where you put that line. We know that, if you put it where the solid line is, at £109 a week, that is going to cost around 8% of GDP.

If you want an earnings-related tier on top of that, it could look like the top line, but broadly going up in line with earnings. That is going to cost even more, whether it is into a state earnings related scheme and we resurrect something like SERPS, or whether it is into compulsory private savings which individuals might own, but they still have to find the money from somewhere if it is compulsory.

The question arises, if we look at where most people are, where the circle is on Figure D.3, where there are the people about whom we are most worried, because they are at risk of low pension incomes. It is a finely balanced trade-off question for them, as to whether or not they would actually prefer a higher state pension, where redistribution could put more money into

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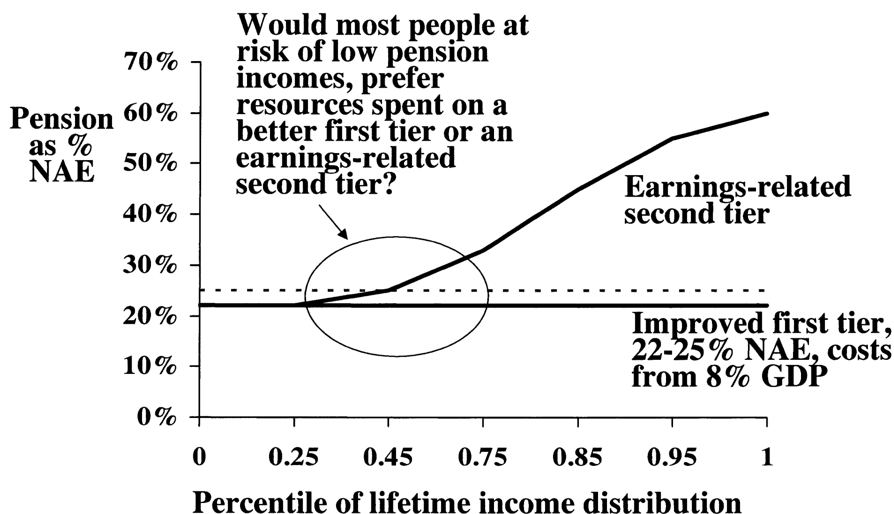

Figure D.3

their pocket through the state, or whether or not they would prefer an earnings related system, where they might get less money out of it, but higher income people might get more. That is the really difficult question being considered in the pensions debate. We need more numbers, and more modelling work in order to understand the costs and the ways in which the different proposals impact on people of different income situations.

I finish with what I think are the key questions which need to be answered:

(1) What first-tier basic pension should the state deliver? What should the state actually deliver through its mechanism, so that it can be distributed and paid for through taxes or National Insurance contributions? At what level should the pension be? How should it be delivered? Should it be through the existing contributory system or through some kind of citizenship or universal pension which uses a residency test instead? Once we have that, then we are in a better position to answer the next questions.

(2) What should the second-tier earnings related pension be, should the state compel it? Should there be such a pension? If not, then the role of the state, once the first tier is delivered, should not be in delivery or compulsion, perhaps enabling, but the state basically should not do very much in the earnings-related tier. Should it be delivered by the state or should it be delivered by the private sector through occupational personal pensions? In this case the state would still intervene in order to mandate how that happens. If there were to be that kind of compulsion, should it be just on the employer or on both the employer and the employee?

(3) Having achieved the first tier, and perhaps the second tier, of what the state says really must happen, we can think about the things which the state should enable, should help to happen, but not necessarily say must happen. In other words, the state has a policy role

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through having an objective, but the state does not necessarily have a role in delivering or mandating. That includes things like incentives, where the state actually puts some money towards incentivising pensions or other savings, like ISAs, or where the state puts down rules for how things should operate, for example, automatic enrolment into occupational pension schemes. Alternatively, should the state just help in giving education and the informed choice of programmes which are currently being developed?

(4) Should there be an option to switch from state to private, or should contracting out be abolished? This concerns a switch of money without necessarily creating new money, and it just makes the whole thing more complicated.

(5) The state also has a role in some kind of encouragement of working later, but the real question is: "How much can the state do in that?'' What more can it do on top of the kind of age discrimination legislation which we are going to see in operation soon? Should the state's efforts be focused on changing employer behaviour, or should the state's efforts be focused more on trying to change individual behaviour? Of course, we need to think of what role the state pension age has in all of this.

These are some very meaty questions, which only, in part, lead to understanding some of the trade-offs which need to be made, but I hope that they set the scene for answers.

Mr R. K. Sloan, F.F.A.: There are countless interlocking pieces in the overall pensions jigsaw, but I propose to focus on the one issue of compulsory pensions saving. This needs to be explored in more detail before the many strongly held views on this subject become even more polarised than they are already. My purpose is not to make out a case for compulsion or to act as a proponent; although some form of compulsion is probably inevitable; my aim is to put forward a blueprint for an acceptable method of 'semi-soft' compulsion.

I first examine the effective pension value conferred by employers on members of existing public sector pension schemes. Table D.1 shows, in columns (1) and (2), the NHS and Local Government final salary schemes and the broad pattern of value being conferred, net of employee contributions at 6%. We can then look at the Civil Service scheme in column (3), which is the same as column (2), but with a 3% differential in the members' contributions. The key point is that the value is clearly age related, as is obvious to us as actuaries, but which is also being recognised elsewhere in tangible ways. One example is under the Civil Service scheme, which now offers a money purchase alternative on an age-related scale, which is set out in columns (4) and (5).

Given the fundamental logic of age-increasing money purchase contributions, I have set out in Table D.2 my proposed scale of compulsory contributions to be applied to pay only between the lower earnings limit (LEL) and the upper earnings limit (UEL), and payable by employers only, not by employees. That way there is no question of these being regarded as a pension tax. It is a simple formula of age divided by ten, in five-year bands. For example, a 30-year-old gets 3%, a 35-year-old 3.5% and so on, as shown in column (7).

On top of this compulsory core, I propose a further layer of optional matching, where employee contributions would be matched £ for £ by employers, up to the same level again as the core scale. So, at its maximum, shown in column (11), this could result in total contributions of three times the core scale, with the employer/employee split being 2:1.

I have then looked at the possible pensions which could be generated by such a scale of tiered contributions, based on the realistic funding assumptions shown at the left of Table D.3. Looking first at non-contributory company core contributions, we see that the pension accrual rate is one quarter of 1/60th, or 1/240ths of (salary − LEL) at virtually every age. Next, we can look at projected pensions at age 65 resulting from the maximum fully matched scale, which gives rise to a pension accrual rate very close to 1.25%, or 1/80th of (salary − LEL), again uniformly at all ages. The overall outcome will lie somewhere in between 240ths and 80ths, depending on each individual employee's chosen optional level of saving; but it is, undoubtedly, a meaningful level of benefit.

If we now turn to some anti-compulsion arguments, unaffordability and other family

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Table D.1. Value conferred by *Employer* in public sector pension schemes

Scheme :	NHS / Local Govt		Civil Service "Choices"		
Basis :	Final Salary		Final Salary	or Money Purchase	
Employee conts :	6.0%	6.0%	3.0%	Nil + match up to 3%	
Status :	Leaver	/ Stayer	Stayer	Minimum (if e'ee nil)	/ If max 3%
age	(1)	(2)	(3)	(4)	(5)
20	(0.9%)	4.0%	7.0%	3.0%	6.0%
30	1.3%	6.3%	9.3%	6.5%	9.5%
40	4.5%	9.2%	12.2%	10.0%	13.0%
50	8.8%	12.5%	15.5%	12.5%	15.5%
60	15.0%	16.6%	19.6%	12.5%	15.5%

Table D.2. Compulsory company core + optional matching

	Employer minimum 'core'				Maximum matching				
attained	(6)	(7)		(8)	(9)		(10)		(11)
age-band	E'ee	Co		Total	E'ee		Co		Total
- 24	-	2.0%	=	2.0%	2.0%	+	4.0%	=	6.0%
25 - 29	-	2.5%	=	2.5%	2.5%	+	5.0%	=	7.5%
30 - 34	-	3.0%	=	3.0%	3.0%	+	6.0%	=	9.0%
35 - 39	-	3.5%	=	3.5%	3.5%	+	7.0%	=	10.5%
40 - 44	-	4.0%	=	4.0%	4.0%	+	8.0%	=	12.0%
45 - 49	-	4.5%	=	4.5%	4.5%	+	9.0%	=	13.5%
50 - 54	-	5.0%	=	5.0%	5.0%	+	10.0%	=	15.0%
55 - 59	-	5.5%	=	5.5%	5.5%	+	11.0%	=	16.5%
60 -	-	6.0%	=	6.0%	6.0%	+	12.0%	=	18.0%

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Table D.3. Illustrative pensions from compulsory tiered MP contributions

	Pensions as % of estimated Final (Sal - LEL)				
	Company Core Only			with Full Matching	
Basis :	Total at age 65	Accrual rate pa	attained age	Total at age 65	Accrual rate pa
7%pa return (less 1% charges)	18%	0.40% pa	20	53%	1.18% pa
4%pa salary growth	14%	0.41% pa	30	43%	1.23% pa
2.5%pa RPI escalation	11%	0.42% pa	40	32%	1.26% pa
+ 50% spouse's pension	6%	0.43% pa	50	19%	1.28% pa
5%pa interest at age 65	2%	0.42% pa	60	6%	1.26% pa
	¼ x 1/60th : 0.42%pa			¾ x 1/60th : 1.25%pa	
	or 1/ 240th Final (S-LEL)			or 1/ 80th Final (S-LEL)	

priorities are addressed by the compulsory core scale being employer only, and with the optional matching being tiered by age, such that higher contributions may be paid at those stages in people's careers when they are likely to be more affordable.

The cost to the employer is, of course, an important issue. The specimen workforce shown in Table D.4 leads to compulsory core contributions costing just on 3.6% of total payroll, perhaps not too heavy a burden. If maximum employee matching were to occur throughout, which is most unlikely, then this would evidently double the potential cost to a maximum of about 7% of payroll. As the actual figure would depend on the salary and age distribution of each workforce, I would propose an overall maximum of, say, 6% of total payroll, to avoid age discrimination. Any excess above 6% could be offset against the employer's total National Insurance bill. There would also be provision for total exemption from such tiered compulsion where alternative schemes met a prescribed requisite contribution, or value, test.

To those who might baulk at even a 6% employer maximum, I would remind them that the well-regarded Australian system of compulsory contributions now amounts to 9% of eligible pay, having started at 3% back in 1992. Moreover, experience there has shown that the introduction of compulsory employer contributions has, in fact, encouraged increasing amounts of voluntary member contributions, which I would expect to be mirrored in the U.K.

I would also introduce greater incentives for the lower paid, by changing employee pension contribution tax relief to a simple flat-rate basis of, say, 25% across the board, which is a one-third add-on to what the employee pays net. In other words, each £75 paid in would become £100 invested.

I then review again, in column (11) of Table D.5, the maximum fully matched scale under my proposal, against which we can compare, in column (12), the Civil Service money purchase option mentioned earlier, including the employee's 3% which was part of the matching option. In column (13) I show the Second Pillar compulsory scale introduced in Switzerland in 1985, 20 years ago, which is similar to my proposed scale. If tiered contributions can work for the financially astute Swiss, and for our own Civil Service, then I commend such a structure as a blueprint against which to consider the possible adoption of compulsory pensions saving in the U.K.

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Table D.4. Analysis of compulsory company core contributions

	Scheme Membership Data				MP contribution rates			MP conts (Sal - LEL)	
age-band	No	@ Salary	Full Sals	Sal - LEL	E'ee	Co	Total	E'ee	Co
- 24	5	£12,500	£62,500	£41,180	-	+ 2.0%	= 2.0%	-	£824
25 - 29	8	£15,000	£120,000	£85,888	-	+ 2.5%	= 2.5%	-	£2,147
30 - 34	10	£18,000	£180,000	£137,360	-	+ 3.0%	= 3.0%	-	£4,121
35 - 39	12	£21,000	£252,000	£200,832	-	+ 3.5%	= 3.5%	-	£7,029
40 - 44	14	£25,000	£350,000	£290,304	-	+ 4.0%	= 4.0%	-	£11,612
45 - 49	17	£30,000	£510,000	£437,512	-	+ 4.5%	= 4.5%	-	£19,688
50 - 54	14	£28,000	£392,000	£332,304	-	+ 5.0%	= 5.0%	-	£16,615
55 - 59	12	£25,000	£300,000	£248,832	-	+ 5.5%	= 5.5%	-	£13,686
60 -	8	£23,000	£184,000	£149,888	-	+ 6.0%	= 6.0%	-	£8,993
	100		£2,350,500	£1,924,100					£84,715
					Conts as % of Full Sals :				3.60%

(LEL = £4,264)
(UEL = £32,760) (2005-06)

Table D.5. Comparison of tiered MP contribution scales

	Proposed Compulsion : with max matching			Civil Service Scheme : max matched MP option	
attained	(9)	(10)	(11)	(12) = (5) + 3%	(13)
age-band	E'ee	Co	Total	Total (Co + E'ee)	Total (Co + E'ee)
- 24	2.0% +	4.0% =	6.0%	9% / 10.5%	-
25 - 29	2.5% +	5.0% =	7.5%	12.5%	7.0%
30 - 34	3.0% +	6.0% =	9.0%	14.0%	7.0%
35 - 39	3.5% +	7.0% =	10.5%	16.0%	10.0%
40 - 44	4.0% +	8.0% =	12.0%	17.5%	10.0%
45 - 49	4.5% +	9.0% =	13.5%	18.5%	15.0%
50 - 54	5.0% +	10.0% =	15.0%	18.5%	15.0%
55 - 59	5.5% +	11.0% =	16.5%	18.5%	18.0%
60 -	6.0% +	12.0% =	18.0%	18.5%	18.0%

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Mr C. M. Stewart, F.F.A.: I am focusing on a narrow point, not yet covered, which is the need to remove the burden of buyout on wind up from existing private occupational defined benefit (DB) schemes. This may be possible if a scheme can still be confident of getting a higher rate of return on its investments than the rate assumed in the calculation of non-profit deferred annuities.

Some years ago, when the Government's plans for a Minimum Funding Requirement (MFR) were being discussed, I reminded the law makers that, in the buy-out provision in scheme rules, we already had a minimum funding requirement, and it would be folly to introduce a lower MFR without over-riding that provision. However, the Government did not heed that reminder, and introduced a lower MFR, with serious consequences today.

It is now too late to over-ride buy-out, but we may be able to persuade members to agree to give it up. In the present climate, it should be possible for a company to convince its employees that drastic measures are required. There are a number of positive approaches.

I suggest that we offer existing members a bigger wind-up benefit — perhaps LPI + 1% in the period to pension age — if they agree to give up the right to buy out. The cash equivalent of the bigger benefit should enable the members to secure at least as large benefits at retirement, since the cash could be invested in something better than non-profit deferred annuities. If they accepted this offer, then they would continue to accrue salary-related benefits in the present scheme. A money purchase scheme would be set up for new employees and for the future service of any existing employees who decided not to accept the changed wind-up benefits. Existing employees would appreciate that the company's business was suffering as a result of the deficiency disclosed in its pension fund, and see the need to eliminate buy-out, but this might not influence former employees with deferred pensions. They could be offered the same increases, but it might prove necessary to offer them an extra incentive, such as an increase in the benefits promised on retirement.

If there is to be any future for defined benefits in pension schemes, the benefit promise must be confined to the benefits paid on retirement. The benefit paid on withdrawal, or wind-up, will have to be a realistic value of the pension benefits accrued to date, reflecting an appropriate investment policy.

We may be too late. Even with guaranteed benefits available only on retirement, the risks may still be too great for companies to accept, in which case personal pensions will become the norm in the private sector, and apparently in the public sector as well. One advantage of a system of personal pensions is that an individual who wished to retire early could draw down on the balance until the state pension became payable. So, it would be compatible with an increase in the state pension age to 70, which seems inevitable.

The remaining question is whether the Government is willing to increase the state pension to a level which would keep most pensioners off means-tested benefits. If it does this, then it can take a more relaxed view of occupational pensions. If it does not, then I expect that personal pensions will have to be compulsory, with minimum contributions specified for the individual and for the employer.

Dr C. S. S. Lyon, F.I.A.: I spent most of my professional career deeply involved in pensions, and found myself on various committees and working parties concerned with the interrelationship between state and occupational pensions. My Presidential Address in 1982 was on this subject. For the past 18 years I have been drawing a pension related to final salary, though, as has been indicated earlier, my children and grandchildren seem unlikely to be as fortunate. Times and attitudes have changed. You may think that an enduring partnership between the state and the occupational sector to produce an earnings related pension was always a mirage, and that the many of us who worked to achieve it were wasting our time — but were we? What went wrong, and could we have foreseen it?

To start with, any cost which falls on the Exchequer is a cause for concern to the Chancellor of the day, especially if it is increasing, no matter that the increase may have been planned or predicted. Action may be taken to contain the growth, as happened in the examples which we have seen earlier, when the basic state pension became linked to prices instead of to earnings,

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and, again, when the formula for the state earnings related pension was cut back. Now, I am not arguing that those actions had no reason, for economic and democratic circumstances change, and changes influence policy, but the effect was to damage the basis of the partnership.

The developments which directly involved occupational schemes were more profound. If we are honest, we can see that it was a mistake to use the introduction of SERPS as a lever for extending final salary schemes right across the board. The losses incurred in such schemes by early leavers relative to long stayers were well understood, and, in an increasingly volatile labour market, a fairer framework, with fewer funding problems, would have involved accruing pensions as a percentage of current earnings and revaluing the accrued benefits progressively for price inflation, rather like SERPS does.

Then, more recently, the funding process has been found wanting. Although a greater than expected improvement in longevity is a significant factor, the root cause has been a Treasury requirement to judge under, or over, funding by reference to assets at market value. While, for solvency purposes, it may be imprudent in a depressed equity market to take assets above market value, it does not follow that it is prudent to give full credence to current market values when the market is booming. To do so encourages the continuing purchase of equities, and, with the cyclical nature of the market, ensures that what appears to be a high surplus will sooner or later turn into a discontinuance deficiency, the more so if the reaction to the surplus is to take a contribution holiday, or to be forced so to do.

The result of recent experience has been the disintegration of the final salary concept and disillusionment with financial institutions and, to a considerable extent, with the Actuarial Profession itself. It has not been helped by the Thatcher Government's decision to abolish compulsory membership of occupational schemes, and the mis-selling of personal pensions that followed.

So, here we are, almost back at square one, debating how to move forward again. It is axiomatic, as Ms O'Connell has explained, that there are two potential sources of a retirement income: an unfunded benefit from the state; and an income from one or more forms of savings. Most people, as we have seen, need both, and savings are most efficiently generated by contributions deducted from pay, or linked to it. This is the key to any comprehensive amelioration of the pensions problem. Suppose that the present state second pension scheme was to be replaced by a DC plan, based on earnings between minimum and maximum percentages of the national average. If the contributions could not be paid into a suitable occupational scheme, would it not make sense for the employer to hand them over to a central agency, which could be instructed by individual contributors to pass them on to approved savings media of their own choosing? Unless, or until, that happened, the agency would hold and accumulate them on the contributors' behalf. Such an arrangement would give employees considerable freedom and flexibility of choice, without involving employers in administration, for which many are ill-equipped. It will also facilitate continuity on changes of employment.

I forbear from offering an opinion about selective retirement ages, compulsory annuities, dependants' benefits, equity release, how to deal with self-employment, who should bear the investment risk and other aspects of the present debate. All I will say is that decisions are more likely to endure if they are simple and readily understood. On these counts, the present partnership may be seen to have failed.

Dr L. W. G. Tutt, F.F.A.: In a thesis which I wrote in 1981, I reasoned that the state pension age should be increased gradually to an age in the late sixties for both sexes. That suggestion may still seem to have merit, although a number of changing circumstances impinge. Indeed, in fairness to the elderly, instead of the state pension age being raised to assist in reducing rising costs, should the proportion of the national income desirably to be devoted to them be increased? Perhaps there may be justification for many in the population to think so. As I understood the remarks of the opener, such is very practicable.

The notice for this meeting reads: "Should the State Pension Age be raised? If so, when and by how much?" There is no reference to the possible lowering of state pension age. May I thus just mention that, in the Government Report, Cmnd. 8173, published in 1981, the year of my

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own thesis, it is stated that a common state pension age of 60 for both men and women would be regarded as a long-term objective.

Such may be considered by some today as an outmoded view of 24 years ago; but would this merely suggest that views being put forward now may be similarly regarded 24 years hence? What is 24 years? It is only 50% of the period of time of the theoretical projections put forward by the opener, as I understood her. Can the adoption of a specified state pension age, in our very diversified population, be reconcilable? For example, can those who have spent all of their working lives in heavy manual work think, reasonably and justifiably, that a lower state pension age should apply to them than to those who have spent their working lives in physically easier sedentary occupations? Thus, there are problems. Nevertheless, a decision needs to be arrived at.

I suggest that, if the decision is made that the state pension age is to remain, at least for the time being, at age 65 for both sexes, then the right to work, to continue to work, should be respected by all, and the financial terms for reasonable deferment, when so chosen by individuals, should be improved significantly.

I am reminded of some remarks by the eminent Canadian actuary, H. R. Lawson, reproduced in the *Transactions of the 17th International Actuarial Congress*, Part 4. He asked whether it was necessarily a good thing for everyone to withdraw abruptly from the accustomed pursuits of a lifetime solely because of reaching some arbitrary age, and he asked whether the removal of all workers from the labour force at a certain age was a good thing or a bad thing for society and for the national economy.

Mr S. F. Yeo, F.I.A.: As Dr Tutt has just reminded us, the notice of the meeting asks whether the state pension age should be raised. If so, when and by how much? This question overlooks an important issue, which is not when and by how much state pension age needs to rise, but how.

There is a tension between the need for long-term planning for pensions and the four to five-year cycle of the election process. This tension is made worse by the tendency of politicians, of all colours, to misrepresent the policies of their political opponents. While we, at this discussion, might see an obvious need for the state pension age to rise, and for that to be made clear to the current working generation, whoever is in opposition at the time when such a change is announced would see it as a chance to capture votes from sections of the electorate who might be unaffected, but amongst whom fear could easily be spread. As a result, politicians have devised a variety of ways, some stealthy, of implementing the unpopular policy of increasing state pension age. I have identified four.

The original, which, for purposes of identification only, I term the Tory way, was that enacted in 1995, whereby the pension age for women retiring after 2010 gradually increases from age 60 to 65. No stealth was needed here, because this had the fair wind of sex equality at its back.

The current route of choice, which I term the Labour way, is to improve incentives for late retirement. Whilst it is still arguable whether these incentives are sufficient to make late retirement attractive for everyone, it is easy to see how they could be improved yet further, so that even more people retire late. This method has the attraction of being effective relatively quickly, but, in this means-tested world of ours, suffers from the drawback that poor pensioners will tend to draw their benefits early, so that the behavioural change is most prevalent amongst the richest part of the population.

The third way, which I term the Lib Dem way, directs resources to providing a significant increase in state pension at an advanced age, perhaps 75, lifting pensioners clear of any definition of poverty beyond that age. Again, this can be implemented relatively quickly, and whilst it might be the intention at the outset to reduce the age at which the poverty-free state pension is paid, one can see how, if this were not done, later retirement would be encouraged. This very attractive policy would also provide significant relief to the beleaguered annuity market, as the first call on small savers' retirement pots would be to top-up their income for the short period between their date of actual retirement and the date at which the large state pension kicked in.

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Finally, there is the Swedish way. There, the significant part of the state pension is provided in the form of a notional DC accumulation, which is applied to purchase a lifetime pension using life expectancy estimates produced by an independent committee.

So, the question of how the state pension age should rise is at least as important as when and by how much. For my part, there would be considerable merit if an independent Swedish style group, perhaps analogous to the Bank of England Monetary Policy Committee, were to play a part in this. This would have the effect of taking a sensitive critical decision out of the adversarial and, in terms of pension reform, ineffective, atmosphere of Westminster.

Mr T. A. Salter (Institute Affiliate)**:** It is encouraging that there is, at least, the beginning of a public debate about increasing the value of the state basic pension as a proportion of national average earnings. The pension, intended by Beveridge in 1948, to be a minimum income for subsistence for individuals to build freely upon it with pensions from employment or personal savings, has never been able to support a reasonable standard of life for poorer pensioners without supplementary means.

When the pension was introduced in 1948, the rate was nearly a third below what Beveridge had recommended as being necessary for subsistence, and, as a consequence, significantly more pensioners than anticipated were forced to rely for support on means-tested benefits. The situation was further aggravated because the pension did not provide for housing costs. (Abel Smith, quoted in Timmins, 2001.)

Since the 1980s, the value of the pension has, as a matter of policy, been allowed to decline steadily as a percentage of national average earnings. Governments have chosen not to restore the link with earnings in the uprating of the pension. This would have given pensioners a share in rising prosperity based on the growth of GDP. Instead, reliance on means-tested benefits has increased. These benefits, including the so called 'pensions credit', are not pensions, but 'poor relief'. (In principle, the pensions credit is no different from housing benefit or council tax benefit.)

Understandably calls for reform of the basic pension have largely centred on achieving 'adequacy' by uprating the pension to a higher proportion of national average earnings. For instance the National Association of Pension Funds (NAPF), wishing to restore the incentive for retirement savings, has advocated a pension set at 22% of such earnings, which would have the effect of restoring the pension (currently about 16% of such earnings) to its level immediately before the first Thatcher Government. Alan Pickering's report for the Adam Smith Institute in 2004 has recommended a universal non-means-tested pension of 40% of such earnings.

The Pickering proposal is virtually identical to one put forward by the Social Policy Subcommittee of the Labour Party in 1973. In Barbara Castle's view, this was a 'very socialist' scheme, and she opted, instead, for the earnings-related additional pension. This, I think, was retrogressive for our 'mixed economy' of pension provision, because it imported into the social security system inequalities of income replacement which more naturally belong in the economic market. If the proposal for a significantly increased state basic pension was considered 'very socialist' by Barbara Castle, it seems unlikely that it would commend itself to the welfare conservatives of 'New Labour'.

Any proposal for a higher rate state basic pension will have to be very focused if it is to succeed. Age Concern has argued for years for a basic pension sufficient to eliminate the need for means-tested benefits. In its view, in common with other groups concerned with the relief of poverty, there will always be incomplete take up of means-tested benefits. The Government's target is to have 3 million pensioners receiving pension credit by 2006. According to Age Concern, this target still only represents about 75% of eligible pensioners, leaving more than 1 million in poverty (Age Concern, 2003).

People can be said to be poor when their incomes fall below the threshold of 'need'. Need, however, is a contestable concept. So, if we are going to propose that the state basic pension should be paid at a high enough level to eliminate the necessity for means-tested benefits, we have to try to base it on a concept of adequacy related to an objective measure of 'human needs'.

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Needs, however, are not static, so that the poverty threshold changes over time; nor are needs entirely material. They include social and psychological needs, as well as food and shelter.

Perhaps a useful way to evaluate and measure this relative concept of need would be to have recourse to household budget standards, that is specified 'baskets' of goods and services, which, when priced, represent particular living standards. These can be 'low-cost or poverty', below which health is at risk, or 'modest-but-adequate', which aim to meet the 'prevailing' standards of what is necessary for health, housing costs, efficient living and participation in community activities. Budget standards, regularly updated, are useful indicators of human needs.

The idea was pioneered by Seebohm Rowntree in his study of poverty in York in 1901, and used by Beveridge in 1942 to help establish benefit levels for Britain's post-war welfare state. Budget standards are used in North America and in mainland Europe, but not in the U.K. until the Family Budget Unit, which originated at a meeting at the London School of Economics and Political Science in 1985, started to revive them. Budget standards, in the view of some people, may not be easy to work with, but I suspect that the Family Budget Unit is right, particularly in relation to pensioners, when it says that, without such standards, 'the risks of poverty and financial injustice are unacceptably great'. (Family Budget Unit, 1994.)

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Professor G. T. Pepper, C.B.E., F.I.A. (in a written contribution that was read to the meeting)**:** People still do not understand that national funding of pensions is a very different subject from funding an individual pension scheme. It is a typical example of the difference between macroeconomics and microeconomics.

A nation can only fund pensions in two ways. First, it can fund externally by accumulating assets abroad. This means that there must be a deficit on the capital account of the balance of payments, which must be matched by a surplus on the current account. The trouble is that the U.K. has a large deficit on the current account.

Second, it can fund internally by building up productive assets, for example new factories, in the hope that workers will allow pensioners to benefit from the consequent gains in capital productivity, as distinct from labour productivity. The trouble here is that the U.K.'s gross fixed capital formation is low. There needs to be a shift from consumption into investment. However, there is a trade-off between consumption and investment. As consumption falls, people increase their savings. Too large a fall in consumption could lead to a danger of recession, in which case industrialists will not build new factories, because they have spare capacity in their existing ones.

Overall, the problems are economic rather than actuarial.

In the real world there are no insoluble problems, because the world carries on. However, solutions to problems which materialise may be very nasty. Within a funded pension scheme there is a hidden transfer of assets; contributors buy assets from pensioners. If all pensions are funded and demographic factors are favourable, there are more buyers than sellers. If demographic factors are adverse, there are more sellers than buyers, in which case asset prices will tend to fall and pensioners will be disappointed with the level of their pensions, however prudent actuaries are.

Mr I. J. Kenna, A.I.A.: I agree with Dr Lyon's remarks about the funding of final salary pension schemes and the personal pensions disaster of 1989 to 91.

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The trouble about personal pensions and other money purchase schemes is that one needs assistance; the average person needs advice on what he hopes to get. The advice costs about £150 an hour, and there are limited people qualified to give it. Money purchase arrangements, personal pensions, or stakeholder pensions, have not met people's needs. We have to take an integrated approach to company pensions and state pensions.

The population seems to be divided into about four categories. There are the undeserving poor, the deserving poor, the fat cats and the people who oscillate between the deserving poor and the undeserving poor, depending on what is best for them themselves. The fat cats are simple to define. They have considerable private pensions. On retirement I did not cease paying higher rate tax, but paid a lot less: I was not paying AVCs or National Insurance contributions or share options any more. Also, from age 65, I received £5,000 a year from the Government.

Now we come to the undeserving poor, the people who have probably never saved very much, or at least not so that anybody can see. They are probably not in a pension scheme. Many of them are in the black economy, where they and their employers have been dodging paying National Insurance contributions, and probably taxes as well. Then, when they get to 65, shall we say, they decide to retire. Strictly, of course, they should be hard up, but they will not be hard up, neither will their employers. They receive the full means-tested benefit, also housing benefit, worth as much as £5,000 a year, council tax benefit (another £1,000 a year) and possibly care benefit, another £1,000 a year. They will probably also get free local transport as well. So, they are really doing quite well.

The deserving poor, who make up the bulk of pensioners, are those to whom the state pension counts for something. They would welcome a citizen's pension, because they realise that they will not get any state supplements if they are receiving over £10,000 a year, or if they have a trivial amount of savings. This approach is not encouraging people to save.

The opener talked about a citizen's pension of £109 per week. We need to know whether there will be a citizen's housing benefit and a citizen's council tax benefit and a citizen's care benefit, because these are the benefits which the vast majority of pensioners are extremely annoyed about not being entitled to. They see themselves as always having paid their taxes, their National Insurance contributions, etc., and, having saved their money, find that they are not much better off than those who have been dodging all their lives.

So, we have to look at the package as a whole. There is still is a role for final salary pension schemes, but they have to be integrated with the whole state benefit package. Some schemes provide for early retirement pensions with a deduction at age 65. For example, at one insurance company, when you get to 65, assuming that you retired early and you are a long-service member, your pension is reduced exactly by the state retirement basic pension. I should imagine that that deductible would have to go up.

A course of action which is also possible is to supply to people benefits which cost very little in practice. The cost of supplying free public transport to old people, especially when most transport firms are subsidised anyway, is not very much. On the other hand, it is a good benefit, and induces people to use public transport instead of using other means. This benefit, and possibly others cutting down pensioners' expenses, should be integrated into the total pension package, from state and private sources. In this 'package', savings, on which tax has been paid on contributions and interest, should not be taken into account.

Mr M. B. Ward, F.I.A.: I was glad to see, in the Institute's response to the Pensions Commission, that it supported a significant reduction in state means testing. There are many reasons why means testing should be significantly reduced. Under present Government policies, if the pension credit system remains unchanged, as many as two-thirds or more pensioners could, by 2050, be in receipt of pensions credit. That is an unacceptable and unsustainable extension of means testing.

Means testing does not get to all its intended recipients; over 1 million people currently are missing out on benefits which they should get. The actual process of claiming means-tested benefits is not an easy one. For all the introduction of call centres and helplines, it is still a stressful process for the average elderly person to have to go through, and it is intrusive into their

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personal affairs. As Mr Kenna pointed out, it is extremely unfair on those people who take their responsibilities seriously and save for themselves. They are penalised very significantly by the current system of means testing.

While I am pleased to hear from the opener that there is a consensus around raising the level of basic state pension, I wonder whether that consensus extends to the present Government. It remains committed to the policy of means testing, on the grounds that it is effective in minimising the resources used, but it fails to meet all the other objectives.

It is not sufficient, if you were to get rid of means testing, to address the level of the state pension. You also have to look at eligibility, which is where we come to the citizen's pension. The Institute appears to be supporting the retention of the contribution test, which is disappointing, as women are disadvantaged by this test. It is also the case that not all men have full contribution records, and therefore earn the full state pension. I favour removing the contribution test altogether, and replacing it with a residence test. This would be fairer as between the sexes. The Institute identified one particular group of pensioners which is disadvantaged, and that is the ethnic minority group of pensioners. While a residence test clearly would not help all of them, it would help a number, those who had been here for the residence period, but not long enough to have a full contribution record.

These are serious issues on which we ought to be pressing for further debate.

Mr P. Mullan (a visitor)**:** I have written a book on the subject, *The Imaginary Timebomb — Why an Ageing Population is not a Social Problem*, which is the theme which I should like to address.

Picking up on one of the opener's key issues, where she articulated the reasons for the consensus which exists around an adequate pension at £109 per week, she said that, perhaps, the debate should focus more on what we can afford, which is a very significant question, and it would be better if we spent more time on it.

The pension discussion should refocus from the very valid question of the distribution of wealth to the creation of wealth, and how much we can create over the next period.

On Figure D.2, the extra cost to provide £109 per week flat rate, the first-tier pension, is 2% of GDP, and 2% of GDP is £20 to £25 billion. How can we afford it? What is the time horizon over which that extra cost of 2% is having to be met?

The time horizon is a process which will take effect over 45 years. That is when the 2% will come into effect. I would ask you to think: "Is 2% over 45 years really that much of a challenge to us to be able to afford? What will be happening during the course of those 45 years?" What I am sure about is that, unless the world falls apart, productivity will grow at some level between now and 2050, and, even if we take very modest levels of productivity growth, say less than we have had over the past 20 years, say something like 1.5% to 1.7% a year, society will be incredibly more prosperous in 45 years' time. In rough terms, we are talking about doubling the amount of resources which are created every year in 40 years' time as compared to today. So, it is a much more prosperous society which we will be looking at with that 2% apparently unaffordable burden. If you consider then compared to today, if everything was equal and everything was evened out, society would be expected to be at 200% of living standards, compared to what they are today.

Now, returning to the extra 2%, even adding on the cost of healthcare and of long-term care, most figures say that something like 4% to 5% of GDP is what is involved — 4% to 5% out of an economy which will be double the size that it is today.

Refocusing more on the question of affordability has three merits. Firstly, if we emphasise the question of affordability and the creation of wealth, it will allow us to break the logjam which we can anticipate from the politicians who say that it is a great idea, but that we cannot afford it. We have to be able to say that we can afford it.

Secondly, we should focus on the fact that, the stronger we are as an economy, the more prosperous we will be. The idea that, because we are getting older we are necessarily going to become poorer, is wrong. As we create wealth, and more wealth is created, we can become more prosperous over that time.

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The final merit for this is if we move away from talking about savings problems and savings issues and focus on productive investment. That is something over which we have more control. We should be working on and focusing on increasing growth in investments; 1% extra compound a year is more important for the future of society than the 2% of GDP which a decent pension would cost.

Mr R. W. Steel, A.I.A.: The basic problem with the Equitable Life was not its guaranteed annuity options, but the fact that its policyholders had been led to believe that they were entitled to a benefit of which the management was not aware, i.e. the exact nature of the terminal bonus. This is the same problem as with many mortgage endowments, where policyholders thought that the guaranteed sum assured applied at maturity as well as on death. The mortgage endowment problem has resulted in 'informed opinion' believing that security is important, and that a death benefit should not be provided unless actually needed.

In contrast, the 'standard pension policy' now offered by the industry is as far away from this as we can get. Essentially, the 'standard pension policy' being offered is just a savings pot which must be used to buy a real pension at retirement. It offers no security of value prior to retirement. It does offer a 'return of fund' death benefit, whether you need it or not.

If we are to provide a 'standard pension policy' conforming to the same standards now required for mortgage provision, we should offer a policy with a specified pension and a choice of death benefits, including none for those without any dependants.

Now, when we had an assurance industry, as opposed to a finance industry, we did offer such policies widely. They were called deferred annuities. What killed widespread deferred annuities was a 'consumer lobby' complaining about the lack of 'return of fund' death benefits. The resulting media hype frightened my then employer to consider adding 'return of fund' to all its existing policies. I am sure that it was not the only one. The fact that policyholders were getting value for money was ignored by the media hype. A good example was the expert on the BBC's 'Moneybox' programme, who, when asked about the point, said: "I think they get lower charges."

The features of a deferred annuity, on the securities side, can be offered within the 'standard pension policy' with a 'must have' annuity option, one that fixes the rate of pension to cash, not the better of this and the market value, and things like 'non-profit funds'. The 'less than fund' death benefits can be provided by 'survivorship bonuses', similar to those for immediate annuities, explained in Wadsworth *et al.* (2001).

This is also how you can solve the problem, or the battle, between the people with self-administered personal pensions who want to do away with the age 75 maximum, and keep the money, and the Inland Revenue, which is afraid that, if you waive that, then people will use that to get round estate duty and death duties and never take the pension. After the age 75 limit, the administrator keeps the fund on death, but adds survivorship bonus instead.

If we want people privately to provide security in their retirement, we ought to offer them a product which provides them with the type of security which they want, and not the products currently available.

Reference

Wadsworth, M., Findlater, A. & Boardman, T. (2001). Reinventing annuities. Paper presented to the Staple Inn Actuarial Society.

Mr P. D. G. Tompkins, F.I.A.: I am spurred to respond to several comments in order to strike a note of caution against three elements which I have heard.

The first is the suggestion of compulsory DC pensions. We should be very careful about going down the route of the state enforcing on the citizen obligations which he or she might decide differently for themselves.

The second is the suggestion of an employer-based compulsion. Charging 5% to the employer is no different from reducing the employee's salary to 95% and taking the 5% from the employer.

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Economically, it might be a sleight of hand that lasts 12 or 24 months, for a couple of pay rounds until things adjust, but the employment cost is the employment cost, regardless of where you actually impose the tax.

Thirdly, in response to Mr Mullan, who has just contributed to the argument about getting wealthier, and therefore an extra 2% is small in response to becoming more wealthy, it is not as simple as that. Indeed, if we were to double our wealth in the next half-century, or whatever it might be, why should we take 10% or 15% out of that wealth and do what the state wants with it? The individual citizen deciding how he, or she, should spend the money earned is a more valuable way of encouraging productivity and encouraging a world where, if we are twice as wealthy, the state does not need to increase its participation in the provision of welfare in retirement.

Mr R. A. J. Waddingham, F.I.A.: Most consulting actuaries involved in workplace pension schemes are busy, but they are doing destructive work. They are closing them down and fighting fires. That is not at all satisfying.

We use the word 'crisis' about things which we had and have lost. We need to look back at history and learn a lesson. I am not apportioning blame for what has gone wrong. For me, the pensions crisis is that, 20 years ago, before 1985 in particular, it was not difficult to persuade a good employer, and there are many of them, to set up good retirement benefits for their workforce. Now it is impossible.

I am not suggesting that we go back to the 60ths final salary scheme, but we can do rather better than basic money purchase pension schemes. It was disappointing that in the last General Election, when pensions featured, very little was said about how we can again persuade good employers to voluntarily set up a scheme. A scheme set up voluntarily will always be better than one set up on a compulsory basis.

We could reinstate National Insurance incentives, which have worked in the past, in particular when introduced in 1978 through contracting out. However, I accept what Dr Lyon said, that contracting out may have caused too many of the wrong sort of schemes to be set up.

Good employers were taken advantage of by successive Governments since 1985, and it is not surprising that they are no longer willing to stand up behind good pension schemes. The Government kept moving the goalposts, in particular in imposing compulsory pension increases. These and other 'improvements' individually may have seemed okay at the time, but history teaches us that it is unreasonable to ask a willing employer to set up a financial commitment and deny all safety valves.

We must allow retrospective changes with regulatory permission, and with adequate periods of notice, to benefits to cope with changing circumstances. We ask for no more than the Government did itself with the retrospective change to female retirement age. Employers, too, should have that freedom.

It is no coincidence that the Netherlands, where a scheme in financial difficulty can pause pension increases until it recovers, is a country where DB schemes still thrive.

The message for workplace pension schemes is that we shall have to decide whether we want 'good' pensions or 'guaranteed' pensions. Life was better when more than half the workforce had good pensions through workplace-based schemes.

Mr T. M. Ross, O.B.E., F.F.A.: I am Chairman of the Pensions Policy Institute.

My point comes through in a number of contributions to this discussion, which is: "What should be the role of the state in retirement provision?" One of the major reasons for the complexity and inadequacy of the U.K. state pension system is connected with the involvement of the state in earnings related pension provision, either through compulsion, which we may have in future, or, as in the past, through SERPS and contracting out. We should not be surprised at that, because earnings related provision does automatically lead to demands from various interest groups for value under a system which, by its essential nature, should be one of redistribution from the rich to the poor.

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A state pension system, as a foundation for further provision, should be, first and foremost, simple and transparent. That is the way to achieve 'consensus'. Political consensus is a contradiction in terms, and will always be undermined by complex systems which allow opportunistic changes to be made without the electorate noticing what has happened. If we really want sustainability and a solid foundation, then it has to be simple and redistributive. I therefore commend the role of the state as a provider being restricted to a suitable flat rate pension. I happen to favour a citizenship pension system, for some of the reasons already given. Whatever form it takes, it should be clear and transparent, and not be obfuscated by providing or compelling earnings related provision. Therein lies the route to complexity, and being here in 20 years' time having the same debates.

The opener's final point, finding ways to make paid work more attractive in later life for the vast majority of older people, is very important. This work should not just be for the few privileged ones, like some of us, who can migrate to non-executive posts and voluntary work. Such opportunities need to be created through re-education and re-training to the wider population. Generous immediate pensions should not be paid automatically to those people in public service jobs which they should not be expected to continue doing beyond middle life because of their nature, such as the armed forces. Instead, the state, as an employer, should provide re-training opportunities for a second career for those people, which would be a far better use, long term, of state resources, rather than paying pensions from unreasonably young ages. It is inevitable that the so-called savings gap will be filled substantially by paid work. What needs to be planned for is an environment where people will wish to take on that paid work as a matter of preference, not as a matter of necessity.

Mr C. G. Lewin, F.I.A.: When reforming a pension scheme you should look at new entrants first, and get it right for them, before addressing existing members. New entrants have no political baggage or existing entitlements.

I want to concentrate on new entrants to the state system, for example my son, aged 17. What should we promise him as a state pension? We do not know what the state will be able to afford in future years. It is sheer guesswork. Our promise should, therefore, be modest. It can always be improved later if the state's resources permit. A modest promise of a very simple nature would easily be understood and encourage personal saving for those who do not think that it is going to be enough.

In looking at what we should provide for someone like this, we need to ask ourselves: "What is the purpose of a state pension?" Most people would say that the purpose is to provide a reasonable minimum level in the declining years of life. On average (not distinguishing between different groups of people), in 1948 that was thought to be the last 12 years of life for men. That is a reasonable measure. Therefore, I think that, for my son, now aged 17, it is quite reasonable to provide him with a state pension which is simple, not linked to expectation of life from age 70. He can retire before that if he wants to save up to do so.

The citizen's pension suggested by the NAPF is a very reasonable measure — 22% of national average earnings, universal, not means-tested, would be quite satisfactory for this purpose as a promise. Then it should be for him and his employer to save on top of this if they wish, knowing that the state has promised no more than a minimum level. I do not think that my 17-year-old would object to this. At the moment, he is going to enter a system which is a mess, and which may be a mess for many years. Why should we not do something for him now which is simple, like my proposal?

That does not solve the whole problem, but it is a start. For existing members, we cannot make such a drastic change, but getting it right for new entrants is possible.

Mr C. A. Speed, F.F.A.: A state earnings related pension perpetuates the income inequalities during working life. Is that a sensible thing for the state to be doing? That brings us back to the idea of the role of the state. It seems sensible that the state should try to have pensioners above the poverty level, although we need to discuss what we actually mean by that.

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I applaud the introduction of pensions credit, because it moved a lot of people out of poverty in retirement. However, looking forward, means-tested benefits are untenable if too many people are caught by them. The earnings related element will also reduce the funds available, the resources available, to pay the first tier pension. Therefore it should be queried.

Effectively, if we have an earnings related pension, it is a state constraint upon the consumption pattern of an individual. If, as an individual, I want to consume in a different way, this is strictly sub-optimal. It does not make economic sense.

There are, however, very good roles for the state, particularly in promoting efficiency. I should like to see the state act as an aggregator of services to produce economies of scale. We all know the problems of having very small pots of money to manage through financial institutions. This can be circumvented. We know that means testing is expensive, but, on the other hand, deductions at payroll are extremely efficient. Whatever we do, it needs to be simple, it needs to be efficient and it needs to be understandable.

Ms D. R. Cooper, F.I.A. (closing the discussion)**:** I shall begin with state provision, because that is where the discussion concentrated mainly, and also with its close relative, compulsory saving. The opener spoke eloquently in favour of reform of the state pension. There was a general consensus among those who contributed to the discussion that certainly something has to be done. I have to mention the contributory system, because I am partially responsible for the Institute's submission to the Pension Commission's response, which was mentioned during the debate.

I can see many strengths to the citizenship principle, but the eligibility criteria and the contributory system have been amended so that some of their previous weaknesses, like the married women's opt out, for example, have been removed, and it could easily be reformed to remove any remaining problems. Assuming that a citizen's pension will be fairer for all women is a mistake. It is the level of the basic state pension, rather than the eligibility criteria *per se*, that makes our current basic state pension seem unfair.

There are two points which are not often raised in the eligibility versus citizenship debate. The first is: "Who pays?'' A citizen's pension still has to have contributions, and who are these women who do not work and cannot be credited with contributions due to caring responsibility, for example? They are certainly not women from low income households. These women enter the employment market certainly when they can, albeit on low rates of pay. Under a citizen's pension, they would then have to pay taxes to subsidise the non-working partners of the better off.

The other point is the political risk which accompanies a citizenship test. Under a contributory system, people accrue rights to a pension, making it difficult for governments to amend state pensions retrospectively. There are no accrued rights under a citizen's pension, leaving it vulnerable to the most successful lobbying group's agenda.

As the proportion of older people increases, for example, they could choose to vote for the party which promises to pay the biggest pension at the expense of those working taxpayers who must then pay for it. We saw this, although at a much lower scale, in the recent General Election, as the Labour and Conservative parties vied to give age-related handouts to those over state pension age.

There was also some debate over whether the state has any place in providing an earnings related pension, and if so, how it could be afforded. On the grounds of simplicity, particularly if contracting out is permitted, the answer is probably not, given past experience. However, if employers continue replacing earnings related provision with DC provision, the state could become the only provider which can actually pay earnings related benefits. Although it might seem unpopular, there was a lot that was good about the original Barbara Castle scheme, particularly the best 20 year rule, for example, which was beneficial to women, and just because it has become the nightmare that it is today, we should not dismiss state earnings related provision without giving it even a cursory glance. The conclusion might be not to touch a similar design with a barge pole, but at least the debate is worth having.

Some people thought that compulsory saving might step in to rescue people from an

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impoverished retirement. Of course, the state pension already provides a form of compulsory retirement saving, and, for people on low incomes, if its current value were maintained in real terms, it could serve very well for a large proportion of society. By current value I mean that this assumes that the state second pension (S2P) is mature.

The real issue which we face is that the system of compulsory saving which we have at the moment is being allowed to wither away because of the way in which basic state pension and the S2P thresholds are indexed. It seems bizarre to consider bolting yet another system of compulsory saving on to this with a whole new set of rules and regulations, when the existing system is already over-complex.

A real difficulty with extending compulsory savings beyond what is needed to provide those on low incomes with a reasonable retirement income, so maintaining the status quo, is that, implicitly, it assumes that there is a single savings regime which will deliver well for everyone, and this is not true. Everyone's financial and household circumstances are likely to differ, as well as their employment history and their ability or propensity to bear risk.

As a result, while compulsory saving could work well for some, it will work badly for others, leaving them less well off whilst at working age, and not that much better off in retirement. Of course, the other consequence of such taxes on working people is that it makes it harder for them to help themselves. The more heavily each pound of pay is taxed, the harder it is for people on low earnings, in particular, to improve their financial status. This is the curse of the tax credit.

However, what the state does will not be perfect for everyone, either. Those of us lucky enough not to be on low incomes while of working age will not want to rely on the state for income in retirement, and why should we? I do not think that the state should compel me to provide well for my retirement, just as I do not think that it should compel me to eat my five units of fruit and vegetables or to take 30 minutes' exercise every day.

In general, it should not be the Government's role to protect us from events which we can control ourselves, albeit that we might need a little bit of a struggle or help from external agencies. It is there to protect us from events which we cannot control.

If I were not the closing speaker, we could get into an argument which would be essentially political about what events we can or cannot control. However, for those of us paid more than the average, I would suggest that savings to provide ourselves with foreign holidays, for example, once in retirement is something which we ought to think of doing for ourselves.

Equity release and other non-pension forms of saving, remaining longer in work or phasing retirement, are all ways in which we can help ourselves to manage this. Provided that our basic needs are met, we ought to be allowed flexibility to balance these choices without too much government interference.

However, pension saving does fall into a special category, because of its long-term nature and complexity and because the distinction between private saving for retirement and welfare is quite blurred. In this sense, the Government does have a role to provide some level of basic income in retirement, and it seems reasonable for pension saving to have a favoured tax status relative to other forms of saving, together with some quite tight restrictions. I deliberately avoid saying 'tax relief' here, since tax is largely only deferred, and what relief there is is actually quite limited. Pension saving is also different, because it is generally associated with pay.

I now consider employer provision and looking at people's patterns of incomes. The majority of income comes from employment whilst at working age, with the bulk after retirement, after state pension age, likely to come from a variety of sources, but largely the state. This pattern makes it clear that employers are incredibly well-placed to help their employees provide for retirement by providing them with mechanisms for deferring their pay. The evidence is that large employers can do this at low cost, certainly relative to individual provision, although smaller employers may need some support. The question is how to do it in a way which imposes acceptable levels of risk to the key parties, the employer and the employee, and the Government as a partner in providing social welfare. The way in which risk is shared between these three groups has changed over the past 20 years. At the moment, it is clear that the balance of risk sharing appears unacceptable to every party.

It is wrong to suggest that employers and the Government are the only villains in this

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scenario. If the status quo in terms of provision had been maintained, then older employees and pensioners would have been the guilty parties, since, by retiring earlier or living longer than expected, they have imposed unanticipated costs on to their employers and on to younger taxpayers.

I do not want to infer that living longer was a cost deliberately imposed on younger generations by a malicious group of elderly pensioners, or that people should be expected to sacrifice themselves just to maintain the original level of risk sharing in the contract, but the balance could have been maintained by reducing the level of benefit provided by schemes or enforcing later retirement. At the time, this flew in the face of perceived wisdom, contributing to a rather extreme move to define contribution provision, a design, incidentally, which naturally incentivises behaviour which will balance this longevity risk.

However, in some cases, as some speakers have commented, replacing final salary with DC schemes has over-adjusted for the shift of risk to employers and placed excessive risk on employees, who, sometimes, cannot deal with it very well. Employers, employees and their representatives need to think of more imaginative approaches to providing deferred pay, which could include some DC provision, perhaps alongside lower level defined benefits, and tax simplification provisions in the 2004 Finance Act might enable them to do this.

The Government has optimistically said that it would like to achieve a consensus before putting in place further reforms, recognising that retirement planning requires long-term stability. Apparently the Government had consensus back in 1975, with the Act introducing SERPS. Within ten years SERPS was already undone, and it was New Labour that served up S2P a few years ago. For all its superficially good points, S2P might prove to be the most futile exercise in state pension reform which we ever have to see.

This debate is likely to run and run, but an adequate conclusion does need to be reached quickly, because people need to feel reasonably confident that they know what to expect once they reach retirement, and employers will be reluctant to touch pension provision until there is a conclusion, and unless they feel confident that the goalposts are not going to be moved again in the near and the not too distant future.

The suggestion that has been referred to for two-tier retirement ages, credited to Adair Turner, but quickly refuted by the Government, shows how hard it is even to contribute a new idea to this debate, even if it is indefensible, and it is clear from the contributions in the discussions that consensus could be hard to reach.

However, I hope that some acceptable compromise will not be so difficult. There are solutions to this so-called pensions crisis which most groups should be able to agree to, even if only grudgingly, particularly if they enable the other partners in retirement provision to act more appropriately, either on their own or, in the case of employers, on their employees' behalf.

The President (Mr M. A. Pomery, F.I.A.): I would like to thank everybody who has participated in the discussion. I ask you to join me in thanking, in particular, our opener and our closer.

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