Spotlight on Pensions
PRESENTS
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Time for a new pensions policy framework – and a new covenant?

The current cost of living crisis starkly highlights once again the need for savings to provide a buffer for when household budgets are placed under strain.

Although the current situation may be unprecedented in recent times, those with greyer hair have experienced financial crises before and are familiar with the regular ups and downs of the national economy. There will also always be unexpected financial shocks, as identified by Harold Macmillan in his famous "events, dear boy, events" observation. The COVID-19 pandemic and the war in Ukraine fall into this category.

Fluctuating finances

Economies ebb and flow (despite some suggestions in the noughties that "boom and bust" had been eradicated). There are uncertainties around those movements, not least in respect of timing, which underline the need for financial contingencies to cover times of stress.

The same principle applies to personal finances. However, some occasions involving financial stress are more predictable. Retirement is one of those. We have a complex regime to address that. However, strongly-held opposing viewpoints, fuelled by pensions' significant fiscal impact, leads to policy shifts and a lack of integration across related policy areas.

There have been many well-intentioned initiatives and policies over the past few decades. Unfortunately, they have not always achieved their full potential due in part to changing policies in other areas, exposing a lack of integration and consistency. The impending change of prime minister offers the opportunity to take a radical new path towards a more relevant and sustainable system.

More savings needed!

It is clear that as a nation we are collectively not making sufficient financial provision to meet even predictable retirement income needs. Whilst automatic enrolment has been a great success in increasing private pension coverage, that success is undermined by insufficient funding. The statutory minimum contribution levels are woefully short of those needed to supplement the meagre state pension to achieve an acceptable aggregate retirement income.

Unfortunately, the promised review of auto-enrolment, including the possibility of increasing required minimum contribution levels, continues to be deferred. One justification is that during the current cost-of-living crisis there is little, if any, scope for asking people to divert more of their income from meeting current financial needs. This is supported by emerging evidence of people reducing or suspending contributions or even active membership of their scheme. However larger contributions could of course be required from employers. Furthermore, for reasons already noted, there will always be fluctuations in affordability of pensions funding. The current crisis is temporary and by the time higher contributions are called for, they may be more bearable.

Barriers

Although there may be scope to increase contributions overall, there are two related underlying aspects of the UK economy that present major impediments when trying to craft a framework that is both effective and affordable for all – the large and growing private wealth disparity and ballooning fiscal pressures on the economy. These are problems beyond the ability of the pensions world to address alone. However, there is scope to craft a pensions framework that would help the poorer in society while reducing the impact on the country's fiscal position.

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Current pensions policy is strongly focused upon those who are at the higher end of the wealth spectrum, given that they have the means to make provision for their own financial welfare, but may nevertheless need some encouragement to do so. A more flexible, broader-focused, system could accommodate and balance the positions of a wider range of citizens. It needs to be relevant to both extremes of the wealth spectrum, and all groups in between. It also needs to allow for fluctuations in individuals' circumstances, whether anticipated, or following Macmillan's "events".

The extent of the problem

Two recent reports illustrate the extent of the challenges posed by these financial issues when designing a new framework.

The wealth gap: The Resolution Foundation reported that in the period running up to the pandemic (2018-20), almost half of families across Britain had savings worth less than a month's income, while around 4% of families – 1.3 million in total – had no savings at all.

The poorest tenth of families were four times as likely to report having no savings as the richest tenth of households (8% vs 2%). The Foundation says that this savings divide will only have been reinforced during the pandemic, as the richest fifth of families were four times as likely to say they were able to increase their savings during lockdowns as the poorest fifth of families (47% of the richest families, compared to just 12% for poorer families).

The fiscal environment: the Office for Budget Responsibility notes the stresses brought on by the pandemic, the war in Ukraine and Brexit, adding:

- "Discretionary fiscal support for households, firms, and public services during the pandemic was unprecedented in scale, reaching 10.4% of GDP at its peak in the UK, and may have raised expectations regarding the role of Government in future crises. The UK Government has so far spent as much this year (1.25% of GDP) to help households to cope with the sharp rise in the cost of living as it did supporting the economy through the financial crisis. It is largely as a consequence of successive shocks, and the Government's response to them, that, at over 90% of GDP, public debt is now more than triple its level at the start of the century ..."

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- "And in the decades ahead, Governments in the UK and around the world face perhaps the still greater economic and fiscal challenges of addressing climate change, dealing with the fiscal costs of ageing, and managing all these pressures and risks against a backdrop of potentially weaker productivity growth, higher levels of public debt, and rising interest rates."

These two extracts show clearly conflicting issues that need to be reconciled. This will require fundamental rethinking, involving multiple disciplines and across areas that fall under the remits of a number of Government departments. A key requirement is to build flexibility into the pensions framework, to reduce its vulnerability to being undermined by inevitable future changes in other policy areas. There should also be a strong focus on achieving the best value for what are always going to be limited resources.

New framework

The new integrated framework and the principles upon which it should be based might include:

- an underlying principle that those who can make their own provision need to do so (while recognising that the tax system should continue to be deployed to encourage own provision). The ultimate manifestation of this would be cessation of the universal state pension, instead reserving state assistance for those falling below a means-tested ceiling. Freed-up resources could provide a higher state pension for those who do qualify and/or fund tax reliefs more carefully targeted at boosting private provision
- encouraging the adoption of scheme designs that provide a greater degree of predictability of outcome than the pure DC variant. An obvious contender is CDC, but schemes offering some element of DB would make a strong contribution to pension stability. Tax reliefs would continue to provide strong incentives and could be graded to relate the level of relief to the extent of risk taken on by the employer. The pensions industry should ensure that clients fully understand the available choices, and the relevant benefits both for businesses and employees
- facilitating assistance for members with their pensions decisions, such as contribution levels, investments and benefit choice, regardless of scheme design. Despite considerable work done both by public organisations and the private sector, progress is still desperately needed. Tax reliefs to encourage the take-up of professional advice and the easing of rules around the difference between advice and guidance would be beneficial.

In addition, there is also a need for detailed reform, such as:

- abolition of the lifetime allowance for DC pensions; this can penalise those who achieve good investment returns

- restriction of the flexible access provisions. In particular, the age from which access is permitted is too low when compared with likely retirement ages. Although potentially allowing greater employment flexibility, it can encourage individuals to access monies built up (with tax concessions) for retirement income to provide non-relevant "goodies"
- review of the current restrictions around the money purchase annual allowance and the carry-forward rules for past years' unused annual allowance. Greater flexibility around permitted contributions would allow them to reflect fluctuations in members' financial situations
- reining back growing Government pressure on schemes to act in ways that support particular political objectives. Nationally, growth for example, requires strong encouragement. However, schemes should not be pressured to invest funds to boost growth. Investment is a core responsibility of trustees and managers, based upon their professional view of what is best for their members. A call by a participant in the recent Conservative party leadership debates to "liberate pension assets" to fund growth has chilling echoes of the language in Government advertisements of the late 1980s encouraging members to leave good quality DB occupational schemes for personal pensions – leading to the pensions mis-selling scandal.

Stability

There is a need to re-set the dial on pension policy, to establish a new integrated framework that fits the nation's future challenges. There will then be a need for long-term policy stability to achieve the planned outcomes. However, history suggests that policy stability over a period of decades is a challenging objective.

Public trust in Governments fluctuates. Citizens, employers and other parties will not adopt a long-term strategy that requires significant financial commitment without confidence that their arrangements will not be undermined by unnecessary future changes. Many employers remember their experience with DB occupational schemes which they voluntarily established on a carefully-costed basis, only to be forced by subsequent Government social engineering to increase the benefits provided. Indeed, employers are still bearing the resultant increased costs today.

The principle of sovereignty of Parliament rightly ensures that no Government can bind its successor. So, a mechanism is needed to encourage the sought-after pensions stability. In practice this is probably best achieved by requiring that any future proposed changes are carefully considered in an open and transparent environment, following consultation with interested parties.

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Delivery

All of which brings me back to the need for a new Pensions Commission, which could both formulate a new framework for Parliament to consider and provide ongoing processes to identify and discourage inappropriate proposed amendment. Once established, it should be supported by a covenant entered into by the Government to continue to support its future work and status. In that way there will be a greater chance of maintaining public confidence in the new pension framework, creating an environment for good planning.

Recent financial shocks have exposed serious issues with the nation's pensions framework. Although these have been known about for some time, finding a long-term solution has been hampered by the absence of an overarching pensions strategy and the limitations of a piecemeal system bound by narrowly-focused restrictions. Any solution is likely to require some radical changes; those may not be achievable without a change to the environment in which they exist.

Pendragon