

Spotlight on Pensions



PRESENTS

LeGrand View

OCTOBER 2022

Economic challenges require urgent pension reform

Now that the official period of mourning for Her Majesty Queen Elizabeth has ended, the focus of attention has shifted rapidly back to the critical issues affecting the economy, and in particular the cost-of-living crisis.

This also coincides with the appointment of a new Government, which whilst not involving a change in the governing party, nevertheless appears to be following a markedly different economic path from its predecessor.

In my last LeGrand View I suggested some high-level policy changes as part of a broad review necessary to improve the effectiveness of the UK pensions system in delivering good retirement incomes for future generations. They included the appointment of a new pensions commission to guide and oversee longer-term pensions policy, whilst simultaneously providing stability and continuity over shorter-term timeframes. A new commission will take time to develop a new framework but would have the benefit of access to the work currently being undertaken by the Pensions Policy Institute in its project to design a new framework, due to be published in November.

Even if such proposals are quickly embraced and energetically pursued (and sadly history suggests that such a scenario is unlikely) the timeframe involved is unlikely to be short. However, once a high-level policy framework is formulated, work could begin quite quickly to introduce some changes at a detail level that would clearly be in tune with those policies. Such changes would produce some important and much-needed quick wins.

Short-term danger

That some early changes to detailed policies are needed has become more obvious as 2022 has progressed, with economic prospects for the coming winter looking particularly challenging. This is despite the promised energy price cap, supplementing the previously announced lump sum contributions towards household energy prices, which together will nevertheless leave households and businesses alike facing substantially higher prices across the board than last year.

It appears that there is already a significant trend currently for members to suspend their pension contributions. That is not surprising. Inflationary pressures excluding energy prices are also increasing, and if the recent falls in the value of Sterling continue, will not ease anytime soon. When pressures on day-to-day finances become extreme, seemingly longer-term (discretionary) expenditure presents a tempting target for cutting. In extremis, where households are struggling to cover even basic costs such as for food and energy, there will

simply be no funds available for pension contributions. In those cases, there is no scope for a purely pensions-based solution.

However, a significant number of households will still be able to afford pension contributions. The danger is that the gloomy predictions will feed negative sentiment and encourage people who could afford to continue contributions nevertheless, to cease making them.

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Fragile position

In the pensions world we are well aware of the fragility of the public's engagement with pensions, and the willingness to make contributions at a realistic level. A persistent lack of understanding of the issues leaves them especially vulnerable to influence from the actions and opinions of laymen rather than experts. The more it appears that people are suspending contributions, the stronger the herd instinct to follow suit – even in cases where contributions are still affordable.

This instinct is also strongly influenced by the level of confidence in the future. Consumer confidence currently appears to be at an all-time low. We should not be surprised therefore if people decide to hold back more of their income in a general cash account against unknown near-future rises in the cost of daily essentials. To make matters worse, that poor understanding of even pensions fundamentals is likely to result in a view that pensions saving is a long-term matter and so short-term breaks in contributions will do no long-term damage.

There will however be damage from the loss of the compounding effect of investment returns on missed contributions. The situation will be exacerbated by the need to get people to actually restart contributions when pressure on their finances ease. It has always been difficult to get people into the habit of contributing to a pension, and the successes in the post-automatic enrolment era are at risk being reversed. Many will require at least a strong nudge to return to a position of deferring current consumption.

Making up is hard to do

For those that are sufficiently aware of the need to contribute, a greater issue may be how to make sufficient further additional contributions to offset not only the earlier missed payments, but also the lost return on them. This will be particularly acute for those over 55s who may have dipped into their pension pots (particularly during the Covid lockdown periods) to access their tax-free cash sums to cover reduced earned income over the period. This means the Money Purchase Annual Allowance (MPAA) may prevent them from making suitable catchup contributions, if and when they have the means to do so.

Action now

So, it is clear that some urgent policy actions are necessary ahead of any comprehensive new framework, in response to the current crisis. Whilst it will not be possible to conjure up real money for contributions where none currently exists, there is still considerable scope for real contributions overall. It is imperative that barriers discouraging such contributions are removed where possible, and at least some solutions should hopefully be uncontroversial.

A clear candidate is the annual allowance and the money purchase annual allowance, with the carry-forward rules for past years' unused allowance. These (particularly the MPAA) need to be increased immediately in order to give the necessary flexibility to enable missed contributions to be compensated for. Such a change would be helpful in any case to reinforce the important message that pension contributions are a Good Thing.

The message would be further strengthened by abolishing the lifetime allowance for DC pensions. The negative sentiment generated by the message that it is possible to contribute "too much" to a pension should not be underestimated.

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Boost the positives, avoid the negatives

Sentiment can also be improved by stepping up positive messages about the benefits of pensions and the need for individuals to take control of their own financial futures. Apart from continuing to develop and promote official guidance and assistance packages through organisations such as MaPS, more industry-led initiatives such as the "Pension Attention" campaign run by the ABI and PLSA will be needed.

Whilst positive actions to bolster sentiment are needed now, it is also important to avoid those that might undermine public confidence in pensions. Dashboards are potentially a major contributor to confidence. However, they also have the potential to inflict serious damage if they fail to meet public expectations from Day One. In view of the messages of genuine distress coming from a number of schemes there appears to be a real risk of that high standard not being universally met. There needs to be serious consideration of that risk and if necessary appropriate further actions to address it before D-Day next year.

Automatic enrolment

Given the urgent need to find ways to make redress for the reduction or cessation of already meagre contributions, the long-overdue review into the automatic enrolment system is needed now. A key recommendation must surely be to increase the minimum contribution levels – both for members and employers. Although that might seem counterintuitive at the moment in the light of the cost-of-living squeeze, implementation of such a change will need to be flagged in advance. Doing so now will reinforce the positive savings message already mentioned and ensure that it will be in place when the economic situation improves.

Of course, these changes need to be applied across the whole population, and there is an ongoing issue with the very low levels of pension savings amongst the self-employed. A conversation with a London cabbie last week reminded me of the challenges presented by a group of workers who do not have a pension arrangement and who stubbornly cling to the view that they cannot afford one – a view strengthened by the current financial situation. Despite their stated belief that they will be unable to survive on the state pension alone, they nevertheless appear reluctant to investigate whether they could in fact afford a private pension arrangement to supplement it. In many cases a private pension would in fact be within their financial means.

Policies to address the self-employed pension gap are urgently needed, once again to be in place to encourage contributions as the economic situation improves. It seems likely that some level of compulsion will be required. A ride from King's Cross to Hyde Park Corner, extended by heavy traffic, gave nowhere near enough time to persuade my particular cabbie to consider the error of his ways, but I doubt that even a ride to John O'Groats would have produced a different outcome!

Whilst fundamental, carefully-considered reform of the pensions system is undoubtedly required, there is a clear financial imperative to make some sensible changes now, "on account."

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