Joint Colloquium of the IACA, PBSS and IAAHS Sections of the International Actuarial Association

Westin Copley Place Hotel, Boston, U.S.A. – 4-7 May 2008

Pension reform and solutions to challenges of providing old-age economic security

The UK position

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The UK position

Agenda

- Changes to State benefits
- “Personal accounts”
- Automatic enrolment
- The self-employed
- Problems with DC
- Risk sharing?

Changes to UK State Pensions I

State Pension Age ("SPA")

- Currently 65 for men, 60 for women
- Women's SPA to rise from 60 to 65 over 10 years from 2010
- SPA for both sexes to rise to 68 between 2024 and 2046

Changes to UK State Pension Benefits II

Basic State Pension ("BSP")

- From 2010, the number of qualifying years needed to receive a full BSP reduces to 30 years for both sexes
- Increases in the BSP will be linked to earnings rather than prices
- Contribution conditions for BSP being made easier

Personal Accounts I

- To come into operation from April 2012?
- A low cost means of saving for retirement
- Targeted at the estimated 7 million people currently not saving enough to give an adequate income in retirement
- This group tends to be younger and on moderate to low incomes
- Also likely to be part-time workers and/or work for small employers

Personal Accounts II

- A high proportion of lower earners are women
- Individuals will be auto-enrolled into exempt work-based pension schemes or personal accounts if they are employees aged between 22 and State Pension Age and earning above approximately £5,000 a year
- Contributions will be made on earnings between around £5,000 and £33,500 a year
- This band will be increased each year in line with earnings

Personal Accounts III

- Employees to contribute at least 4% of earnings
- Matched by a minimum 3% employer contribution and 1% in the form of tax relief from the government
- Contributions phased in over three years
- But will some employers "level down"?

Auto-enrolment I

- An effective way of combating people’s tendency not to act when faced with difficult financial decisions
- Greatest impact among groups where participation rates are low
- American research into 401(k) schemes showed auto-enrolment had the largest effect among people with low incomes, minority ethnic groups and women

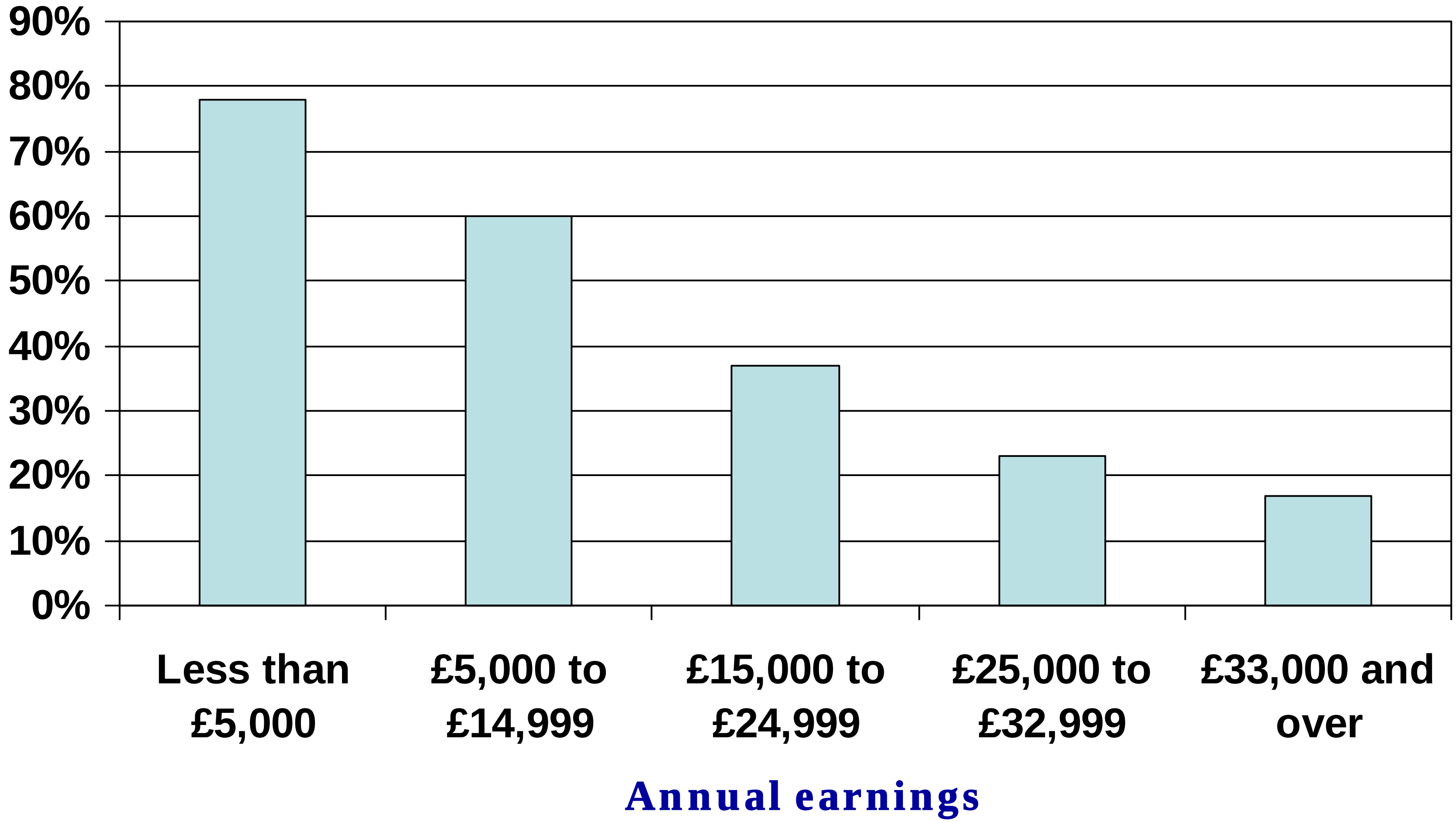
Auto-enrolment II

- Employees over State Pension Age may opt in to personal accounts and receive an employer contribution on qualifying earnings
- Employees under 22 will not be auto-enrolled but may opt in to personal accounts
- What about existing GPPs?

The self-employed

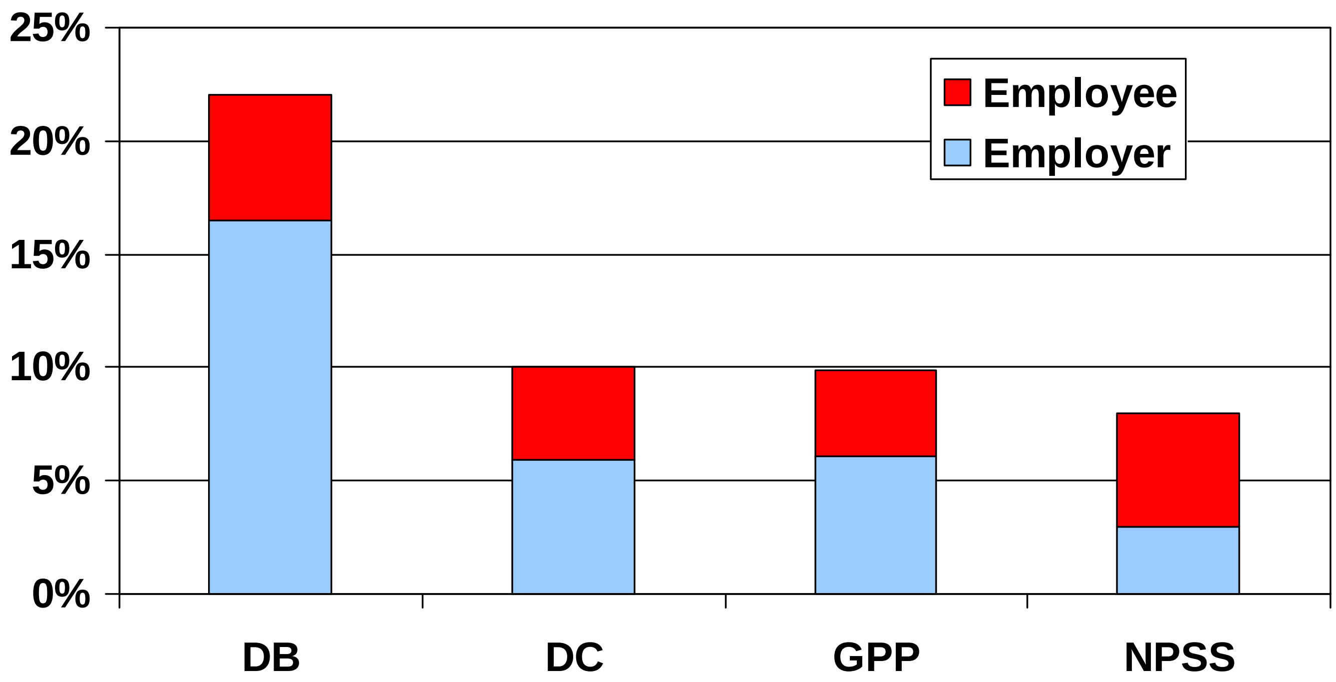
- Around 3 million self-employed people in the UK.
- Around 2 million not saving in a private pension.
- Self-employed will be able to participate in personal accounts on a voluntary opt-in basis.
- They will be able to save in personal accounts at a level of their choosing, subject to the cap on contributions which applies to all members.

Percentage of employees not contributing to a private pension by earnings band



Source: Family Resources Survey 2004/05, UK

Contributions as % of earnings



(ACA survey 2006)

Targeting resources

- The cost of benefits is more or less the same whether DB or DC
- Under DC, members are exposed to market volatility
- Under DB, companies are generally exposed to the volatility
- New DB approaches share the risks and the advantages?

Government's answer…

- National Pension Saving Scheme
- DC – leaves all risk with members
- Auto-enrolment

Security in retirement:
towards a new pensions system

DWP Department for Work and Pensions

Shared risk schemes I

Employer takes the risks

Employer has more control over costs

DB schemes

Shared risk schemes

DC schemes

More certainty for employees

Employee takes the risks

Shared risk schemes II

- CARE - Career Average Revalued Earnings
  - Benefits still based on salary and length of service
  - But not “final salary”
- Less risk for employer
- Less attractive to high fliers
- Longevity risk still borne by employer
- Investment risk probably borne by employer

Shared risk schemes III

- Cash balance schemes
  - Benefit promise is a cash sum based on length of service and final salary
  - At retirement, sum is converted into a pension at current annuity rates
- Employer bears investment risk prior to retirement
- Member bears investment and longevity risk at retirement

Shared risk schemes IV

- ACA proposals – a “third way”
  - Help to boost occupational pension provision
  - Address concern for potential levelling down
- Creative benefit designs
  - Sit between DB and DC
- More practical than changing the requirements for DB schemes

Shared risk schemes V

- Main characteristics
  - Average pensionable salary to retirement
  - Targeted increases:
    - Revaluation for each year *if funding is available*
    - Increases in payment *if funding is available*
  - Funding reserve based on prudent assumptions under new SSF regime
  - Each year's pension becomes defined benefit subject to no past service shortfall
  - Increases must "catch up" before granting future increases

Shared risk schemes VI

- Incorporates safety valves:
  - Revaluation and increases only if funding allows
  - Ability to increase normal pension age
  - Reduce rate of future accrual
  - Wind up scheme without providing future revaluations or increases
- Risks not eliminated
  - Likely to be more attractive to medium and large employers

Shared risk schemes VII

- Eligible for PPF
  - 100% of accrued (DB) benefits
  - Levy to take this into account, as well as the reduced risk
  - Levies to be held separately from DB scheme levies
- Not contracted-out, but exempt from NPSS