



Introduction

The long awaited government Pensions Green Paper, “Simplicity, security and choice: Working and saving for retirement” was published in December 2002 at the same time as an HM Treasury and Inland Revenue consultation paper “Simplifying the taxation of pensions: increasing choice and flexibility for all”.

The Green Paper looks at the partnership between State and private provision.

The primary objective of the paper is to increase funded private provision. It is proposed that this is accomplished by a simpler framework, the provision of better information to individuals, improved regulation, with greater protection for members of occupational pension schemes and, more generally, by encouraging people to work longer, with more flexible retirement options.

This Briefing summarises the key points of the Green Paper.

The HM Treasury and Inland Revenue consultation paper on simplifying the taxation of pensions will be considered in more detail in a separate Briefing.

Press comment

The initial response from some commentators on the Green Paper was that the paper was a lost opportunity.

Some commentators were looking for radical reform in relation to State Pension provision. We disagree with these commentators.

The government has already made significant changes to State Pension provision by replacing the State Earnings Related Pension Scheme (SERPS) by the State Second Pension

(S2P). It is also introducing Pension Credits for pensioners on low incomes. In our view, S2P is rightly targeted at those employees on lower earnings and that, whilst a case could be made for an alternative design, to make another change to State Pension provision at this stage would be counter-productive and just introduce another layer of complication.

Other proposals put forward by such commentators, such as increasing the State Pension Age, also miss the point.

The cost of State Pension provision in the UK is not projected to impose an undue burden to the government over the longer term. State Pension costs as a percentage of GDP are projected to remain around 5% of GDP over the long term.

In our view, the main concern relates to the burden on the government from non-pensions Social Security benefits, both before and after State Pension Age. These costs must be kept under control by increasing private provision and keeping people in work. This is the government’s objective.

Other commentators wanted the government to make private pensions contributions compulsory. They pointed to the example of Australia. The government has held back on this point but will keep compulsion under review through an independent Pensions Commission.

The Green Paper only accepts some of the proposals to simplify occupational pensions put forward in the Pickering Report (A Simpler Way to Better Pensions – An Independent Report, by Alan Pickering, July 2002). This has been criticised by some but we believe that the government is right in this stance. A proper debate is required.

The government has to balance the interests of scheme members and employers. It is not clear that the balance was right in the Pickering Report.

One other concern which has been raised about the Green Paper relates to the length of time before changes will be implemented. In the interim, the government is not proposing that scheme members have any increased protection. We share this concern.

DB versus DC

Employers rightly have concerns about the cost of defined benefit (DB) pension arrangements. The falling stock market prices over recent years and increased longevity have made many employers review their pensions’ strategy.

Whilst we believe that employers should endeavour to honour their past DB obligations, the shift to defined contribution (DC) arrangements is likely to continue apace.

The government accepts this in the Green Paper by an even-handed approach, pointing out that for employees there are pros and cons to each type of structure. The government wants to increase pension provision and considers that encouraging pensions savings is far more important than a dogmatic preference for DB over DC.

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Key points

- No significant changes to State Pensions but contracting-out to be simplified;
- A single, simplified, tax regime to replace the existing eight regimes;
- Better protection for occupational pension scheme members with immediate vesting of pensions;
- MFR to be replaced by scheme-specific funding requirements documented in a Statement of Funding Principles;
- Improved information for members of occupational and personal pension schemes; and
- Extended opportunities for older workers.

Background

The Green Paper has been produced against a background of increased life expectancy and an ageing population. The government estimates that around 3 million people are seriously under-providing for their retirement and a further 5 to 10 million may wish to consider saving more.

The danger to the government is that whilst the cost of the State Pension benefits as a percentage of GDP is projected to remain around 5%, the level of under-provision would result in a growing means-tested burden on the State. The government wants to avoid this burden by encouraging:

- people to work to an older age; and
- increased private sector provision through pensions and other savings on a voluntary approach.

State Pensions

The government does not propose any significant changes to:

- The Basic State Pension;
- The State Second Pension (S2P), although it is markedly more cautious about introducing the second, flat-rate, phase of S2P;

- The State Pension Age; or
- Pension Credits (which from October 2003 replace the government's previously introduced, and means-tested, Minimum Income Guarantee (MIG)).

The government considers that the changes that it has made over recent years have set the right framework. The changes it has made include the replacement of the State Earnings Related Pension Scheme (SERPS) by the State Second Pension (S2P) and the introduction of Pension Credits. Both of these changes were aimed at improving the retirement income of individuals on lower earnings.

The key changes proposed in relation to State Pensions are:

- To allow self-employed people to opt to pay higher National Insurance contributions and accrue rights under S2P on a voluntary basis;
- Simplifying the arrangements for contracting-out – see the section *simplifying contracting-out*;
- To bring forward changes to enhance State Pensions for individuals who defer their retirement past State Pension

Age, including the possibility of taking a taxable lump-sum payment – see the section *extending opportunities for older workers*.

Simplifying contracting-out

The government proposes:

A simplified reference scheme test (RST) for DB Schemes

- The minimum accrual rate will be reduced from 1/80th to 100th;
- Schemes will be allowed the choice of a career-average calculation of pensionable earnings revalued in line with RPI up to 5% a year. Currently, only a three-year average final salary calculation is allowed; and
- All earnings will be included in the calculation. Currently only 90% of earnings between the lower and upper earnings limits are included.

The simplified RST is based on the proposals made by Alan Pickering.

It is generally weaker than the current test and, whilst the government have put it forward as their proposal, they have asked

whether it will encourage more contracted-out provision. They have also asked whether it should be allowed as an alternative to the current RST, rather than requiring all existing schemes to comply with the new test.

Conversion of Guaranteed Minimum Pensions (GMPs)

To simplify scheme administration, the government wishes to allow GMPs to be converted to other RST benefits of equivalent value. It is looking for appropriate solutions so that scheme members are not disadvantaged.

Removing restrictions on contracted-out benefits

It is also proposed that the current restrictions on contracted-out benefits are removed. In future, they will be able to be taken at the same time as other benefits and count towards any tax free lump-sum.

A single tax regime

The government has made radical proposals to simplify the taxation of pensions. It proposes moving existing benefits from the current eight tax regimes to one single regime.

The 8 existing regimes cover:

- 4 occupational pensions regimes (Old Code pre-1970, New Code Post 1970, 1987 regime and 1989 regime);
- 2 individual pensions regimes (retirement annuity and personal pensions); and
- 2 unapproved regimes (FURBS and UURBS).

The proposals will give rise to a streamlined regime with most of the compliance burdens under the current regime swept away.

The new regime includes:

- A single, lifetime, limit of £1.4 million on the amount of tax advantaged savings. This limit

will be indexed, probably in line with prices, rather than earnings. Where existing tax approved pension savings for an individual exceed the £1.4 million limit then the limit for that individual will be the current amount of those savings;

- Contributions under the new regime will be very flexible. Contributions across all vehicles will obtain tax relief up to the level of an individual's annual earnings, subject to a maximum limit of £200,000 which will also be indexed;
- Retirement benefits may also be taken on a flexible basis. Benefits will be able to be taken at any time from age 55 onwards up to age 75. There will no longer be a requirement to take all benefits at one time and benefits may also be taken whilst still in employment. This will enable people to reduce their working hours and supplement their pay with pension;
- For defined contribution arrangements there will no longer be a requirement to buy an annuity; and
- In all cases, 25% of all benefits will be able to be taken as a tax free lump-sum on retirement.

These proposals will be considered in more detail in a separate Briefing.

Better protection for scheme members

The government proposes:

A new pensions regulator

The government is proposing a new pro-active pensions regulator to replace the Occupational Pensions Regulatory Authority (OPRA). Details are given in the Quinquennial Review of OPRA published by the Department of Work and Pensions in December 2002.

The recommendation in the Quinquennial Review is that the

new regulator should be separate from, but work alongside, the Financial Services Authority. However, the Independent Reviewer of the Quinquennial Review, Dr Brian Davis (formerly Chief Executive, Nationwide Building Society) suggested that the FSA should take over responsibility.

The new regulator will have statutory objectives and it is proposed that these include:

- Protecting the interests of scheme members;
- Promoting good practice;
- To educate, inform and provide support on pensions matters;
- To investigate, take action and sanction those who breach statutory provisions; and
- Engaging actively with pensions professionals and the government, raising the profile of pensions issues and publicising the regulator.

The new regulator will be expected to be:

- Flexible and pro-active;
- Maintain much better information on the schemes that it regulates;
- Focus on the real risk to funds and loss to individuals (i.e. have a risk-based approach);
- Have a much higher profile than OPRA; and
- Carry out more compliance visits and fine fewer people/schemes larger amounts of money.

The new regulator will still respond to whistle-blowing reports. It is proposed that the list of designated whistle-blowers is increased to include investment managers. In future, whistle-blowers will only need to inform the regulator of breaches of material significance.

The new regulator's name has not been decided but will not include the word "Occupational" as the new regulator, like OPRA, will have regulatory responsibilities in

relation to personal as well as occupational pension schemes. It will continue to be funded through the pensions scheme levy.

It is likely that the functions of the Pensions Scheme Registry, which is currently part of OPRA, will be moved into a central government department.

Changes to the priority order for scheme members

The government is proposing that the priority order for pension scheme members on wind-up is changed to make it fairer. Currently, pensioners are ranked higher than non-pensioners, with non-pensioners ranked equally.

Options include:

- Increasing the priority of those non-pensioners nearer retirement or with the greatest number of years pensionable service;
- Changing the relative priorities of those with larger and smaller pensions, adjusted according to length of pensionable service. The aim would be to achieve a fairer balance between the better off and the less well off;
- Introducing a capping system, with pension benefits only being fully protected up to a certain level. This would also have the effect of reducing the scope for abuses of the system e.g. where key individuals take early retirement just before an under-funded pension scheme is wound-up.

Insolvent employers

The government has put forward various options including:

- Moving pension schemes up the priority order for creditors e.g. by placing them above unsecured creditors but below preferential and secured creditors. However, the government is worried that this could be considered unfair on

unsecured creditors such as consumers and trade creditors;

- Introducing a central clearing house to buy deferred annuities for schemes being wound-up, with the intention of reducing costs and obtaining finer rates;
- Introducing an insurance scheme, perhaps a central discontinuance fund akin to the US Pension Benefit Guaranty Corporation, to provide a level of guaranteed protection for scheme members. This could be financed by schemes reducing benefits or increasing contribution rates.

Solvent employers

Currently, solvent employers who wind-up their pension scheme do not have to guarantee a full buy-out of benefits. They are only required to secure the benefits of pensioners in full. For non-pensioners, they only need to provide for the value of accrued benefits calculated on a Minimum Funding Rate (MFR) basis. This basis is not necessarily sufficient to buy-out the full deferred pension entitlements.

With the change to scheme-specific funding requirements, the MFR will be replaced by the scheme-specific transfer value basis, which is meant to be fair to all – see the section *MFR replacement*. However, this will still not guarantee the benefits for non-pensioners.

The government has put forward two suggested options. However, it states that it is “guided by the aim of not increasing the burden on employers providing pensions” and so is unsure whether there is a case for further strengthening of member protection. The options are:

- A full buy-out, with the employer meeting any shortfall of funds over the cost of buying immediate and deferred annuities for all members; or
- A partial buy-out, with full protection only for pensioners and those nearing retirement. The remaining members would

only be guaranteed cash equivalent transfer values calculated on the scheme-specific basis.

Improved compensation arrangements

The Compensation Scheme run by the Pensions Compensation Board currently provides restricted compensation for losses caused by dishonesty where the employer is insolvent. It is financed by levies on occupational pension schemes.

For DB schemes, the compensation is restricted to the amount needed to bring the funding of the scheme up to 100% for pensioners and members within 10 years of retirement, and to 90% for other liabilities, if this amount is smaller than the loss. For DC schemes, only 90% of the loss is covered.

The government proposes that these restrictions are removed, so that 100% of the loss is covered in all cases.

Changes of employers

The government proposes to include pension arrangements with the Transfer of Undertakings (Protection of Employment) Regulations or TUPE, for short. The regulations protect employees where their business is transferred between employers.

In essence, the government proposes that where the former employer made pension contributions then the new employer will be obliged to continue the practice.

The new employer will have flexibility in the form of pension provision, so it could move from DB to DC or vice versa. However, it will be required to ensure that contributions are at a broadly the same level as before, after taking into account any change in the contracted-out status.

Improved consultation

The government proposes a requirement that employers consult their employees and/or employee representatives before making any changes to their pension schemes.

Immediate vesting

The government proposes that the current statutory period of two years before preserved pensions have to be granted to members on leaving service (the so-called vesting period) is removed.

In future, all members must be granted a preserved pension or, alternatively, subject to the member not objecting, de minimis amounts could be automatically transferred into a stakeholder pension plan. However, the government's proposal does not remove the right of employers to impose a waiting period.

MFR replacement

The government proposes to replace the MFR by a scheme-specific funding requirement. The move to scheme-specific funding will remove the constraint which the MFR basis has had on investment policy.

There will be a Statement of Funding Principles (SFP) which will be agreed by the scheme trustees with the employer on the advice of the scheme actuary. This will set out the principles used in determining scheme-specific funding.

There will be powers for the trustees to freeze or wind-up the scheme if they cannot agree the SFP with the employer. These powers will also be available if contributions are not made in accordance with the Schedule of Contributions.

Actuarial valuations on the scheme-specific basis will be required at least every 3 years. The government proposes that trustees will be required to provide information to scheme members on funding levels, with regular updates, perhaps on an annual basis.

With the abolition of MFR and a move to scheme-specific funding, it will be for schemes to determine transfer values (which were previously underpinned by the MFR basis). They will be required to set transfer values on a basis which is fair to all. Cash Equivalent Transfer Values (CETVs) will in future be calculated on the advice of the scheme actuary. Actual transfer values will be allowed to be reduced below the CETV, if the scheme is underfunded.

Improved information to scheme members

The government wishes to make people better equipped to understand their financial choices. People need to know how much to save to obtain their required level of income in retirement. They need to understand the savings options available.

The key proposals in relation to improved information are:

- The government plans to roll-out the automatic provision of State Pension forecasts, starting with the self-employed and extended across the whole working population within 5 years. Forecasts will then be provided automatically on a regular basis;
- The possibility of making combined pension forecasts compulsory is put forward. The combined pension forecasting service, which was launched by the government in October 2001, enables employers and providers to obtain information on a voluntary basis from The Pensions Service (part of the Department of Work and Pensions) on the projected State Pension benefits of individuals. These projected State Pension benefits can then be added to private pension projections in benefit statements produced by those employers and providers who have voluntarily chosen to participate;

- Employers with pension arrangements for their staff may be required to provide information to publicise their arrangements:

- (i) in recruitment material;
- (ii) on pay slips – showing the amount of employer contributions;
- (iii) in a *pension information pack*. This will be in a FSA-approved format.

The government will also keep regulatory reform of the provision of financial advice in the workplace under review;

- Various options are put forward for employers who do not provide pension provision to their staff (other than access to a designated stakeholder pension scheme). These include:

- (i) the provision of regular State Pension forecasts to employees with a reminder about the availability of a designated stakeholder pension plan; or
- (ii) provision of the *pension information pack* annually or on appointment; or
- (iii) annual presentations to all staff by the designated stakeholder pension provider or authorised retailer; or
- (iv) annual interviews on an individual basis (rather than a presentation to all staff), with the government sharing costs on a pilot basis;

- The government proposes to change the emphasis of its awareness campaign on pensions to one which prompts people to take action to save and will look at targeted “life events” marketing e.g. when people start a new job or have a new baby. It will also “rebrand” tax relief on personal pensions saving by saying “for every £1 an individual contributes to a personal or stakeholder pension, the Government provides an additional 28p”;

- Other proposals are a telephone “helpline” as a first port of call for people wanting advice, the availability of generic advice and a website information service, including an online retirement planner (building on the ABI and FSA’s www.pensionscalculator.org.uk and possibly including the pensions tracing service currently run by OPRA).

Extending opportunities for older workers

The government wishes to encourage people to work to an older age. It is also looking at a more flexible retirement regime with the opportunity to take pension benefits whilst still in employment

The government also wants to encourage people aged over 50 years old who are currently on incapacity benefit or jobseeker’s allowance back into work.

The key changes proposed in relation to older workers are:

- The earliest age at which a tax-approved private pension may be taken will be raised from 50 to 55 by 2010;
- New members of public-service pension schemes will only be able to receive an undiscounted pension from age 65 in future, rather than 60;
- Occupational pension schemes will be allowed to pay pensions to employees whilst the employee is still in work, allowing people to continue working on a part-time basis whilst supplementing their salary with pension (this forms part of the pensions tax simplification proposals – see the section on a *single tax regime*);
- The concept of a normal retirement age will be removed from the legislation, although it will continue to be retained by defined benefit schemes as the age at which unreduced benefits are available. The removal of

the legislative requirement will encourage more flexible provision (this forms part of the pensions tax simplification proposals – see the section on a *single tax regime*);

- More generous increases for deferring State Pensions will be introduced by 2006, rather than 2010 as originally planned. Currently, pensions are increased by 7.5% per annum simple for each year of deferral. This will be raised to at least 10% per annum. In addition, a choice will be offered to take a taxable lump-sum payment, instead of an increased State Pension;
- Age discrimination will be outlawed in employment and vocational training by December 2006, in accordance with the EU Employment Directive (2000/78/EC). Compulsory retirement ages will be unlawful in most circumstances;
- Pilot programmes will be introduced for people aged 50 and over on incapacity benefit and jobseeker’s allowance to provide greater financial and other incentives to return to work. The pilot programmes will augment the Working Tax Credit (which replaces the New Deal 50 plus Employment Credit in April 2003).

Monitoring pensions

An independent pensions commission

The government proposes an independent pensions commission which will report to the Secretary of State for Work and Pensions. The commission will monitor trends in occupational, personal and stakeholder pension provision. It will also look at the level of non-pension savings by individuals.

The commission’s first job will be to make recommendations to government on how the quality of data available to policy-makers in these areas can be improved. Once the data is available, it will be the commission’s job to make

recommendations to government on how the voluntary approach is developing and whether there is a case for moving beyond that approach to compulsory private pension provision.

An employer task force to share best practice

The government proposes an *employer task force* to encourage employees to save more and for longer and to promote best practice in the workplace. This task force will also include representatives from the TUC. It will have ready access through an advisory group to other pensions experts.

Additional proposals

The government has made a range of other proposals in the Green Paper. The proposals include:

Improved flexibility

- A limited ability to change the form of accrued rights of DB scheme members, provided that members do not suffer a reduction in their benefits. The proposals would allow up to 5% of the value of accrued rights to be converted to rights of a different type without member consent;
- Removal of the prescriptive process for member-nominated trustees. However, in future, employers will not be able to opt-out of the requirement to have one-third of the trustees member-nominated;
- Improve the procedures for dealing with internal disputes, allowing the option of a one-stage process, instead of the current two-stage process, before a complainant has to go to the pensions ombudsman.

Compulsory scheme membership

The government is considering allowing employers, on an elective basis, to make membership of their occupational pension scheme a condition of employment for new employees. Employees could only

opt-out if they were, for example, contributing to a stakeholder arrangement.

Annuities

- Legislation will be brought forward to ensure that occupational DC schemes offer and publicise an open-market option. This will bring such schemes into line with the FSA's requirements for pension policies from insurance companies;
- Limited period annuities (i.e. where an individual uses part of their personal pension fund to buy, for example, a 3 or 5 year annuity) and value protected annuities (where a death benefit will be available prior to age 75 if the cumulative amount of the annuity payments made is less than the purchase price) will both be permitted. However, as mentioned in the section *a single tax regime* there will no longer be a requirement to buy any form of annuity.

Trustees' expertise

The government will make legislative proposals on the level of expertise required by trustees after discussions with practitioners. It will do this alongside a two-year review of the Myners' principles (these principles are contained in Institutional Investment in the UK: a Review which was published by HM Treasury in March 2001).

Pension sharing on divorce

The government proposes that safeguarded rights are abolished. These rights relate to the contracted-out element of a pension being shared. The only requirement in future will be that the total value of the pension share must be used to secure pension benefits.

Other issues

Generic financial advice and the Sandler suite of products

The government wants to create a market for generic financial advice

to help those on moderate incomes identify their financial priorities and save where it seems sensible for them to do so, whether through pensions or other savings products. It is seeking views on how this can be accomplished, including views on financial advice through the workplace.

It is also promoting the proposed Sandler suite of products. This is covered in three papers:

- Proposed product specifications for Sandler "stakeholder" products, a consultation document from HM Treasury and the Department for Works and Pensions dated February 2003; and
- 2 documents from the Financial Services Authority dated January 2003: Issues for with-profits business arising from the Sandler Review and Options for regulating the sale of "simplified investment products".

On Sandler, there are two issues mentioned in the Green Paper where views are sought on their applicability in a pensions environment:

- The possibility that the 1% charge cap could be raised; and
- The investment restrictions on the Sandler suite of products, whereby no more than 60% of the assets can be invested in a diversified portfolio of equities.

Tax relief on employer contributions

The government points out that the tax relief on employer contributions is far greater than that on contributions from employees because of the saving in both employer and employee National Insurance contributions. The saving in National Insurance contributions is normally worth 21p per £1 contributed.

In the US, tax relief for employer contributions to 401k plans is contingent upon the level of employer contributions, coverage of

the workforce and fair treatment of higher and lower-paid employees. The government asks whether the 401k approach lends itself to private provision in the UK.

Survivors' benefits and indexation

The government has also asked for views on Alan Pickering's proposals to remove compulsory limited price indexation (LPI) and the contracting-out requirement to provide survivors' benefits.

It also puts forward options for changing LPI e.g. a cap on LPI at £30,000 per annum, revising LPI to RPI up to 3%, or to RPI less 1% up to 5%.

The government does not promote any of these ideas and would only implement them if it were convinced that the coverage of occupational pensions were higher.

Abolition of contracted-out mixed benefit schemes

The government is asking for views on the abolition of COMBS, primarily due to lack of take-up.

Consolidation of pensions legislation

The government proposes that, once all the changes are made, the legislation should be consolidated.

At the same time, obscure or redundant legislation could be removed e.g. the government gives an example of the money purchase uniform accrual preservation requirements.

Speeding-up winding-up

Alan Pickering put forward the idea that schemes could buy out members' benefits through a stakeholder or other DC pension, if the member did not object and provided the member was at least 10 years from retirement. The government asks for views on this and other suggestions on how winding-up could be speeded-up.



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