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United Kingdom: the pension scheme revolution continues

After the introduction of Automatic Enrolment into Workplace Pensions in October 2012, which required employers to set up a pension scheme for all their employees, followed by the Public Service Pensions Act 2013 which reformed civil service pensions, the Pensions Act 2014[1] introduced on 14 May of this year has revolutionised the basic pension scheme. One of the most striking provisions of the Act is one which allows people to withdraw their entire pension in the form of a lump sum.

The reform of the basic pension scheme[2]

The 14 May 2014 Act provides for the introduction as of April 2016, of a **Single-Tier State Pension**, which guarantees a minimum weekly income of GBP 148.35 (around EUR 186) for everyone who has paid National Insurance contributions for 35 years (compared with 30 at present). People with insufficient contributions can nevertheless receive this minimum if they spend 20 hours per week caring for a child under 12 or a disabled or sick relative. One innovation is that self-employed people will also be able to benefit from this scheme.

It is interesting to note that the Single-Tier State Pension will not vary depending on earnings: it is line in with the Beveridge[3] principle of a basic minimum pension for all. It will replace the current Two-Tier State Pension, which consists of a basic State pension (GBP 110 per week) plus a supplementary pension, which is not only extremely complicated to calculate but which, in addition, penalises those who have saved for their retirement, since it takes account of personal savings and assets. The government considers that the new scheme, which is simpler, will give people a clear understanding of the minimum pension they will receive from the State, protect them from poverty and provide them with a solid basis which they can supplement with personal savings.

Workplace Pensions have been developed to encourage saving for retirement. These are pension schemes set up and managed by employers or on behalf of employers, which are separate from the basic pension scheme. Since October 2012, the measure known as Automatic Enrolment into Workplace Pensions has required employers to provide a pension for all their employees aged over 22, starting in 2018 at the latest, which should enable nearly 1.5 million more people to benefit from this employers' pension scheme. Employees will automatically contribute to the scheme unless they expressly opt out. It is therefore a private pension scheme but, as part of the reforms, the government has set up NEST (National Employment Savings Trust)[4], an independent public body which, for a small charge, will manage these types of schemes for businesses that wish to use its services and which will allow employees to change jobs without having to change their Workplace Pension. The 14 May 2014 Act in fact makes it easier to transfer various small pension pots from one employer to another to enable people to consolidate and build up their pensions[5]. Employers can offer two types of Workplace Pensions, one of which is the **Defined Benefit (DB) Pension**, where the employer guarantees that the employee will receive a specific monthly sum. However, since businesses are increasingly unable to afford this type of pension, owing to increased life expectancy and low returns on financial investments, it is unlikely to remain on offer in the

[1] https://www.gov.uk/government/collections/pensions-bill
[2] Extremely clear details of all the types of pensions schemes available can be found on http://www.pensionsadvisoryservice.org.uk/.
[3] From William Beveridge, 1879-1963, the 'inventor' of social security, whose 1942 report bearing his name promised protection for everyone from the cradle to the grave. That report laid the foundations for the Welfare State.
[4] http://www.nestpensions.org.uk/schemeweb/NestWeb/public/home/contents/homepage.html
[5] https://www.gov.uk/government/publications/automatic-transfers-consolidating-pension-savings

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long term. The alternative is a **Defined Contribution (DC) Plan**, that is to say a pension pot to which both the employer and the employee contribute, the earnings from which will be paid out on retirement, depending on the investments made[6].

The new system as laid down in the Pensions Act 2014 will be introduced progressively and will therefore comprise a basic pension guaranteed by the State for everyone, the Single-Tier State Pension, and a supplementary pension which will vary in amount, based on a capital sum built up via the Workplace Pensions. The government's aim is therefore to encourage the British people to save, since 11.9 million of them (18.5 % of the population) do not save enough for retirement.

The reform of Public Service Pensions

As a result of the ageing population, the cost of public service pensions increased by over one third between 1998 and 2008-2009, today representing of a sum of GBP 32 billion (EUR 40 billion)[7]. In order to make the system more sustainable, the Public Service Pensions Act 2013 introduced the following measures[8] :

- public service pensions will remain Defined Benefit (DB) type Workplace Pensions; as of April 2015, for employees who joined the public service after 30 July 2007, pensions will be based on **average career earnings**[9] and no longer, as today, on final year salary;
- **the retirement age will be brought into line with that in the private sector** (60 for those who joined the service before 30 July 2007 and 65 for everyone else, apart from firemen, police officers and members of the armed forces, for whom it will still be 60); the pensionable age for employees in the private sector is currently 65 for men and 62 for women. It will be 65 for everyone in 2018 and 66 in 2020. Then, the minimum age for retiring on a full pension will be increased for all employees to 67 between 2026 and 2028. However, the statutory retirement age will be reviewed every six years. In order to encourage people over retirement age to defer drawing their pension, the government currently adds 10.4% to the pension payable for each year deferred. However, this bonus will fall to 5.8 % as of 2016[10]. For those who retire earlier, the amount will be revised downwards;
- the Act provides for a maximum contribution from the employer in order to protect the taxpayer. There will also be measures to protect rights accrued during the transitional period;
- new rules on the governance of the scheme will be applied in order to ensure transparency and confidence[11];
- the pensions of employees of agencies and other public bodies will be reformed before 2018.

As for those receiving the basic State pension, measures to ensure that public service pensioners retain their purchasing power were introduced in 2010. Last January, the Prime Minister promised to increase public servants' basic pension by at least 2.5 % per year up until 2020 if the Conservatives win the next election.

Generally speaking, public servants' pension conditions (contributions/pension payments) are better than those of private sector pensioners[12]. Nevertheless, these various measures, coupled with the freeze on public sector pay since 2010 and budgetary restrictions in government departments, have resulted in widespread strikes and major demonstrations, most notably on 10 July[13].

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6 For a comparative assessment of the effectiveness of DB and DC Pension Schemes, see the recent OECD study *Comparing the Robustness of PAYG Pension Schemes* on: http://www.oecd-ilibrary.org/economics/comparing-the-robustness-of-payg-pension-schemes_5jz158w3ghmx-en

7 The State can no longer support these pension schemes in their current forms and with the current contribution levels, nor can those schemes provide a decent income for future pensioners. See the analysis of the financial robustness of pension schemes in OECD countries: http://www.oecd-ilibrary.org/fr/economics/overcoming-vulnerabilities-of-pension-systems_5jz1591prxth-en

8 http://www.civilservicepensionscheme.org.uk

9 http://www.civilservice.gov.uk/pensions/reform
http://www.moneywise.co.uk/pensions/managing-your-pension/public-sector-pension-changes-how-will-you-be-affected

10 http://www.theactuary.com/news/2014/07/webb-cuts-deferred-state-pension-increase-to-58/

11 http://www.thepensionsregulator.gov.uk/press/pn13-34.aspx

12 http://www.moneywise.co.uk/pensions/managing-your-pension/changes-to-the-civil-service-pension-scheme

13 http://www.theguardian.com/society/video/2014/jul/10/public-sector-protest-draws-thousands-london-video
http://www.theguardian.com/society/2014/jul/10/strikes-public-sector-industrial-action-pay-pensions

The option of a capital sum for all on retirement

Last March, the Chancellor of the Exchequer, George Osborne, proposed allowing pensioners greater freedom in the use of their pension money. At present, three quarters of members of DC Schemes are virtually forced to choose to receive a fixed annuity, which is often very small, because the sums offered by financial institutions have fallen significantly over the last fifteen years[14]. The advantage of this highly rigid system, which produces very low annual incomes, is obviously that risks are pooled and annuity holders are guaranteed an income for life.

The reform enables those over 55 to withdraw all or part of the capital they have built up. A quarter of the capital withdrawn remains exempt from tax. Above that amount, the capital withdrawn will be liable to income tax, but no longer at the fixed and dissuasive rate of 55 %. Savers can still opt for an annuity or choose to receive only the income from the capital invested. At least 13 million British employees are affected by this reform.

This option for pensioners to do what they like with their pension money has been criticised by the Left on the grounds that such a measure might mean that some people, once they had spent their capital, would become dependent on State benefits. However, the Coalition Government is relying on the common sense of its citizens[15], especially since over three quarters of those affected are interested in the possibility of receiving their money in the form of a lump sum.

Public and private collective pension funds

In order to offer contributors more certainty and a better return on their investments, the British government plans to promote new schemes, known as **Defined Ambition Schemes**[16]. These consist of creating pension funds by amalgamating sums saved by a number of employees, which means that the capital paid in is pooled, as are the investments, rather than treating them as individual pension accounts. This system already exists in Denmark, the United States, Canada and the Netherlands, where questions are being raised about its efficiency[17]. It is said that the reduced management costs resulting from pooling and the possibility of investing in more risky assets could increase the earnings received by savers by over one third. However, there is a risk that those additional earnings could fall in the event of lower yields from the collective investments.

As shown by a study carried out by the Institute for Public Policy Research think tank, the public has differing expectations regarding pensions, and a certain distrust of the government, which could change the rules of the game at any time, is clearly perceptible. Nevertheless, the majority of the British people are in favour of the introduction of these private pension funds[18]. The opposition Labour Party also supports the introduction of these Collective Pensions as proposed by the Minister for Pensions[19] last January[20]. The reforms could come into force in April 2015.

Public servants' pensions are managed by four bodies: the National Health Service, the Civil Service Pension Scheme, Teachers' Pensions and the Local Government Pension Scheme. A report on the latter scheme[21] proposed merging the 89 local funds, which are very variable in terms of running costs and risk management[22], to form five funds, and the creation of collective investment funds shared between them in order to reduce management costs, which totalled GBP 790 million in 2012. Only the second proposal was adopted by the government[23], as it could save up to GBP 660 million per year. In addition, this year saw the first steps towards cooperation between voluntary funds: this allows joint negotiations with financial institutions, which improves the

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14 http://www.telegraph.co.uk/finance/personalfinance/pensions/10710606/Budget-2014-How-will-the-new-pensions-system-work.html
15 http://www.telegraph.co.uk/finance/personalfinance/pensions/10709942/Budget-2014-Savers-handed-freedom-on-pensions.html
16 https://www.gov.uk/government/news/public-backing-means-full-steam-ahead-for-pension-reforms
17 http://www.channel4.com/news/pensions-holland-dutch-system-overhaul
http://blogs.lse.ac.uk/politicsandpolicy/dutch-pension-system-uk/?utm_source=feedburner&utm_medium=email&utm_campaign=Feed%3A+BritishPoliticsAndPolicyAtLse+%28British+politics+and+policy+at+LSE%29
18 http://www.ippr.org/publications/defining-ambitions-shaping-pension-reform-around-public-attitudes
19 http://www.publicfinance.co.uk/features/2014/05/rainy-day-man/
20 http://labourlist.org/2014/05/labour-brings-fresh-support-to-collective-savings/
21 https://www.gov.uk/government/consultations/local-government-pension-scheme-opportunities-for-collaboration-cost-savings-and-efficiencies
22 http://www.cipfa.org/policy-and-guidance/publications/a/accounting-for-local-government-pension-scheme-management-costs-book
23 http://www.publicfinance.co.uk/news/2014/05/government-backs-lgps-reforms-but-rules-out-mergers/?utm_source=Adestra&utm_medium=email&utm_term=

yield on investments. The local government pension schemes, which manage assets worth GBP 178 billion and have 4.7 million members, are one of the largest pension funds in Europe[24].

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24 http://www.adjacentgovernment.co.uk/lg-edition-002/transforming-the-lgps/