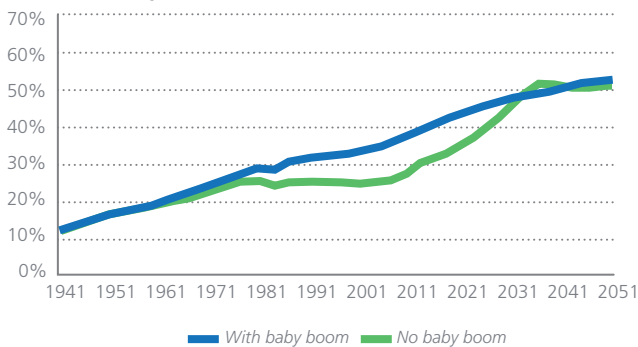


## Introduction

Late last year the Pensions Commission made known its proposals for changes to the UK state pension system. At its heart, they propose a more generous state pension, partly funded by a rise in the state pension age, and a new nationally administered savings scheme to top up income from the state pension called the National Pension Savings Scheme. This comes at a time when debate over the future of pension provision has never been higher. Improvements in health and lifestyle mean people are living longer increasing their need for additional income in retirement, while the closure of generous Defined Benefit schemes continues to dominate media headlines.

To describe the current situation as one of crisis would be wrong. UK pensioners in retirement are actually well provided for by both private and public provision. The real crisis comes in another fifteen years, as the true cost of rising longevity and falling fertility becomes more apparent. Over the last thirty years, the expansion of the workforce by baby boomers (those born between the late 1940s and 1960s) has helped keep the cost of providing state pensions down. However this is now coming to an end, as baby boomers retire. The 15-year time lag before action becomes pressing meant the Pension Commission were able to recommend an evolutionary approach to reform of the state pension system. Eschewing a "big-bang" approach in which current arrangements are replaced by a new state pension system avoids the danger of intergenerational conflict. As any new system would have to be funded immediately, the cost of providing increased pension provision would fall on existing tax payers rather than those who would benefit most from it.

### Impact of the 1940s-1960s baby boom: ratio of 65+ year olds to 20-64 year olds



Source: Pensions Commission analysis based on a synthetic model of the England and Wales population

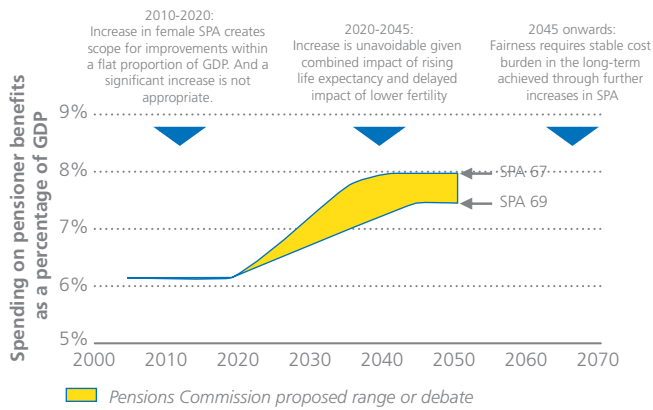
## Reforming the state sector

The Pension Commission's main proposal for reform of the basic state pension was that its value should rise. This would be partly paid for by a progressive rise in the state pension age to 68 by 2050 and by restoring the link with average earnings from 2010. When the link between the state pension and average earnings was severed in the early 1980s in favour of prices, few felt its future impact would be quite as serious as it has been. At the time, average earnings were running at approximately 14% and prices at 12%. However that high inflationary period in which this decision was taken was very different to the world we live in today. Average earnings are now closer to 4% while inflation is currently hovering above 2%. The Pension Commission argues this can be financed by rolling the retirement age higher, as longevity increases. Also public coffers should start to benefit from the decision already taken to raise the state retirement age for women from 60 to 65.

Linked to the restoration of the state pension's link with average earnings would be a freeze in the Savings Credit. Introduced by the government to lift the poorest pensioners out of poverty through a top-up to the basic state pension, its suitability is assessed through a system of means testing. According to the Commission's own estimates, over 70% of pensioners by 2050 would be eligible for means testing if the current system of indexation to prices continues. While the new Savings Credit has undoubtedly alleviated pensioner poverty, it is also a disincentive to save. After all why go through the bother of saving, if you know that the state is prepared to step in to help you?

They see the new basic state pension as a flat rate system, which is universal in scope, helping those individuals that have traditionally been excluded from pension provision, such as women and carers. Its much tinkered twin, the second state pension, is also set for change. With its original purpose superseded by the creation of the National Pension Savings Scheme, they envisage it transforming into a second flat-rate pension over time by freezing the upper earnings limit in nominal terms for accruals. The Commission has estimated that the cost of providing state pensions will rise to 7.8% of GDP by 2050 assuming a rise in the retirement age to 68 – a figure that compares less favourably to the current expenditure level of 6.2%.

## Public expenditure and pension age increases: Pensions Commission proposed range for debate



Source: Pensions Commission analysis using Pensim2

Note: Pensioner benefits include BSP, SERPS/S2P, Pension Credit, Housing Benefit, Council Tax Benefit, Disability Living Allowance and Attendance Allowance and other benefits including Winter Fuel Payments.

## Is 68 too high a retirement age?

While increasing the state pension age to 68 seems a logical step, it also raises a range of questions: how easy will it be for people above the age of 50 to find work? And how fit will they be to perform it? Although the government is set to introduce legislation on the issue of age discrimination later this year, it remains to be seen how effective it will prove. A sea change in social attitudes needs to take place, cajoled by both the government and interested lobby groups. The issue of health is also problematic, especially amongst lower socio-economic groups. However, the benefit of having a National Health Service means that the UK is in a much better position than some other countries to look after the needs of an ageing workforce. To use the US as an example, companies there are responsible for health care provision, creating an immediate disadvantage to hiring older workers. Another factor supporting the increased participation of older workers into the labour market is the current composition of the UK economy. The predominance of the services sector means there is much greater requirement for mental rather than physical alertness.

## Creation of National Pension Savings Scheme

Outside of the current state system, the Commission wants to see a National Pension Savings Scheme created. While the government would administer it and encourage individuals to save through it via automatic enrolment, it would not be responsible for contributing except through tax relief. The National Pension Savings Scheme has a specific target group in mind: low-middle income earners in the £15-25K salary bracket that have been traditionally neglected by the savings industry. The model behind the NPSS is well-run Defined Contribution schemes that not only benefit from employer and employee contributions but also have low management costs. Minimum default contributions would be set at 8% of earnings above the primary threshold level (£4,888) – the level above which

tax and national insurance become payable – but below the upper earnings limit. It is proposed that this 8% figure would comprise 4% from an individual's post tax earnings, 1% from tax relief and 3% compulsory contributions from employers. In addition, voluntary contributions would also be encouraged. Directed at those who currently have no adequate pension arrangements in place, it is not intended to replace good quality occupational pension schemes.

The money taken from employers and employees would be invested in a small range of funds, with a lifestyle fund the default option. In a lifestyle fund, an individual's exposure to bonds (relative to equities) would increase as they grow older, thereby lowering the risk associated with their holding. The idea of having a small number of mega-investment funds is to avoid a repeat of the Swedish experience. When Sweden introduced a pension scheme similar in scope to the National Pension Savings Scheme, it deluged individuals with choice by putting over 600 funds on its platform. Confused by the sheer number of funds on offer, more than 85% of savers plumped for the default fund instead. Perhaps the most revolutionary aspect of the National Pension Savings Scheme is the cost of its annual management fee: 0.3%. A charge at this level could increase an individual's pension by as much as 25%-30%, above and beyond what they would have received if they had paid the current industry standard of close to 1%. Despite cries from some members of the savings industry that fee levels will be too low, investment firms in the US have been able to provide a fund management service for their own version of the National Pension Savings Scheme – the Thrift Savings Plan – for as little as 0.06%. The type of funds likely to be put out for tender, aside from the lifestyle fund, should be passive in nature. They should also be restricted to the major asset classes such as UK equities or bonds. Even a lifestyle fund should require little active management, as asset allocation will largely be decided by age, not market conditions.

## Need for greater communication

One of the criticisms levelled at the proposal for creating the National Pension Savings Scheme is that it will foist responsibility onto the individual. Adair Turner, Head of the Pensions Commission, responded to this by saying that people already have to confront this decision when they join a new job. When asked if they wish to join the existing company pension scheme they must decide whether to accept or decline. The idea of effective communication also raises an important issue. How can the government inform people of the choices facing them and the investment decisions they should make as a result? Is it through a leaflet dropped through a letterbox or through an advertising campaign on television, in which the long-term rates of return on different asset class can be explained in plain and unambiguous language? Three minutes before Eastenders or Coronation Street might have a surprising impact on the general public's financial awareness.

## Review of debt strategy

The Commission has also suggested that National Pension Savings Scheme members could receive bi-annual statements, which provide a range of retirement outcomes. Aside from reporting the pension an individual would receive at their expected retirement date, it would also inform individuals what they might get if they were to delay their retirement for a set number of years. For some workers, the thought of a higher pension at a later age might encourage them to continue working.

Any move towards adopting a new pension scheme system such as the National Pension Savings Scheme will have to be accompanied by a government review of its current debt strategy. Long-dated bond yields have already fallen in recent years, as the closure or maturing of Defined Benefit schemes has shifted focus from equity to bond markets. To escape the danger that low government bond yields depresses the level of retirement income available, the Treasury will have to ensure there is a sufficient supply of long-dated bonds available.

## The future

Later this year the government will release a white paper on the subject of pension reform. According to the Department of Work and Pensions, any reform to the current system has to meet five basic criteria: it has to be affordable, sustainable, simple, fair and promote personal responsibility. Whatever guise future reform takes, the government has a responsibility to put the public sector's house in order. Amid general agreement that the state pension has to rise, many public sector employees are still able to retire early on a final salary pension scheme. Despite the prospect of conflict with powerful public sector unions, any government that proposes reforms, along the lines suggested by the Pension Commission, will have to ensure equality of treatment between individuals in the public and private sector if it is to be successful.

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