Private and public pension provisions in the uk economics essay

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The pensions industry is currently in transition. With Lord Hutton's completed review of UK state pensions imminent and the 2012 reforms primed to take effect, there are many changes expected in both private and public pensions over the next 5 years; not least of which is the increasing popularity for the shift from final-salary to contribution based schemes. This report will discuss these changes and the reasoning behind them.

Introduction

This report aims to discuss the pension crisis currently faced by the UK and describes what we can expect from private and public pensions over the next five years. It will discuss the problems faced by pension provisions and how new regulations and reforms will affect the industry in the future as it tries to combat huge deficits. [1]

Private pensions are divided into two types; personal and occupational pensions. Occupational pensions vary from company to company but are usually either a ' salary related' or ' money purchase' schemes. In a salary related or defined benefit (DB) scheme, the pension receivable is based on your final salary and the number of years you have been in the scheme. Whereas with a money purchase, also known as defined contribution (DC) scheme the pension is based on how much has been paid into the scheme and how well it has been invested.

Public pensions, more commonly known as state pensions, is the pension provided by the UK government when an individual reaches the national retirement age (NRA). The state pension is contribution based and depends on an individual's National Insurance contribution history. The amount

payable as a basic state pension currently lies between a £24. 41 and £97. 65 per week (Directgov, 2010). [2]

What is the pension Crisis?

Simply put, there is not enough money salted away in pension funds to guarantee a comfortable retirement for today’s working population. The main reason for this is the fact that people are simply living longer. This is quantified as ‘ longevity risk’ and has resulted in funds having to support a retiree for longer than planned. According to Swiss Re, the world’s second largest reinsurer, underestimating life expectancy by just one year can increase a pension plan’s liabilities by up to 5 percent. [3] This effect is compounded by the fact that the number of retirees is increasing while being supported by a decreasing working population; ultimately meaning that more money is being removed from the fund and less money is being entered into it.

How did we get into this mess?

Figure 3. 1: Steadily increasing life-expectancy in the UK.

(Source: Office for national Statistics, Sep 2010)Medical advances over the last few decades have increased life expectancy and people are living longer than was expected while retirement age remained fixed. In fact, a newborn baby boy is now expected to live 77. 7 years; that figure is even higher for girls at 81. 9 years (Office for national Statistics, September 2010). [4] This trend of steadily increasing life expectancy is the reason that pension funds now have to support more people for longer.

However, not all problems could have been foreseen. The bulk of pension provisions are invested in the stock market meaning the dwindling stock market returns, caused by the 2008 economic crisis, have led to significant shrinkage in most pension funds.

Changing pension provision's inflation link

Figure 3. 1: RPI vs CPI for the past 10 years

(SOURCE: Office for national Statistics)The government has decided to change how both private pensions are calculated with respect to inflation. The change will mean that inflation in pension funds will be linked to the Consumer Price Index (CPI) rather than the Retail Price Index (RPI), which is typically higher. The difference between the two indices being that RPI includes housing costs and mortgage payments where as CPI does not. CPI is typically between 0. 5% and 0. 75% lower and slower growing, and has been higher than RPI only three times in the past 20 years. [5] This is good news for the pension funds since the UK pension fund liabilities are expected to fall; ultimately meaning millions of people would be likely to see lower increases to their pensions in retirement. A pensioner currently receiving £10, 000-a-year, would earn a pension of £11, 400 p. a. rather than £12, 200 p. a. in 2016 due to the change.

A pensions analyst for Hargreaves Lansdown, cites final salary schemes as the cause of the huge deficits:

" What the government is trying to do here is prop up final salary schemes by reducing their costs, but this means watering down benefits for members" – Laith Khalaf, Hargreaves Lansdown [6]

Defined Contribution and Defined Benefits

Problems with Defined Benefit Schemes

There has been a recent rush to close final salary defined benefit pension schemes. The problem with this type of schemes lies in where the risks lie. Typically in a defined benefit scheme there will be some sort of compulsory employee contribution, however it is ultimately the employer's responsibility to cover the costs and meet the quoted benefits. In recent times, employers have struggled to keep up with these benefits blaming longer life expectancy, falling stock markets and increased regulatory burden. The main problem with this type of scheme, however, is that all liability lies with the employers rather that the employee and companies have had to bear the brunt of the financial downturn. New legislations are compounding this problem further. Under new accounting standards, schemes are now required to report deficits such as those arising from defined benefit schemes, within company accounts. This means any negative changes in pension fund liabilities or investment returns will have to be published by law. Costs have also increased due to regulatory requirements and the removal of advance corporation tax relief has also led to a reduction in investment returns. As a combined result of all these factors, firms have started to close their DB schemes off to new entrants.

Benefits of Defined Contribution Schemes

Under defined contribution schemes the benefits received on retirement depend on the contributions invested into the scheme and the investment returns within the arrangement. So if investment returns fall, so does the pension benefit. This relieves the company of any obligation to meet annuity

benefits as there are no quoted benefits, instead, the amount paid out will depend entirely on the amount contributed and the return made when it is reinvested. Ultimately it is the employee who must fund any increased costs or increase contributions in the case of bad investments if they wish to maintain their current projected pension annuity.

A survey conducted by the National Association of Pension Funds reported an average decrease in employer contribution of around 1. 9%; down from 8. 3% in DB schemes to 6. 4% in DC schemes. [7] While the Trade Union Congress state that the savings may be even greater. The implications of the switch from DB to DC for companies and provisions cannot, and has not, been underestimated by companies – as shown by the increased urge for the majority of DB schemes to be closed, while the remaining few contemplate an average-salary scheme as a compromise.

Scrapping Means testing

The current pension credit system is the Government's way of topping up the basic state pension. It favours people who have less than £6, 000 in savings – people who depend on the top up – guaranteeing them a certain income per week. However, the system has been criticized as it unfairly penalises people who may earn little but have the presence of mind to save up for the future. However business secretary Vince Cable has recently intimated that new proposals by Steve Webb will aim to scrap means testing altogether and instead provide a flat rate pension of £140 per week for everyone.[8]

The 2012 reforms

According to pensions minister Steve Webb, around 7 million people are currently under-preparing for retirement (The Independent, July 2010) [9] and the government is putting onus on employers to save. There are four main areas for reform:

Increase of the State Pension Age

The difference in pension ages between men and women is gradually to be abolished. The national retirement age (NRA) for both men and women is to then increase to 68 years. The table below (table 6. 2) shows how the pension ages are to be changed.

INCREASING WOMENS RETIREMENT AGE

DATE OF BIRTH (after)

6th April, 1951

6th April, 1952

6th April, 1953

6th April, 1954

6th April, 1955

Table 6. 2: Increasing the state pension age to 68. (Source: Directgov)

INCREASING COMBINED RETIREMENT AGE

DATE OF BIRTH (after)

6th April, 1960 onwards

6th April, 1969 onwards

6th April, 1978 onwards

â€ The government has announced new proposals to increase the NRA quicker than first planned. The proposals mean that women's NRA will increase more quickly to 65 between April 2016 and November 2018 and from December 2018 the combined NRA age will start to increase to reach 66 by April 2020.

Changes to the state pension and qualification for a full state pension

In addition to changes in the UK state pension age, there will be several important changes to the state pension itself. The link between state pension and earnings will be reintroduced and while the link with inflation will be severed. This is due to the fact that earnings generally rise faster than inflation meaning pensions have been lagging behind increases in average earnings.

Another change to the current state pension system is the reduction in the minimum number of national insurance contributions needed to qualify for a full state pension. The law required you to have NI contributions for 44 years for men and 39 years for women [2] – equating to roughly 90% of an individual's working life – to qualify for a full state pension. As of April 2010, this will be reduced to 30 years for both. Mothers who stay at home to care

for children up to 12 years old and full-time carers for disabled people will get full NI credits. This means that being a carer or homemaker will not hinder qualification for a full state pension.

Additional State pension (S2P) Changes

S2P is paid in addition to the basic state pension and is currently linked with past earnings. However, this will gradually be changed until 2030, at which point the link with past earnings will be severed and the S2P will be a flat rate based on time in service. It is planned that for every additional year's work completed, an extra £1. 50 per week will be added to the basic state pension. There will however be a maximum S2P of £60 per week (I. e. 40 years of service). Unlike the basic state pension itself, S2P will not be linked to average earnings and will instead be linked to inflation. [11]

Introduction of National Employment Savings Trust (NEST)

Table 6. 1: Phasing in of employer contributions toward NEST.

Source: NEST Pensions Guide, 2010

NEST is designed to be a low-cost pension scheme for any employer (with costs of around 0. 3%) [10] – however, this figure is rumoured to rise to 0. 5%. The accounts will act as an occupational pension scheme and is intended for lower earners who don't have access to a good company scheme. The idea is that every employee 22 and over, who is earning more than £5, 035 p. a. and not already contributing to a pension, will automatically be enrolled into one of these accounts from 2012. However, the scheme is not mandatory and people can opt-out but will automatically

be re-enrolled every three years to guard against people feeling indifferent to the scheme. The minimum contribution is expected to be 8% which will be gradually phased in (see Table 6. 1) with a maximum contribution of £3, 600 p. a. (increasing with average earnings from 2005). The final plan for the NEST scheme is yet to be announced by the Liberal Conservative coalition.

Employer Pays

Employee Pays (net)

Tax Relief

Total

From Oct 2012to

September 2016

1%

0. 8%

0. 2%

2%

From Oct 2016to

September 2017

2%

2. 4%

0. 6%

5%

From Oct 2017 onwards

3%

4%

1%

8%

Conclusion

With employers struggling with huge pension deficits and having to pump large sums of money into them to keep the benefits flowing, and the government accused of making the rich richer, everyone is looking for a solution to the pension crisis. While private firms seem to have found the answer to relieving their obligatory benefits by shifting the onus and responsibility onto employees, Government reforms will target distribution of wealth in the hope that they can increase the quality of retirement in general and urge more people to save for their future. Whether these changes will have any effect or will lead to other issues remains to be seen as will the Government's ultimate decisions which will be made when the Hutton report is fully published in time for the 2011 Budget.

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