Hitting the Target: Delivering better retirement outcomes

RESPONSE FROM ICAS TO THE PENSIONS AND LIFETIME SAVINGS ASSOCIATION

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Background

ICAS is a professional body for more than 21,000 world class business men and women who work in the UK and in more than 100 countries around the world. Our members have all achieved the internationally recognised and respected CA qualification (Chartered Accountant). We are an educator, examiner, regulator, and thought leader.

Almost two thirds of our working membership work in business; many leading some of the UK's and the world's great companies. The others work in accountancy practices ranging from the Big Four in the City to the small practitioner in rural areas of the country.

We currently have around 3,000 students striving to become the next generation of CAs under the tutelage of our expert staff and members. We regulate our members and their firms. We represent our members on a wide range of issues in accountancy, finance and business and seek to influence policy in the UK and globally, always acting in the public interest.

ICAS was created by Royal Charter in 1854.

General comments

The ICAS Pensions Panel welcomes the publication by the PLSA of 'Hitting the Target: Delivering better retirement outcomes' and the invitation to comment. From the perspective of savers, the adequacy of their retirement income is what matters most. However, the consultation is very broad, and we are concerned that by not focusing on a smaller number of key themes, the PLSA risks diluting its efforts.

The challenges of funding retirement through to later old age are well articulated by many commentators on pension matters and the work of the PLSA on publishing 'Pensions Adequacy: Generation by generation' (November 2016) provides valuable evidence about the extent of under-saving. However, the challenge is so big, that inroads are unlikely to be made without political leadership and, perhaps, agreement across political parties on the outcomes the UK's pensions system should be seeking to deliver.

We understand that the proposals on income targets have already had an impact on the DWP's 'Automatic Enrolment Review 2017: Maintaining the momentum'. However, with the consultation as broad as it is, it will be essential for any recommendations or calls to action which arise from the consultation to be addressed to the organisations or groups that the PLSA is seeking to influence, whether Government, the pensions industry or employers.

We have not responded to all the consultation questions directly and have focused our attention on the following key themes:

- Setting the target: How much is enough?

  We support the development of income targets but favour a more tailored approach, perhaps focusing on individuals achieving a percentage of earnings which would provide them with a modest standard of living. We have some reservations about setting minimum targets in case this reduces the ambitions of savers and negatively influences the behaviour of employers. It is also important that savers are made aware of the amount of capital they would need to achieve a modest income.

- Tax relief

  We continue to believe that pensions tax relief does provide an incentive to save and that an Exempt, Exempt, Taxed (EET) model is preferable to Taxed, Exempt, Exempt (TEE) model as it acts as a break on cash withdrawals from Defined Contribution (DC) pots. However, we believe it is now time for the UK Government to consider abandoning the lifetime allowance in favour of a lower annual allowance to encourage people to work longer rather than retire early. In addition, we believe it would be possible to incentivise younger workers to save into a pension by offering an age-related bonus, with a higher bonus for the youngest workers.

- Retirement decisions

  We are broadly supportive of the PLSA's thinking around pension decumulation and the development of a pathway which could encourage 'default' solutions in this space. However, we believe that the Government's role in relation to pension decumulation is broader than the development of a regulatory regime which supports industry innovation and that further policy development around incomes in later old age is needed, for example, in relation to low earners.

  As things currently stand, we question whether market-based solutions are possible. The pensions industry needs to be candid with Government as to whether market-based solutions to pension decumulation post-Freedom and Choice, which deal with longevity risk, are feasible.

  Collective Defined Contribution (CDC) arrangements would provide pension savers a greater degree of certainty around retirement income. However, the current Government has chosen not to pursue the implementation of Regulations which would enable their establishment. The Work and Pensions Commons Select Committee's on-going inquiry into CDC could encourage a re-think by Government, which we would support.

- Engagement: building confidence

  We believe that fin-tech solutions are and will continue to be an important element in increasing engagement in pensions saving. The pensions dashboard project will be hugely important in this regard. Fin-tech solutions can assist in the delivery of guidance and advice and can evolve as our understanding of behavioural finance and human decision-making evolves: we are aware of some ground-breaking work in this sphere.

  We believe that the following two issues are key to improving public confidence: simple products with financial guidance and advice tailored to those products; and more effective financial education which enhances financial planning skills and the value of financial guidance and advice.

Any enquiries should be addressed to Christine Scott, Head of Charities and Pensions, at cscott@icas.com

Responses to consultation themes

Setting the target: how much is enough?

We agree that savers need to understand how much they need to save to generate an income in retirement. However, we would favour a more tailored approach than the PLSA's proposed approach, perhaps focusing on individuals achieving a percentage of earnings combined with tools which help them assess anticipated expenditure. This approach may help address the difference in needs between homeowners and those who are renting.

Of course, a person's earnings will vary over the course of their working life, for example, through career progression or moving from part to full-time working or vice versa. Obviously, this will impact on any retirement income target based on a percentage of earnings. This reinforces the importance of building anticipated expenditure needs into any model.

Another challenge in developing income, and therefore savings, targets is assessing what state support will be available in future, especially for younger savers where the time horizon to retirement is so far in the future.

Savers have some certainty around State Pension provision with any changes likely to be determined well in advance. However, the UK Government needs to communicate changes effectively and not repeat the failure to inform adequately individual women born in the 1950s of changes to their State Pension Age.

Building in assumptions about other social support is more challenging, for example, support with housing costs and benefits which are not currently means-tested such as the winter fuel allowance.

Care needs to be taken in setting minimums as this can impact on employer behaviour. For example, anecdotally, we are aware of examples of the minimum wage/ national living wage depressing earnings at the lower end of the income spectrum and of minimum auto-enrolment contributions depressing employer pension contributions.

There is a general lack of understanding of the capital required to purchase a desired level of income and savers also need to be aware of the capital likely to be needed to achieve their target income.

The public tends to switch off to messages which are too complex or are perceived as too difficult to deal with. Any messages about saving need to be clear but delivered in a manner that does not scare people.

The pensions dashboard has a part to play in encouraging saving. We understand that the dashboard will include an estimate of the income a person's savings or current rate of saving may deliver. We would also welcome the inclusion of modest income targets and accompanying pot sizes too and we see the aspects of this consultation on developing income targets as being influential in this regard. We do not underestimate the complexity of the dashboard project, for example, including the ability for an individual to input their anticipated expenditure needs into the dashboard will perhaps make it more interactive than is currently intended.

We also believe that illustrative case studies could be helpful to savers and these could accompany information on income targets and pot size.

Minimum Contribution Rates

We believe that the 12% minimum recommended by the PLSA is still not enough to deliver a modest level of retirement income and, on the other hand, we do not yet know how sensitive savers will be to the current planned increases in auto-enrolment contributions.

It is clear therefore, that default automatic enrolment contributions will need to rise in the future from the current target of 8% of qualifying earnings up to at least 12% of salary and that it may also be necessary to supplement this with additional voluntary contributions and an increase in one's working life.

Savers may be more willing to make changes to their lifestyles now if they have a better understanding of what needs to be saved to achieve modest standard of living in retirement. Therefore, increasing minimum contributions beyond the 8% currently planned by Government may have more traction once the pensions dashboard becomes available.

Tax Relief

In 2015, we responded to the Government's consultation on the reform of pensions tax relief "Strengthening the incentive to save." At that time, we did not believe that the Government had made a case for any fundamental reform of pension tax relief and we maintain this broad position.

The premise given for reform seemed to be that a lack of awareness of the availability of tax relief on pension contributions meant that current system was not providing a sufficient incentive to save. We do not agree with this premise and believe there are other positive reasons for continuing to apply an Exempt, Exempt, Taxed (EET) model, for example, it acts as a break on cash withdrawals. We also stated that:

"We believe that the EET model has the potential to provide an incentive for more saving, especially in an auto-enrolled environment; therefore, we would prefer to see further efforts by Government to raise awareness of the availability of tax reliefs rather than a change in the model."

While we support the current EET model, we believe that aspects of the current arrangements could be improved.

We have not previously called for the Government to consider removing the lifetime allowance, but we now believe this is desirable, if combined with a reduction in the annual allowance.

The advantages of this approach would be to:

- build public confidence in pensions saving by reducing complexity. We recognise that a major challenge with the current approach to pensions tax reliefs is targeting reliefs to where these are most needed. However, a consequence of this has been added complexity through the combination of the annual allowance, the annual allowance taper and the lifetime allowance. While we acknowledge that the lifetime allowance is now to be indexed and therefore not eroded further, the reductions in the lifetime allowance over several years are a concern, for example, to middle income public sector workers who risk being caught.
- remove the disparity between the application of the lifetime allowance between Defined Contribution (DC) arrangements and Defined Benefit (DB) schemes, which is currently more favourable to DB scheme members.
- remove the risk of someone inadvertently exceeding the allowance, for example due to having a mixture of DC and DB pensions or having many employers during their working life, which is now acknowledged as the norm.
- encourage individuals to work longer to build up a substantial pot, anecdotally, for example, we are aware of GPs retiring when they have reached the lifetime allowance i.e. retiring earlier than they may have otherwise.

If the Government takes the view that it is necessary to maintain the lifetime allowance to target pension tax relief, raising it to a level which would not catch middle income earners participating in DB schemes, would at least reduce complexity for some. In these circumstances creating a level playing field between the application of the lifetime allowance between DC and DB arrangements would also be desirable and would also be more appropriately achieved through raising, rather than reducing, the lifetime allowance.

Rather than introduce a flat rate tax relief, we believe it would be possible to incentivise younger workers to save into a pension by offering an age-related bonus, with a higher bonus for the youngest workers.

This is similar to the approach taken to the Lifetime ISA, and we believe such an approach would have the potential to boost auto-enrolled contributions, and with a compounding effect over time, increase the likelihood that individuals will achieve their target retirement income.

The draft Scottish Budget delivered on 14 December 2017, which sets out the Scottish Government's intention to diverge from income tax rates and bands now set separately by the UK Government for earned income, creates additional complexity for pension schemes operating on a relief at source basis. In the short term, the practicalities for pension schemes and for Scottish taxpayers need addressing. However, in the medium-term, the divergence may be the catalyst for the reform of pensions tax relief. This may also create an opportunity for the UK Government to consider other incentives to save for a pension which could be made available, for example offering bonuses to younger workers.

Property

For property owners, the equity release market is evolving and there is much work to do around the funding of social care. Therefore, it may be a case that it's the concept of managing one's overall wealth that needs to be emphasised in financial guidance and advice models in future.

Working longer

In our comments on tax relief, we suggest that reducing the annual allowance along with the removal of the lifetime allowance could provide an incentive to work longer.

Retirement decisions

We are broadly supportive of the PLSA's thinking around pension decumulation and the development of a pathway which could encourage 'default' solutions in the space. However, we believe that the Government's role in relation to pension decumulation is broader than the development of a regulatory regime which supports industry innovation and that further policy development around incomes in later old age is needed. Indeed, we question whether market-based solutions are possible.

The announcement in the 2014 Budget of the Freedom and Choice reforms and their rapid implementation in April 2015, is an example of a major change to pensions policy which was not properly thought through. The objective seemed to be to address concerns over the pricing of annuities, with a widely held perception that HM Treasury was keen to bring forward cash flows. One of the consequences of this is an increase in the risk that individuals will exhaust their pension pots even if these are drawn down prudently, falling back on the state pension and other forms of state support later in old age.

Michael Johnson, Centre for Policy Studies Research Fellow, wrote a piece for Money Marketing in April 2017, entitled "Why we should scrap state pensions for the rich". The title and the content of the piece are provocative, and he challenges the status quo. While we are not advocating this approach, his suggestion that that state support up until later old age should be means tested so that a more generous state pension can be made available from age 80, advocates a state-based rather than a market-based solution to later old age.

His proposal addresses the risk of running out of money and acknowledges that spending patterns in retirement change over time with the need for cash diminishing in later old age, albeit there is still the question of social care funding. Such an approach would also change the investment horizon for DC pots.

As well as being controversial from a public policy perspective, especially given the largely settled view that reform of the state pension is complete for now, transitional arrangements would be immensely complex. However, without 'challenging conversations' to bring forward new thinking this issue may well be kicked into the long grass.

The pensions industry needs to be candid with Government as to whether a market based solution to pension decumulation post-Freedom and Choice, which deals longevity risk, is feasible.

However, another area of policy which is perhaps worth revisiting is the potential for Collective Defined Contribution Schemes (CDC) to offer pension benefits based on pot size which could be altered depending on the Scheme's finances. The UK Government seems to have abandoned plans to develop Regulations which could create a space for the establishment of CDC Schemes, yet this is a model which, through risk being shared amongst scheme members could go some way to addressing the challenges created by the Freedom and Choice reforms by providing a greater degree of assurance of retirement income.

The Work and Pensions Commons Select Committee launched an inquiry into CDC schemes in November 2017 and will receive and hear evidence in 2018. The inquiry pages state:

"The Pension Schemes Act 2015 created by the 2010-15 Coalition Government defined "shared risk/defined ambition" or CDC as a distinct pension category.

However, regulations under the Act to bring them into effect have not yet been introduced. In October 2015, the Government announced the plans would be shelved indefinitely so as not to distract from other major reforms such as auto-enrolment and pension freedoms."

Engagement: building confidence

This is a very broad topic in itself. We believe that fin-tech solutions are and will continue to be an important element in increasing engagement in pensions saving. The pensions dashboard project will be hugely important in this regard. Fin-tech solutions can assist in the delivery of guidance and advice and can evolve as our understanding of behavioural finance and human decision-making evolves. We are aware of some ground-breaking work in this sphere.

However, we believe that the following two issues are key to improving public confidence:

- Simple products with guidance and advice tailored to those products
- Financial education supplemented by guidance and advice

We welcome the contribution to the debate on defaults from Paul Johnson, Director of the Institute of Fiscal Studies, in an article 'Auto-enrolment has changed the pensions landscape, but big questions still remain' published in the Times on Monday 11 December 2017. Of the key points he raised the following stands out:

"……deciding on a default is only a first step. Nearly all those who default into a pension also end up in the default fund choice. Regulation and arguably education become more, not less, important in the face of disengaged consumers, especially if they are expected to become engaged at some point later on."

Financial education should be sufficient to equip individuals with enough knowledge and understanding of personal finance so that they have the capacity to plan for the future, supported by either guidance and/ or advice. We recognise that there has been some progress in schools and that education in schools is not a panacea that on its own will address under-saving.

The basics should be taught at the earliest opportunity and through-out school education, possibly integrated into the maths syllabus, for example, so that the compounding effect of saving is better understood.

Guidance and/or advice about lifetime saving is needed at key points in a person's adult life (for example, when starting work, mid-career and pre-retirement) and we recognise that behavioural finance suggests that that a just-in time approach is more likely to be effective. Therefore, there is perhaps a greater role for the employer in this which Government could encourage.

Products should be commensurate in terms of complexity with the guidance and advice available to savers. We believe, there is scope for developing simple products and making pensions more understandable.

We believe the level of complexity around auto-enrolment makes it difficult for some employers to be confident that they are fully complaint. For example, employers with more complex staffing arrangements may find it difficult to ensure that all staff meeting the criteria are enrolled i.e. where staff work irregular hours, or temporary or seasonal staff are employed.

The regulated financial advice market needs to be clearly segmented with tailored advice targeted towards the wealthy and guidance targeted towards those expecting to retire on a modest income and who are relying in default solutions.

Simplicity is about communications as well as products and a ‘story board’ approach with several examples for savers to relate too could be powerful.