THE FOUNDATION FOR SCIENCE AND TECHNOLOGY

## DINNER/DISCUSSION SUMMARY

# Pensions policy - what are the future liabilities and how should government and business respond?

Held at The Royal Society on 11th July, 2006

We are grateful to the Gatsby Foundation for supporting this meeting

**Chair:** **The Earl of Selborne KBE FRS**
Chairman, The Foundation for Science and Technology

**Speakers:** **The Rt Hon the Lord Turner of Ecchinswell**
Chair, Pensions Commission
**Alison O'Connell**
Director, Pensions Policy Institute
**Dr Reg Hinkley**
Chief Executive, BP Pensions Fund

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LORD TURNER set out the assets of the personal sector, totalling some £7.3 trillion. Assets which created corresponding liabilities were £1.2 trillion, pension funds, £500 billion for unfunded public sector pensions and £1.1 trillion for accrued state pension funds. These had to be seen in the context of a rapidly increasing old age dependency ratio (age over 65/age 20 to 64), moving rom 20 per cent in 1960 to the high 40s in 2050. Government policy had been to keep the state pension below the increase in average earnings and to rely on increasing private sector provision from 40 per cent to 60 per cent. But this is not happening. Defined Benefit (DB) schemes are disappearing and will be likely to be preserved only in strong FTSE 100 companies; and individuals are not contributing to non-state pension schemes. The result would be that pensions as a percentage of GDP would diminish. Possibly using increasing housing assets - now some £3 trillion - might offset this decrease in income, but there would be other pressures on their use, such as enabling young people to climb onto the housing ladder. The Pensions Commission's conclusion was that the state must provide a flat rate pension sufficient to keep pensioners out of poverty - an earnings-related state pension would not be affordable - but the element of means testing in the present system should be reduced. There should also be a strong encouragement (though not compulsion) for people to save, through cost-effective schemes with low administrative costs. But long-term risk to any scheme as old age dependency ratios change through increasing longevity and declining fertility could not be avoided - the question was who should bear the risk.

MS O'CONNELL pointed out that although the combined flat rate from the two state pensions should provide an income of £135 per week, this assumed that people had been in full employment for their working lives. For many this was not true. The means tested pension credit scheme was crucial for many, and would still be essential under the government's proposals. There was, however, a great deal of uncertainty about the numbers - the Department for Work and Pensions (DWP) calculated that 31 per cent would be on pension credit by 2030, and 29 per cent by 2050, but the Pension Policy Institute calculated the figures to be 45-60 per cent and 30-65 per cent. But even the DWP figures showed means testing at too high a level. There must be considerable doubt about how successful the proposals for encouraging private saving would be. Because of the uncertainty about future state pension provision, it would be very difficult for many people to be able to predict what their state pension would be, and how it would be affected by their private assets. Without that knowledge, it would be difficult to persuade people to save. The Pensions Commission had set its aims to simplify the existing system, reduce the inequality between men and women, clarify the role of the state in providing a basic pension and reduce means testing. The White Paper showed some progress on these aims, but there must be great uncertainty over whether the level of personal saving would enable the system to be stable over the long term.

DR HINKLEY said it was important to understand the context in which companies considered their pension schemes and the long-term liabilities they created. He illustrated the various factors which, over the years, had changed the asset/liability ratio in BP's scheme from 152 per cent to 97 per cent. These included statutory improvement in benefits, increasing life expectancy, the investment cycle, inflation, actuarial practice and regulation. It was true that, as a percentage of BP's capitalisation, pension liabilities were small, but they were a debt which had to form an element of capital allocation in the company's plans. Any over-provision for pensions meant capital could not be used for other investment purposes. Loss of flexibility in planning for pension provision could lead to unnecessary use of capital. The increasing cost of regulatory requirements and administration was also important. He could not see DB schemes continuing into the future except in a small number of cases, and in the public sector. They assumed a timescale of 50 years, and no organisation could responsibly commit itself to a liability of that timescale. Companies were not natural holders of such long-term risks. Who would accept a 50-year bond? The range of outcomes on investment in gilt-edged bonds or equities was too wide. The Pensions Regulator was doing his best to meet his aims of protecting benefits and reducing the risks of claims on the Pension Protection Fund, but he was operating under flawed legislation. There was doubt about whether the current structure of Pension Trustee Boards was right given the sophisticated investment evaluation they were supposed to undertake and the onerous responsibility placed on trustees.

A number of speakers in the following discussion raised concerns about the likely success of the Pensions Commission's proposals to increase the level of private saving. There was doubt about whether the Government had adequately considered the likelihood that the opt-out rate among young people would be considerably higher than expected. Indeed, there was some doubt about whether it would be wise for them to invest in future pension provision rather than devote all their efforts to securing housing. People are reluctant to save when on low incomes because they see the immediate problems of affordability as more important than long-term provision. To suggest to a 20 year old that any saving he makes will bring rewards when he is 60 is unlikely to succeed, in an era when deferred gratification is unfashionable. The case for saving can only be made successfully if it shows earlier results, is easy to understand, involves institutions which are trusted and indicates what alternatives are available. Equally important, there must be clarity about what the effects of saving on state pensions will be. No one doubted that the base provision of a state pension which safeguarded people from poverty was essential (although there were divergent views about whether the failure to recommend an earnings-related scheme because of affordability concerns was justified) but the considerable element of means testing that would remain was bound to be a deterrent on saving. This could only have been overcome through complex transitional arrangements, which would have further undermined the aim of making the system simpler. There was always a temptation to take people's investment decisions for them; it was important that this should be resisted.

Speakers generally agreed that there was no way of avoiding risk - even in our risk averse times - and the question was how to share risk among employers, financial institutions, the state and individuals. There was some concern that employers were being written out of the risk-sharing scenario too easily. Even accepting that it was unrealistic for them to accept full long-term pension liabilities, were there not ways of enabling them to accept part of the risk, through developing schemes part-way between Defined Benefit and Defined Contribution schemes - e.g. schemes where they accepted risk up to a defined limit? For example increases in life expectancy could be removed from their share of the risk. It was important not to over-emphasise the role companies had played in pension provision - only 50 per cent had had schemes - but large companies at any rate must continue to play a part, simply because they are part of society. But their role would be in part determined by the understanding of employees about the nature of state, employer and personal responsibilities. This was essentially a question of education and financial understanding of a state/capitalist society. If companies did remain important pension providers, it would be necessary to consider further the role of Trustees. They are a heterogeneous group, with representatives from the pensioners and the company and independents. Should they have the responsibilities they currently have, and, if so, should they be paid?

Speakers also raised questions about mortality rates, and how far future trends could be foreseen. It was doubtful whether actuaries could take sufficient account of medical advances which could further reduce mortality rates, or whether adequate consideration had been given to life-threatening trends in modern living such as obesity and the increased incidence of diabetes. An alternative way of looking at the future would be to examine the movements in terminal diseases such as cancer or heart problems. But it was clear that there would inevitably be a wide degree of uncertainty about life expectancy in the future, and any scheme – company or state – must be sufficiently flexible to deal with it. However, death was not the only problem of old age – there was also the question of when retirement started and how long people could be expected to remain in employment and so reduce the burden of pension provision. A simple model was to link retirement age to life expectancy and increase it at the same rate as mortality rates moved. But this raised difficult problems of inequality, as the poor had a lower life expectancy than the rich. How could they be expected to work longer, unless the average life expectancy could take account of different social groups?

Sir Geoffrey Chipperfield KCB

The presentations are on the Foundation website at www.foundation.org.uk.

**Useful web links:**

**Association of British Insurers:**
www.abi.org.uk

**Department of Work and Pensions - Pensions White Paper:**
www.dwp.gov.uk/pensionsreform/whitepaper.asp

**National Association of Pension Funds:**
www.napf.co.uk

**Pensions Policy Institute/response to Lord Turner's Paper:**
www.pensionspolicyinstitute.org.uk/news.asp?p=232&s=5

**The Pensions Commission:**
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