Simplification is the key

Stimulating and unlocking long-term saving

MICHAEL JOHNSON

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CONTENTS

Foreword

Guiding principles

Summary

Introduction 1

Part I: Today's long-term saving's landscape

1. Background: what and how we save 3
2. The saver's perspective 14
3. The employer's perspective 25
4. The pensions and savings industry's perspective 30
5. The Treasury's perspective 37

Part II: The proposals and their implications

6. The proposals 49
7. Tax simplification: some options 53
8. The implications for savers 55
9. The implications for employers 62
10. The implications for the industry 63
11. The implications for the Treasury 66

Conclusion 75

Acknowledgements 77

Appendices 79

Glossary 91

A note concerning data

Finding a consistent and comprehensive data set in respect of the nation's long-term savings (i.e. retirement savings) is a source of considerable frustration. Indeed, it would appear not to exist; HMRC (the official source for personal pensions information) does not, for example, collect information on contributions to SIPPs, and the various industry bodies (ABI, NAPF etc.) naturally focus on their own memberships, none of which represent the whole retirement savings industry.

Consequently some of the data herein is "patchy", and much pertains to 2007 rather than more recently; data collection, verification and reporting takes time. But this should not materially affect the key messages, not least because when it comes to the pensions and savings arena, change is rarely rapid. Indeed, policy makers should focus on long-term "signals" (e.g. increasing longevity and the decline of final salary, DB schemes) rather than short-term "noise" (e.g. poor investment returns and the impact of low interest rates on present value calculations).

A note on tax treatment nomenclature

This paper has adopted the pension industry's form of product codification for tax purposes, namely Exempt or Taxed, shortened to "E" and "T". A product's tax status is described chronologically by three letters, either E or T, where the first letter refers to contributions (of capital), the second to investment income and capital gains and the last letter to post-SPA income (e.g. a pension).

Thus, for example, pension savings products are typically "EET" because the saver's contributions are tax deductible (at his marginal rate, to the extent that they paid tax in that year) and any employer contributions are a deductible business expense (and attract a NICs rebate). Accruals (income derived from the investments, and capital gains) are treated as exempt (except for the 10p tax credit on dividends), but once the State Pension Age has been reached and the assets are realised, perhaps as an annuity, the income is taxed (excluding any tax free lump sum (up to 25%) paid upon retirement). Conversely, ISAs, for example, are TEE.

FOREWORD

This paper should be welcome by everyone interested in the future of savings and pensions in the UK, for the clarity of its analysis and practical solutions for encouraging a stronger savings culture.

Few doubt that our current complex system of products and tax structures is in urgent need of reform. The UK used to boast strong pension provision for many of those in work, based on the old final salary "defined benefit, DB" occupational pension schemes. However this pattern did not typically work well for women, who often had less consistent employment. Furthermore as these schemes have become unaffordable, the weight of future retirement provision has shifted towards the building up of personal investment pots, much of this through direct contribution pension schemes. Without the guarantee of a final salary match, the risk has transferred to the individual and the attraction of pensions has reduced. Take up rates in group schemes are not much higher than 50%, suggesting that many people consider the tax relief insufficient incentive to persuade them to tie up their savings in a long-term fund where they have limited access prior purchasing an annuity in retirement. Recent tax changes have compounded doubts about the value and permanence of the tax relief.

At the same time, new savings vehicles, ISAs, with a different, simpler structure of tax relief and much greater flexibility, have been growing in popularity. Yet, although for many people they can be an equally effective way of providing tax incentives for retirement income, the current regime severely limits ISA savings and treats ISAs and pension savings under entirely separate rules.

This paper sets out a number of important and practical proposals to end this artificial complexity and bring all long-term retirement savings together into a simpler lifetime savings account. The resultant structure would be simpler and more attractive for savers. It would be welcomed by many in the industry as a way of streamlining their marketing and administration processes. And for government it offers the prospect of helping build a stronger long-term savings culture without increasing, and potentially reducing, the immediate tax cost of savings incentives.

These proposals depend upon having a secure foundation of basic State Pension income, pitched at or above means-tested Pension Credit level, thus ensuring that even for those with very modest resources, it will pay to save. These issues have been the topic of a previous paper by Michael Johnson, and, more recently, a pamphlet edited by Patricia Hollis calling for a New State Pension. The additional proposals in this new paper, to support a stronger savings culture and build provision over and above the basic State Pension, deserve serious government consideration.

Norman Blackwell (Lord Blackwell)

Patricia Hollis (Baroness Hollis)

June 2010

GUIDING PRINCIPLES

The following guiding principles have been adopted for this paper, notably that:

(i) lasting affordability, equality, generational fairness and simplicity (particularly in respect of tax) are desirable;

(ii) customer need and the national interest (including the need to reduce the deficit) should override commercial interests;

(iii) the tax framework should not distort rational, economic decision making. There should be no double taxation and no disincentives in respect of long-term saving;

(iv) proposals should not rely on costs being deferred, in keeping with generational fairness;

(v) to reduce the scope for inaccuracy, cashflow projections (requiring some simplifying assumptions to be made) should be *comparative,* i.e. compared with the pre-proposal cashflows using the same underlying assumptions. Furthermore, for clarity, they should be expressed in terms of today's money; and

(vi) it is desirable to minimise rules. They add to complexity, there are usually ways around them and they offend libertarian instincts. That said, the state has a right to protect taxpayers' interests.

SUMMARY

- The UK's long-term savings landscape can be characterised by one word: "complex".[1] Tax is at the root of this complexity. There are multiple tax regimes in each of the three phases of saving (accumulation, decumulation and post-death). Another challenge is that the long-term savings industry is characterised by a fundamental schism. Two very differently taxed businesses (pensions and savings) are competing for the attention of one client base. Furthermore, they are offering products with very different attributes, making meaningful comparison almost impossible.

- This complexity is hugely damaging and is not in the national interest. Fewer savings means less long-term investment, which translates into lower economic growth in the long term,[2] accompanied by more pensioner poverty. If the savings landscape were simplified, we as a nation would save more.

- The pension and savings industry has suffered a near fatal erosion of trust, fuelled by mis-selling scandals, excessive costs and a long period of poor investment returns. This has catalysed a regulatory backlash. The industry must now embrace the Retail Distribution Review and work collaboratively with the FSA to help it rebuild that trust. Only once this has been achieved could the industry credibly commence negotiations with the FSA to reduce the regulatory burden.

- Occupational pension schemes are by far the largest source of long-term savings, but successive governments have failed to appreciate their value. Consequently, support for employers to promote them has been insufficient (limited to NICs rebates on employer contributions and tax-exempt investment returns). Where leadership to promote saving has been shown, it has buckled under the onslaught of vested interests; for example, NEST's[3] contributions cap serves no customer need.

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[1] Throughout this paper, reference to "long-term savings" includes pension savings.

[2] Saving less does usually produce some *short-term* economic growth (via consumer spending).

[3] National Employment Savings Trust, formerly the Personal Account.

- This paper makes 16 proposals to help simplify saving and improve flexibility. These involve bringing ISAs and pensions closer together, while enhancing incentives to save.

- This paper also discusses four alternatives for a unified tax framework for ISAs and pension savings products (including tax harmonisation between products with and without embedded life insurance). Such a radical simplification of the long-term savings arena is a prerequisite to encouraging more people to save more, and it would, for example, enable the industry to offer customers a simple savings continuum, perhaps under a "lifetime savings" banner.

A limit of £45,000 a year for tax-incentivised savings

- An annual contribution limit of £45,000 for tax-incentivised saving is proposed, encompassing both ISAs and pension savings. Within this limit there should be a maximum contribution to pension savings of £35,000 which, roughly, represents breakeven in terms of the cost to the Treasury of upfront tax relief.[4] This would replace the existing annual ISA limits and pension saving allowances, although the two distinct products should remain the fundamental planks of retirement provision.[5]

- Tax relief should be granted at the saver's marginal rate, limited to tax paid that year.[6]

- The ISA is perhaps the only remaining trusted savings product. These proposals seek to harness the popularity of ISAs to encourage long-term saving by permitting ISA assets to be transferable into pension savings products with tax relief at the standard rate (20%).

Allow savers access to pension savings before retirement

- It is no secret that lack of access to pension savings is a serious deterrent to saving for the long term. Consequently it is proposed that savers should be given a one-off opportunity to withdraw, tax-free, up to 25% of their pension savings before reaching retirement. This would be deducted from their subsequent 25% lump sum entitlement upon retirement.

Abolish the requirement to annuitise whilst still protecting the state

- Post-retirement access to pension savings should be amended so that savers are free to draw down their assets as required (taxed conventionally as income), without

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[4] i.e. after taking account of the changes to tax relief introduced in the 2009 Budget.

[5] It is stressed that a new savings product is not being advocated. The emphasis of the proposals is to enhance the capabilities of existing products.

[6] Except for the basic rate tax relief (20%) that non-taxpayers receive on contributions of up to £2,880 in a year, for a total contribution of £3,600; this should be retained.

any annuitisation requirement, provided that a minimum of £50,000 of assets (at the SPA) is not accessed until the age of 75. Savers who have already secured an income equivalent to 40% of median earnings, say, from the State Pension, lifetime annuities or guaranteed private pensions, should be exempt.

- Annuities purchased with ISA-derived funds should be exempt from income tax, consistent with the tax-exempt status of withdrawals from ISAs.

Broaden auto-enrolment of savings

- The effectiveness of auto-enrolment in boosting saving has been demonstrated abroad. Saving within a pension product is, however, unpopular; many people prefer to save in an ISA. Consequently, the DWP's auto-enrolment initiative (for occupational schemes and NEST) should be broadened to include ISAs, a product that people like (and will therefore be less likely to opt out of).

- Initially, employer contributions (under auto-enrolment) should be restricted to pension savings (to ensure funds retention). Eventually, however, if ISA auto-enrolment proves to be attractive, ISAs could also be included as an alternative for compulsory employer contributions. Concerns over savings persistency may require an initial leap of faith, but ISA assets are more "sticky" than many would expect. Furthermore, there could be some limited employer NICs relief targeted on low-earning under-25s, to encourage them to catch the savings habit early, subject to employee matching.

Address gender inequality

- To avoid the income-in-retirement disadvantage often suffered by women in particular, couples should be able to contribute to one another's pension savings irrespective of the recipient's earned income. Tax relief should be granted at the contributor's marginal rate, limited to the amount of tax paid in *aggregate* by the couple in that year.

Allow pension assets to be bequeathed free of IHT

- Savers should be able to bequeath unused pension savings assets to third parties free of IHT (perhaps limited to £100,000), provided that the assets only go into the recipients' pension savings. This would encourage a wealth cascade down the generations and reinforce a sense of personal ownership of pension savings. The paper extends this theme to include some proceeds of the sale of the primary residence or a business.

Introduce a Junior ISA

- The ISA should be extended to the under-16s, perhaps branded as a “Junior ISA”, with an annual savings allowance of £1,200 (equivalent to £100 per month). Introduction of the Junior ISA would complete the association of the ISA brand with lifetime saving.[7]

Opportunities to reduce the deficit

- Simplification could be accompanied by an opportunity to save the Treasury considerable amounts of money without risking a sharp reduction in long-term saving; a rare example of a policy “win-win”. In 2008-09 nearly £30 billion was spent in upfront tax relief, but the effectiveness of at least some of this spend is questionable, pension saving having become so unattractive, particularly for standard rate taxpayers. Indeed, upfront fiscal incentives have little impact on many people’s propensity to save; flexibility, including immediate access to savings, is their key influencer (after the availability of cash).

- This paper compares the cost to the Treasury of a variety of alternative tax relief structures,[8] based upon the actual 2008-09 outturn[9] (in £ billion), i.e. *before* the changes to tax relief introduced in the 2009 and March 2010 Budgets. These are expected to produce a net yield of £3.5 billion per year from 2012-13.[10]

	Tax relief on			Pensions	Net cost	Saving
	Contributions	NICs*	Accruals	in payment	to Treasury	vs. actual
Actual cost (EET)	£21.7	£8.2	£6.7	-£9.5	**£27.1**	-
TEE	£0.0	£8.2	£6.7	£0.0	**£14.9**	£12.2
$E^{20\%}$ ET	£14.7	£8.2	£6.7	-£9.5	**£20.1**	£7.0
$E^{20\%}$ $ET^{20\%}$	£14.7	£8.2	£6.7	-£8.1**	**£21.5**	£5.6
$E^{20\%}$ EE	£14.7	£8.2	£6.7	£0.0	**£29.6**	-£2.5
ETE	£21.7	£8.2	£0.0	£0.0	**£29.9**	-£2.8
$E^{20\%}$ TE	£14.7	£8.2	£0.0	£0.0	**£22.9**	£4.2
TTT	£0.0	£0.0	£0.0	-£9.5	**-£9.5**	£36.6

Front $E^{20\%}$ means that upfront tax relief is limited to 20% for everyone
Back $T^{20\%}$ means that all pensioners pay income tax at 20%
** NICs rebate in respect of employer contributions*
*** Some 30% of pensioner income tax is paid at 40% (ref. HMRC Table 3.4)*

For an explanation of EET, TEE, EEE, TTT and ETE, see the “Note on tax treatment nomenclature” at the beginning of this report.

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7 Existing Child Trust Funds could automatically become Junior ISAs when the CTF product is abandoned in January 2011.

8 The current tax treatment of pension savings is described as "EET" (exempt, exempt, taxed), referring to contributions, investment growth and income in retirement, respectively. ISAs are described as “TEE”, with contributions taxed, investment growth exempt and income in retirement exempt.

9 HMRC, *Cost of reliefs for approved pension schemes*, September 2009.

10 HMT, *2010 Budget Report,* 2010, Table A2, page 122, footnote 4.

- Thus, had pension savings products been taxed as per the ISA world of TEE, the Treasury would have saved roughly £12 billion in tax relief costs in 2008-09.

- A tax regime of TEE does, however, present one significant challenge: the lack of an upfront incentive to save for the long term. A compromise approach is to retain EET for pension savings but cap upfront tax relief to the standard rate of tax (20%), irrespective of the saver's marginal rate of tax (i.e. $E^{20\%}ET$). In 2008-09, the Treasury would then have saved £7 billion in tax relief costs. However, those who expect to pay 40% income tax in retirement would then lack an incentive to put any money into pension savings whilst working (and probably paying 40% or 50% income tax). This risk could be addressed by limiting income tax to 20% for all pensioners (i.e. $E^{20\%}ET^{20\%}$); had this structure been in place in 2008-09, the Treasury would have spent £5.6 billion less on tax relief than it actually did. A further saving of £2.5 billion[11] would have been made in 2008-09 had there been no entitlement to a 25% tax-free lump sum at retirement.

- The proposed annual pension savings contribution limit of £35,000, if it were combined with a 20% universal rate of upfront tax relief (i.e. ending relief at 40%), could save a further £6 billion to £7 billion a year. This is after taking into account the changes to tax relief introduced in the 2009 Budget.[12]

- Further research is required to develop an understanding of the effectiveness of upfront tax relief: i.e. how tax relief influences saver behaviour. Only then could a specific proposal to simplify the tax treatment of pension savings be robustly evidenced. In addition, a transition strategy to migrate the existing tax regimes to a single one would have to be developed.

The benefits of the proposals

- These proposals, to bring ISAs and all pension savings closer together, meet people's desire for more savings flexibility, combining the instant access of ISAs with the tax advantages of conventional pension savings. They are already capable of being delivered via a single, lifetime savings platform, which would enable savers to view and analyse their assets on a portfolio basis, irrespective of different product wrappers. Savers would also be able to project potential retirement income incorporating all of their assets, under a range of different assumptions for future asset performance and personal taxation (made much simpler if there were a single

[11] HMRC *Table 7.9, footnote 3*.

[12] Note that the March 2010 Budget's changes to the earnings threshold is expected to increase the yield to the Treasury by an extra £600 million from 2012-13 (HMT, *Budget*, 2010, page 121, table A2, row f).

tax regime). Providers would have a single customer interface through which to communicate, simplifying account administration and the delivery of focused sales messages. All these attributes should attract more savings and, ideally, competitive pressures would encourage the industry to cut charges so that savers could benefit more from the power of compounding of accruals.

- This paper considers the perspectives of four different interest groups: savers, employers, the pensions and savings industry and the Treasury, both pre- and post-implementation of the proposals.
- The basic State Pension is not discussed; that is the provenance of a sister paper,[13] which proposes a larger State Pension for older pensioners, an essential foundation on which to build a wider and deeper retirement savings culture. This earlier paper also considers the savings challenge faced by low earners, in particular, and public sector pensions; its eight proposals are summarised in Appendix I.
- This paper focuses on reforms to the structure and tax rules around retirement savings for those who can afford to save in order to lift their retirement income above the state minimum. The proposals should be seen as independent of whether or not NEST proceeds. As auto-enrolment is rolled out, it is likely that many companies will opt out of the state scheme in order to continue with their own group pension arrangements. In any case, the limits on annual contributions into NEST accounts mean they will only suffice for the lower income end of the working population. These proposals are intended to have universal application; they could be adopted as either an extension of NEST (which could offer an ISA option) or as a replacement.
- It is hoped that these proposals will attract cross-party consensus. That said, it is recognised that this will not be easy as many view tax relief, for example, as an instrument of social policy.

[13] Michael Johnson, *Don't let this crisis go to waste*, Centre for Policy Studies, September 2009.

INTRODUCTION

There has been a flood of reviews of different aspects of the governance, operation and structure of the pension savings system, including reports from such eminent figures as Cadbury, Higgs, Myners, Penrose, Pickering, Sandler and Turner. This is indicative of successive governments wrestling with a simple, crucial question: who pays?

To date, the answer has largely been the working population. But this inter-generational wealth transfer is unsustainable (and unfair). Our aging population is often cited as the main concern, but the deterioration of the pensioner support ratio[14] has largely been arrested by sending the State Pension Age (SPA) into retreat (to 68 by 2046). However, this is unlikely to fix the problem, and may well prove to be simply a re-labelling exercise. The real issue may be that most people in their 60s could be living in an income desert, dependent upon benefits because they are unable or unwilling to find work.[15] Whether or not they are categorised as pensioners is largely academic. Ineligible for the State Pension, they will need some other income source.

Once the SPA is reached, the low real value of the basic State Pension[16] means that those without savings will be increasingly dependent on means-tested benefits to make up their income. Indeed, the less savings they have, the greater the incentive not to save because of the loss of means-tested benefits. In addition, the deterioration in the quality of (private sector) occupational schemes will diminish what has historically been a crucial source of retirement income for many people. There is also the ongoing problem for many women, in particular, who, because of their intermittent work patterns, have not accumulated a meaningful pension in their own right and find themselves inadequately provided for when they become widows or divorcees.

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[14] The pensioners support ratio is defined as the number of people of working age, per pensioner.

[15] Today, across Europe, only 50% of people are still employed at the age of 60. The European Commission, *The 2009 Ageing Report,* 2009.

[16] Notwithstanding the Coalition commitment to return to earnings-indexation from April 2011. It would be prudent to question the viability of this proposal.

Reference to “the pensions crisis” is not so much a reference to today’s pensioners as today’s workers, when we come to retire. Unless the retirement age is pushed back much faster than currently planned, the alternative is an increasing tax burden on the future working population; a serious political challenge. It seems inevitable that today’s workers will have to rely more on sources of income other than a pension (state or otherwise), but savings levels are simply too low to meet their retirement income expectations.

Consequently, saving for the long term has to be made easier, but the challenge should not be underestimated. Attitudinal, behavioural, informational and structural barriers seriously inhibit retirement saving. Many people lack the necessary financial understanding to make informed decisions, or have difficulty accessing information. Financial myopia (“spend now”) is commonplace, particularly understandable amongst those on low incomes whose behaviour is more influenced by immediate deficiency rather than the prospect of distant, and uncertain, future reward.

PART ONE: THE LONG-TERM SAVINGS LANDSCAPE

1. BACKGROUND: WHY, WHAT AND HOW WE SAVE

1.1 Why we need to save

Our population is ageing. Today approximately 10.3 million people are aged 65 and over (16.5% of the UK's inhabitants); in 2050 that figure is expected to rise by more than 80%, to 18.7 million (24.3% of the total).[17] This is likely to have major implications for the shape of our future economic activity, including the demand for goods and services, workforce composition and productivity.[18]

In parallel, at some future time we may reach a tipping point when, collectively, the UK moves from the net accumulation to decumulation of savings, as assets are increasingly realised to sustain people in retirement. In parallel, a rising tax burden (not least to fund the State Pension) on a diminishing worker population (relative to the number of retirees) may constrain the ability to save. Consequently, investment needs may increasingly have to be met by foreign capital, perhaps at a time when other developed nations are similarly capital constrained. The cost of capital is likely to rise.

If this is not enough to stress the importance of encouraging people to save, consider the individual's perspective. There is an ongoing transfer of income-in-retirement risk from the state to the individual; the retreating State Pension Age (SPA), the likelihood of increasing (state-paid) healthcare rationing and a less generous welfare state. Similarly, employers are placing more post-retirement financing risk with employees, notably through the move from DB (defined benefit, or final salary) to DC (defined contribution) pension provision.

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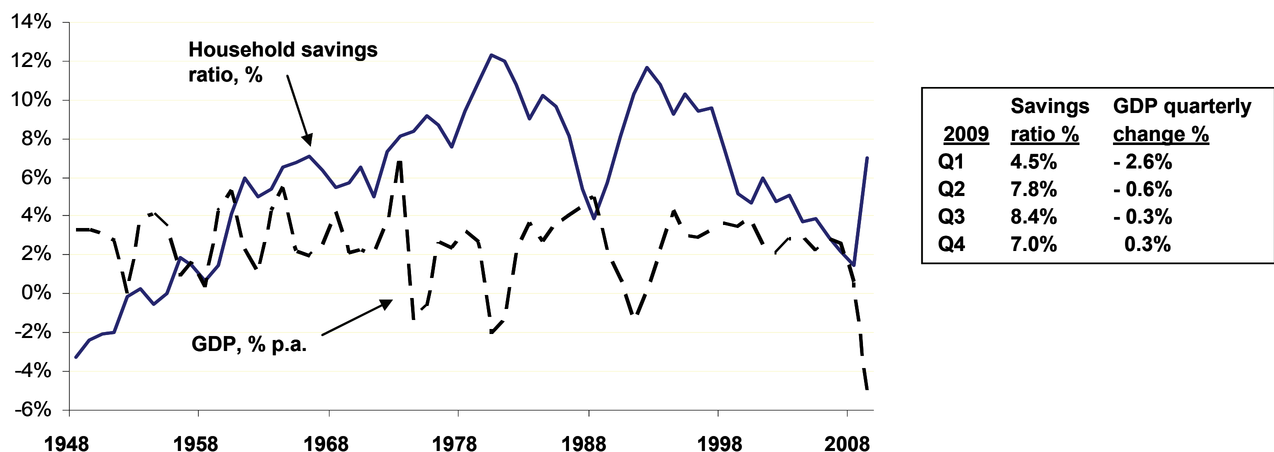
[17] ONS. Amongst developed nations, the extreme example is Japan: 22.6% of the population is aged 65 and over today. This is expected to rise to 37.8% in 2050; UN*, World Population 2008 Revision*.

[18] An ageing population may well lead to diminishing productivity. Given that assumptions for productivity growth are central to driving GDP forecasting, which is turn is used as a measure of affordability of the State Pension and public sector pensions, this raises serious affordability questions. The Treasury assumes 2% annual productivity growth in its Long-term Public Finance Reports. Our ability to innovate is likely to be of increasing importance.

1.2 The UK's household savings ratio[19]

The most frequently quoted indicator of the UK's savings activity is the household savings ratio. It includes both pension contributions and debt repayment (which is akin to saving) and is closely associated with how people view their economic situation. The ratio tends to rise when economic confidence is low (e.g. when job prospects are uncertain) and vice versa, although GDP is a more readily quantifiable proxy (Figure 1). The savings ratio has averaged 5.8% since 1948 (7.4% since 1960) but since 1992 (11.7%) this ratio has seen sixteen years of decline, only reversed in 2008, when consumer confidence plummeted.

Figure 1: Household savings ratio (%) and GDP (% per annum)[20]



2009	Savings ratio %	GDP quarterly change %
Q1	4.5%	- 2.6%
Q2	7.8%	- 0.6%
Q3	8.4%	- 0.3%
Q4	7.0%	0.3%

The household savings ratio does not accurately represent the savings experience of the average earner. Once the wealthiest 5% of the population are removed from the data (they hold around a third of total savings), the average person had just £2,205 set aside, after increasing their savings levels by only £38 during the whole of 2009.[21] During 2009 the focus was on paying down unsecured debts, such as credit cards and loans, and making overpayments on mortgages.

1.3 Household savings: lessons from Japan

Japan presages the UK's demographic experience by approximately 30 years; today some 22.6% of Japanese are aged 65 and over, a figure that the UK is expected to reach in around 2040. Consequently it is worth looking, briefly, at the Japanese experience.

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[19] Household saving expressed as a percentage of total resources (gross household disposable income plus an adjustment for the change in net equity of households in pension funds).

[20] ONS data and quarterly national accounts, 4th quarter 2009, 30 March 2010.

[21] ING Group, January 2010.

Japan's savings ratio was once the highest in the developed world, peaking at 23% in the mid-1970s. Since then it has declined, particularly in the four years to 2001 when it fell from nearly 12% to 5%; in the last five years it has stuck in the range of 2.5% to 3.0%. Alarmed by this (and recognising that the household savings ratio is one harbinger of future economic development), the Japanese researched the underlying causes of the ratio's rapid decline.[22] They identified four causes, all of which put downward pressure on the savings ratio:

(i) the ageing population. Retired people tend to run down their savings;

(ii) economic stagnation. Since 1990, growth in disposable income has slowed more than (inertial) household consumption, squeezing the capacity to save;

(iii) reform of the social security system. In particular, higher state pensions (reformed in 1995) and the introduction of public long-term care insurance have reduced people's anxiety about financing their retirement, leading to less saving (a trend of which proponents of a higher basic State Pension in the UK should take note). The Japanese are now questioning the sustainability of these reforms; and

(iv) changing lifestyles, as people place increasing value on their current lifestyle rather than worrying about the future.

Causes (i) and (iv) are structural, and likely to continue to exert downward pressure on the savings ratio, whereas the other two causes are cyclical, and therefore could be considered as temporary phenomena. The Japanese Cabinet Office concluded that the household savings ratio is expected to continue to decline over the long-term, driven by the aging of Japan's population; a negative savings ratio beckons.[23]

1.4 UK pension saving

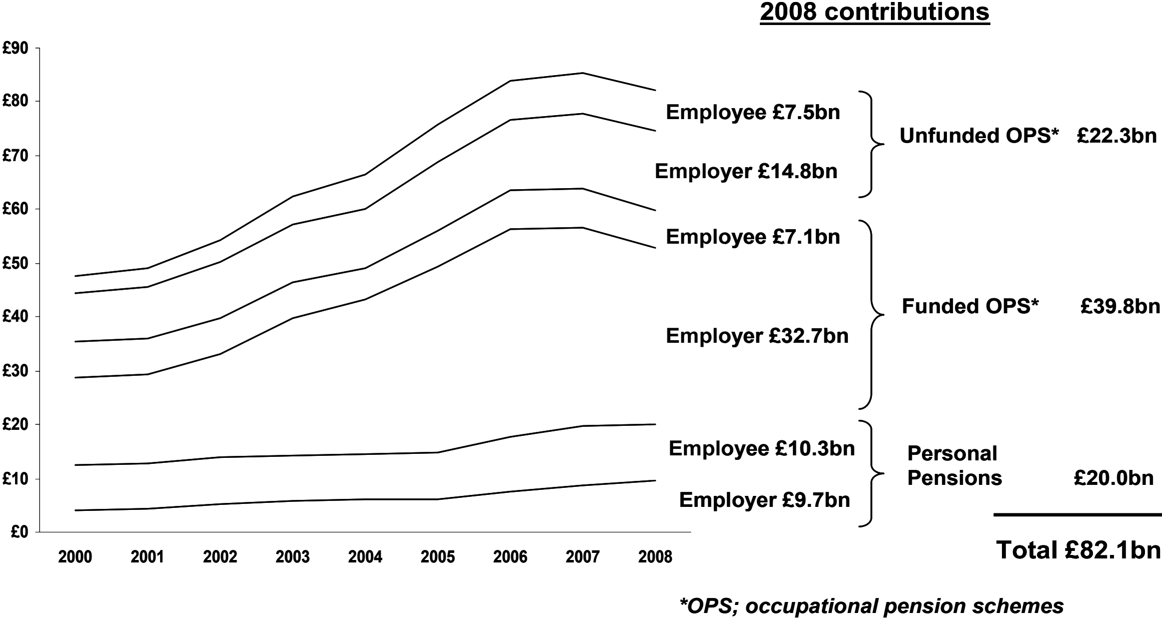
In 2008 the UK, as a nation, put aside over £82 billion in private (non-state) pension schemes, primarily in occupational pension schemes and personal pensions. Total contributions fell at the start of the recession, from £86 billion in 2007, the fall being driven by a decrease in employer contributions to funded schemes, which fell from £37 billion in 2007 to £32.7 billion in 2008, as company finances came under pressure. Figure 2 shows contributions made to pension schemes since 2000, split between both funded and unfunded schemes (the latter being largely in respect of the public sector), with

[22] K Katayama, *Why Does Japan's Saving Rate Decline So Rapidly?,* Policy Research Institute, Ministry of Finance (Japan), 2006.

[23] K Masubuchi, *Japan's Household Savings Ratio,* Cabinet Office (Japan), 2006.

personal pensions including group-based schemes (GPP), stakeholder and some SIPPS (HMRC does not receive SIPP returns from *all* providers; perhaps another £3 billion).[24]

Figure 2: Contributions to pensions, £ billion[25]



Pension saving grew particularly strongly in the five years to 2006 (£83.8 billion), up more than 70% on 2001 (£49 billion), primarily because employer contributions to funded occupational schemes rose to finance deficits in defined benefit (DB, or final salary) pension schemes. One consequence of occupational schemes closing has been an increase in employer contributions to personal pensions; up from £2 billion in 1995 to £9.7 billion in 2008.

This has all come at a price. In the period between 1996 and 2000, annual private sector employer contributions to funded schemes were typically £15 billion to £20 billion, whereas the figure for 2008 was nearly £33 billion. To the extent that this increase has been required to repair pension fund shortfalls and deficits, it has acted as a drag on new business investment.

1.5 Occupational schemes

It is clear that work-based schemes continue to play a major role in pension provision, accounting for three quarters of all contributions, with 76% of these coming from employers. But this snapshot of the data masks the decline in the quality of private sector occupational schemes, as they continue to retreat from DB to DC provision. DC

24 Based upon 30% under-reporting and 40% market growth in 2008, to £35 billion of assets.

25 ONS *Pension Trends*, Chapter 8, Table 8.14, April 2010. This data excludes some SIPPs.

scheme contribution rates are lower than DB schemes; the average total contribution rate (member and employer) for open DC schemes was 9% of earnings in 2008, compared with 19.7% for open DB schemes.[26]

The sharp dichotomy between the quality of private and public sector pension provision is the subject of increasing analysis and media attention. Almost 90% of state employees receive final salary pensions, compared to 16% in the private sector. Between 1991 and 2008, active public sector pension scheme membership increased by 28%, from 4.2 million to 5.4 million.[27] Conversely, in the private sector it fell by 45% over the same period, from 6.5 million to 3.6 million, of whom 2.6 million were in DB schemes (down from 3 million in 2006) and 1 million in DC schemes. The relative generosity of public sector pensions skews the labour market, placing the private sector at a disadvantage (as well as hindering mobility from public to private sectors).

The affordability of public sector pensions is also hotly debated. But given that any change to pension benefits is likely to produce more losers than winners, it was no surprise that the issue of public sector pensions was not discussed before the 2010 General Election. An independent commission to review the long-term affordability of public sector pensions is now proposed, not least to free up the political logjam.

1.6 Personal pensions

The current framework[28] for tax-incentivised pension saving permits the employed or self-employed to contribute up to 100% of the value of their relevant UK earnings (salary and other earnings), to a maximum of £255,000 for the 2010-11 tax year. Contributions above this annual limit are permitted but do not attract tax relief. There is also a £1.75 million Standard Lifetime Allowance (SLA) for the amount of saving on which tax relief can be obtained (£1.8 million from April 2010 to 2016).

Tax relief is provided at the saver's marginal rate; 20% (basic rate tax relief) is added by the government, and higher rate taxpayers can claim a further 20% via their tax return, and 30% if an additional rate taxpayer. From April 2011, 50% taxpayers (those with gross income of £150,000 or more) will not be able to claim 50% relief on pension contributions,[29] potentially affecting about 290,000 people. Thereafter, relief will be

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[26] ONS, *Occupational Pension Schemes Annual Report 2008*, October 2009. But data varies: *ONS Pension Trends,* Chapter 8, April 2010 reports average employer contribution rates for 2008 as 16.6% of salary for DB schemes and 6.1% of salary for DC schemes.

[27] ONS, *Occupational Pension Schemes Annual Report 2008*, October 2009.

[28] Established by the "Pension Simplification" ("A-day") measures of April 2006.

[29] Introduced in the April 2009 Budget.

tapered away with the effect that those earning more than £180,000 will only receive basic rate pension tax relief (i.e. 20%). A variety of anti-forestalling measures, including a special annual allowance charge and limitations in respect of salary sacrifice, largely ensures that 50% relief will never get started (the 50% rate of income tax commenced in April 2010).

Non-taxpayers can contribute up to £2,880 in a year and benefit from basic rate tax relief (at 20%), for a total contribution £3,600. There is no tax relief for contributions above this amount.

The upfront tax relief on pension contributions is the primary attraction, but benefits cannot be drawn until the age of 55 (from April 2010), with up to 25% of the value of the fund taken as a tax-free lump sum. Pension products include Additional Voluntary Contributions (AVC), personal pensions, Self Invested Personal Pensions (SIPPs) and Stakeholder pensions (and their group equivalents), plus DC pension schemes. As money purchase vehicles, they all serve much the same purpose, but each is accompanied by subtle legislative differences which add to complexity.

The declining quality of occupational schemes presents the personal pensions market with an opportunity, but the Labour Government's Stakeholder initiative is widely considered as having failed. Distribution is dependent upon the industry, and provider and distributor interest has been severely muted by what the industry considers to be an insufficient remuneration incentive.[30]

The industry's hopes rest on SIPPs. There are over 150 providers, 500,000 accounts and the market now exceeds £75 billion, up 50% since 2007.[31] But this growth is misleading: most of it does not represent net new saving; assets are merely being redistributed from other personal pension arrangements, attracted to SIPPs by lower costs (for individuals; not necessarily so in respect of group personal pensions) and greater flexibility.

1.7 Pension fund asset allocation

At the end of 2007 the UK's pension fund assets (Table 1) amounted to at least £1,955 billion, more than three quarters of which still reside within occupational schemes. Subsequently, pension fund assets have fallen substantially, perhaps by 20%, in the light of weak financial markets.

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[30] Stakeholder charges are capped at 1.5% p.a. for the first ten years, 1% p.a. thereafter.

[31] Suffolk Life.

Table 1: Funded pension scheme assets, 2007, £ billion[32]

Occupational pensions		**£1,505**	77%
Insurance company administered	£440		
Self-administered	£1,065		
Personal pensions		**£450**	23%
Insurance company administered	£415		
Self Invested Personal Pensions (SIPP)	£35		
Total invested in funded pensions		**£1,955**	100%

The composition of these assets has changed over recent years as fund managers have responded to short-term "noise" (global economic downturn, fund deficits and accounting and regulatory pressures) by de-risking their portfolios. As Table 2 shows, the direction of travel has been into bonds, from equities, as well as geographic diversification into overseas investments. Alternative asset classes (such as art and wine), remain almost invisible in pension funds, and property is almost entirely commercial, not least because residential property cannot be held directly within a SIPP.

Table 2: UK pension funds' asset allocation, £ billion[33]

	1996		2007	
Equities		**75%**		**56%**
UK	53%		26%	
International	22%		30%	
Bonds		**14%**		**30%**
UK	11%		26%	
International	3%		4%	
Cash		**6%**		**7%**
Property (commercial)		**5%**		**7%**
		100%		**100%**

The long-term consequences of this asset reallocation are, of course, unclear, but in the short term the UK's pension funds have done less badly than they would have done had they maintained their historic (higher) allocation to UK equities.

1.8 Pensions wealth distribution

The distribution of pensions assets is hugely skewed in favour of the wealthy, as Figure 3 illustrates.

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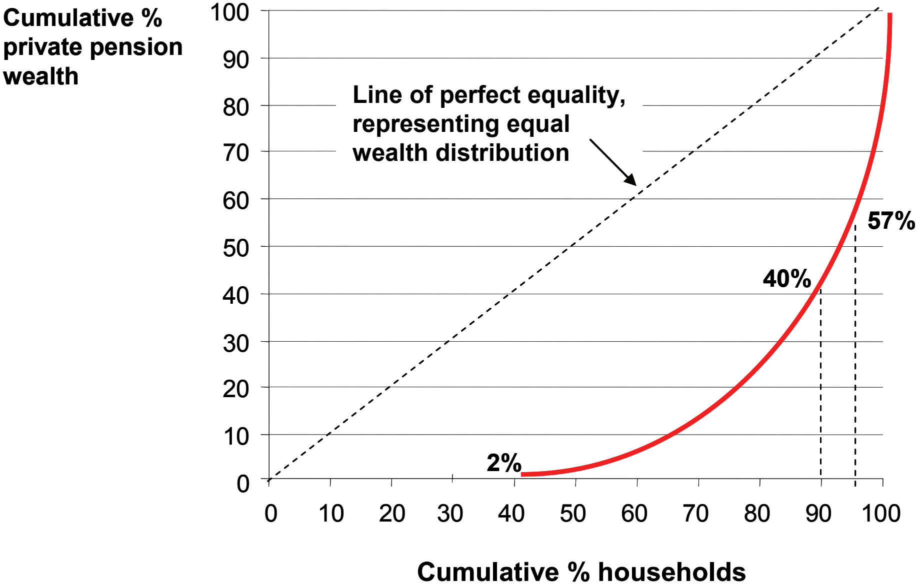
[32] *PPI Pension Facts, Table 24,* December 2008. The SIPP figure is from *Money Management Survey, April 2007*, and excluded some providers; therefore an under-estimate.

[33] UBS, *Pension Fund Indicators.* Later date suggests that 49% of DB scheme assets are now held in equities as funds switch into bonds *(ACA Pensions Survey 2009,* January 2010*).*

Figure 3: Distribution of household private pension wealth, 2006/08[34]



This chart shows that the poorest 40% of households own 2% of pension wealth, while the wealthiest 5% and 10% own 43% and 60% of pension wealth, respectively. One consequence of the credit crunch is that there are fewer people saving, but those who do so are saving more. Not surprisingly, they are the better off (with annual net household income of more than £20,000),[35] thereby increasing the polarisation of pensions wealth.

The skewed distribution of private pension wealth can be seen by comparing the mean (average) and median of pension wealth for all adults.[36] The mean was £80,400, the median was just £4,900. This data includes adults without *any* pension wealth; if they are excluded, the mean rises to £141,500.

In recent years the proportion of Britons on course to enjoy an adequate retirement income has been a consistent 50%, with minor fluctuations, with a consistent 25% not saving at all.[37]

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[34] ONS, *Wealth in Great Britain: Main Results from the Wealth and Assets Survey 2006/08,* Figure 6.25, December 2009.

[35] Scottish Widows, *UK Pensions Report 2009*, June 2009.

[36] ONS, *Wealth in Great Britain: Main Results from the Wealth and Assets Survey 2006/08*, Table 6.9, December 2009.

[37] ONS, *Social Trends 39,* page 63, 2009.

1.9 The international perspective

At the end of 2007, the UK ranked second in the world in terms of its holding of global pension assets, with nearly 11% of the total worldwide pension assets of $30.4 trillion. Only the US had more (with 64%), while the UK was followed by Canada (5%) and the Netherlands (3%). This reflects our long tradition of providing occupational pension schemes, and also indicates that our pensioners rely to a large extent on income from private pension funds, rather than the state. Furthermore, some European companies (in Germany, for example) carry large pension liabilities on their balance sheets as debt, rather than operate funded schemes with assets.

The OECD nations accounted for 97.9% of all pension assets,[38] as private pension provision is in its infancy in most of the developing world. Brazil, Chile and South Africa are exceptions to this; and, in other countries, pension funds are now growing quickly.

In 2008, OECD pension funds (in aggregate) experienced on average a negative return of 21.4% in nominal terms, but the UK's negative 17.8% return was partly mollified by having been exposed to currencies that appreciated against Sterling.[39]

Relative to the size of its economy, the UK's private pension assets ranked sixth[40] in the international league (79% of GDP; see Appendix II). By contrast, the private pension assets of major competitors such as Germany, France and Italy are tiny (4%, 3% and 3% of GDP, respectively), reflecting pensioners' greater reliance on the state.

The UK has no public pension reserves, in stark contrast with some countries, notably Sweden, Japan, South Korea and the US (32%, 26%, 24% and 17% of GDP, respectively); see Appendix II. The tax treatment of private pension assets varies widely from country to country (see Section 5.6).[41]

1.10 Individual Savings Accounts (ISAs)

An overview of the UK's long-term savings framework is not complete without referring to ISAs. Although ISAs are not explicitly sold as a retirement savings product, many savers, particularly basic rate taxpayers, retain their ISA assets for many years, and come to consider them as a flexible form of retirement saving.

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[38] IFSL Research, *Pension Markets,* 2009.

[39] OECD, *Pension Markets in Focus,* Issue 6, October 2009.

[40] After the Netherlands (138% of GDP), Iceland (134%), Switzerland (119%), Australia (110%) and the US (93%); data for 2007. OECD, *Pensions at a Glance 2009: Retirement-Income Systems in OECD,* last updated 10 August 2009. These figures all dropped sharply in 2008, the average falling from 75.5% of GDP in 2007 to 63.4% in 2008. Furthermore, OECD may significantly underestimate UK funded pension assets.

[41] Also see HMT/HMRC, *Implementing the restriction of pensions tax relief,* Annex B page 59, December 2009.

Unlike pensions, ISAs do not attract upfront tax relief on contributions. However they do provide similar tax relief on investment returns during their lifetime and also benefit from incurring no tax charge when the proceeds are withdrawn. As demonstrated later in this paper (Section 2.9), someone who expects to be an income or capital gains taxpayer in retirement may find that the tax relief on an ISA held to retirement is worth as much the tax relief on a pension;[42] it is just deferred to when assets are realised rather than made explicit at the start. In addition, an ISA offers the added flexibility of having no restrictions on withdrawing funds. Conversely, retirement savings products do offer a 25% tax-free lump sum when the associated pension commences, partly to reward non-access to assets pre-retirement.

The importance of ISAs within the savings arena cannot be overstated: they are our most popular non-pension savings vehicle. More than 19 million people hold accounts that attracted over £37 billion of new savings in the last financial year, taking total assets to £275 billion[43] (more than 50% of the £450 billion of personal pension assets).

Table 3: Individual Savings Accounts, 5 April, £ billion[44]

	2006	**2007**	**2008**	**2009***
Stocks and shares subscriptions	£9.2	£10.4	£10.4	£9.4
Cash subscriptions	£21.9	£22.7	£25.3	£28.1
Total subscriptions	**£31.1**	**£33.1**	**£35.7**	**£37.5**
Stocks and shares market value	£70.4	£80.1	£78.6	£116.5
Cash	£111.0	£127.7	£142.8	£158.1
Total market value	**£181.4**	**£207.8**	**£221.4**	**£274.6**
# accounts subscribed to in the year (million)	13.0	13.6	14.7	14.2

** Provisional*

ISAs appeal across the income spectrum, albeit with some skew towards lower incomes. Table 4 shows that the majority of accounts are held by people on less than median earnings;[45] to them, the annual investment limit (£10,200 from April 2010) is irrelevant.[46] Similarly, low earners are unlikely to be attracted by the CGT exemption, given their annual capital gains allowance (£10,100 for 2010-11).

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42 Not taking account of a pension product's 25% tax-free lump sum.

43 Updated to £290 billion in the 2009 Budget speech.

44 ONS, HMRC, *ISA statistics,* Tables 9.4 and 9.6, September 2009.

45 £23,764 p.a. using April 2007 data to be consistent with Table 4. ONS, *Annual Survey of Hours and Earnings*, 2007.

46 The March 2010 Budget announced that from April 2011, and over the course of the next Parliament, ISA limits will be indexed annually in line with the Retail Prices Index (RPI).

Table 4: ISA savers' income distribution as at April 2008[47]

Savers' total income	Number of savers	Proportion	Cumulative
Less than £5,000	2,331,000	11%	11%
£5,000 - £9,999	3,299,000	16%	27%
£10,000 - £19,999	6,249,000	30%	58%
£20,000 - £29,999	3,827,000	19%	76%
£30,000 - £49,999	3,166,000	15%	91%
£50,000 - £99,999	1,314,000	6%	98%
£100,000 or more	461,000	2%	100%
Total	**20,647,000**	100%	

Table 5 shows that savers are attracted by the tax-free income and withdrawals, the access to income information, the rates of interest (albeit less so in recent months), ISAs' ready access and their simplicity. In a word, the ISA brand has, to date, been trusted, but it should be noted that the recent media coverage of woeful rates of interest now being paid is beginning to tarnish the brand.

Table 5: The attractions of ISAs[48]

% of respondents	Cash ISAs	Equity ISAs
Tax free	68%	54%
You can see exactly what you have made	57%	35%
Better interest rate than other savings	49%	n/a
Access at any time	40%	n/a
Simple and easy to understand	35%	n/a
An easy way to access the stock market	n/a	35%
Recommended by a financial adviser	n/a	34%
Can invest in a wide range of funds	n/a	32%

ISAs blur the distinction between general saving (with ready access) and long-term saving, because some 50% of annual cash subscriptions remain within ISAs over subsequent years. In other words, ISA savings are persistent. Initially attracted by instant access, many ISA savers succumb to inertia and, over time, come to consider their ISA as a core part of their retirement saving. But some 57% of the funds invested in ISAs are held as cash,[49] rarely the ideal asset class for long-term investment when, for example, compared to property. This demonstrates muddled saving objectives; few savers have a savings strategy, a problem compounded by a lack of financial wherewithal.

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[47] ONS, *ISAs Table 9.10,* released April 2010.

[48] Scottish Widows Savings and Investment Report, 2009.

[49] The ISA has two components: Cash ISAs and Stocks & Shares ISAs. Prior to April 2008 they were known as Mini ISAs and Maxi ISAs, respectively.

2. THE SAVER'S PERSPECTIVE

2.1 Certainty

As we age, we increasingly crave certainty, particularly in respect of retirement income. But the price of certainty, in the form of DB pensions and annuities, is rising with increasing longevity and dismal investment performance. Prevailing low interest rates exacerbate the problem. Annuities do provide a hedge against longevity, but in recent years prices have risen substantially, not least because the FSA (and the industry) has realised that life expectancy has been under-projected for decades and its expectations for reserves have now been raised. But annuities also introduce uncertainty because the saver could die prematurely (actuarially speaking) and then fail to get full value from the asset, although some providers do now offer money-back guarantees in event of early death (but they do not come for free).

2.2 Balancing simplicity and choice

Experiments confirm that, for most of us, the less choice we have, the simpler life is, the better we feel and the more empowered we are to make decisions. Excessive choice can lead to paralysis rather than liberation; it is overwhelming, and often prompts "consumer vertigo". When swamped with too many options, we procrastinate and cannot make a decision, or become rushed and make poor decisions.

In the UK, there is a perplexing array of long-term savings products which savers are not always equipped to rationalise. Each product offers different attributes that make it hard to compare with others but, ironically, as product choice increases, expert advice becomes less available and more expensive. The commonly-held view is that if the savings landscape were simplified, we as a nation would save more.

2.3 Tax: the root of much complexity

Tax is the root cause of our retirement saving complexity, a huge issue in respect of asset accumulation and post-retirement decumulation. Table 6 details the different tax treatments of five established long-term savings products.

Table 6: The complexity of the tax treatment of savings[50]

Savings product	Tax treatment and main tax attributes	Other features
Pensions	$EE^{partial}T$. "Middle E" is only partial as the 10% dividend tax credit is not recoverable. 25% tax-free lump sum can be taken at retirement.	Large contributions allowances, but restrictions on how benefits can be taken.
ISAs	$TE^{partial}E$. Partial "middle E" as per pensions.	Contributions limited, but instant access.
Single premium life assurance bonds (onshore fund)	$TTE^{partial}$, with "middle T" being taxed at the life company's special rate (20%); HMRC treats this as if basic rate tax has been paid so investors do not have to add the income to a tax return. The "E" is partial because withdrawals of up to 5% of the original investment can be taken over 20 years without immediate tax. Higher rate tax (HRT) payers making withdrawals over this amount, or after 20 years or on complete encashment (whichever is the earlier) face additional income tax.	Unlimited investment amount. Investors are free to spend life policy proceeds as they wish.
Regular life fund contributions/Maximum Investment Plan (MIP)	TTE; "middle T" taxed as a life bond. "Final E" requires the fund to be held for a minimum of ten years to be deemed a "qualifying policy". There is then no tax on withdrawals. This is a benefit for a HRT payer as the tax on the life fund during the period of investment is often less than his personal tax rate.	Unlimited investment amount.
Collective direct investment scheme (OEICs, Unit Trusts)	$TTE^{partial}$, with E being partial as asset realisation is subject to CGT; disinvestment needs to be planned.	Unlimited investment amount and benefits can be taken at any time and in any format.

[50] Table 6 describes a product's tax status chronologically by using three letters, either E (exempt) or T (taxed). The first letter refers to contributions (of capital), the second to investment income and capital gains and the last letter to post-retirement income (e.g. a pension).

Many savers are particularly bewildered by the tax treatment of life bonds,[51] which are taxed very differently to pension funds. A life bond commingles long-term investment with a single premium life assurance policy, and it is this latter feature that provides life funds with their "non-qualifying" tax status.[52] This is in spite of the life assurance element of the investment being very small (i.e. less than 1% of the amount invested). Consequently, life funds pay tax but can deduct the expenses of writing new business against capital gains, thereby reducing their effective tax rate on gains to less than 20% (industry numbers range from 15% to 18%). Conversely, pension funds do not pay tax, and therefore cannot offset their expenses.

HMRC treats life bond investors as if full basic rate tax has been paid, a benefit that insurance companies are keen to point out via "technical notes" to investors when selling investment bonds against other investment funds. But these notes never disclose the rate of tax that the life fund could expect to pay in the future, because it varies, depending on the financial position of the insurance company. This leaves the investor (or his adviser) to guess the true extent of the benefit. More complexity to wrestle with.

Finally, tax relief adds to complexity because product design is often driven by the need to maximise tax benefits rather than meet customer need. Why, for example, are life insurance policies embedded into savings products which are regularly sold to trusts designed to benefit children? The answer is related to tax and, historically, sales commission (the latter will end once the Retail Distribution Review[53] has been implemented).

2.4 Taking income in retirement: more complexity

Individuals retiring with appropriate pension rights can commute up to 25% of their pension fund as a tax-free lump sum. Thereafter, but prior to reaching the age of 75, retirement savings must either be used to purchase a lifetime annuity[54] or be taken as unsecured income.[55]

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[51] Life bonds are also known as investment bonds which, confusingly, are nothing to do with the (fixed income) bond market.

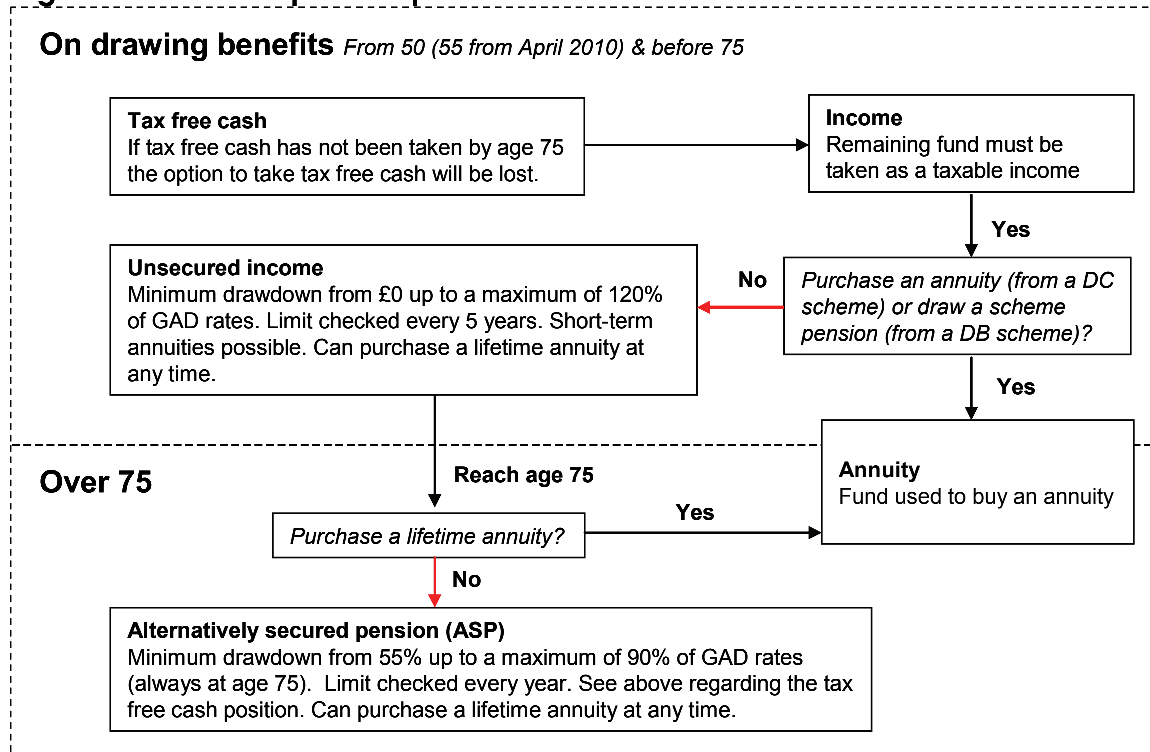
[52] The Taxes Act 1988 specifies that single premium life assurance policies cannot be "qualifying" policies. The underlying fund is therefore taxed on investment income and capital gains under the special rate of corporate tax applicable to life assurance companies: 20%.

[53] See Sections 4.7 and 4.8.

[54] The May 2010 Coalition Agreement proposed the abandonment of compulsory annuitisation at 75.

[55] Introduced in the Finance Act 2004 after the Plymouth Brethren objected on religious grounds to compulsory annuitisation (which is against EU law).

Figure 4: Income options upon retirement[56]



At first sight, having to choose between only two different ways of realising assets to generate income in retirement appears relatively straightforward. The choice is between either a lifetime annuity or unsecured income, potentially leading to an alternatively secured pension (ASP) at 75. But there is a wide variety of annuities to choose from (see Appendix III) and they lack flexibility; for example, it is either impossible, or very expensive, subsequently to switch the form of income stream, or to switch between single life and joint lives. Alternatively, if the saver elects for unsecured income, there are a number of potential tax traps, the most serious of which is a potential 82% tax rate on residual ASP assets (see Section 2.5).

But why are life funds and pension funds taxed differently? The simple answer is that successive governments have chosen to reward long-term pension saving by offering a gross roll-up regime (“middle E”), whereas life policies are generally accessible at any time.

2.5 Settling an estate after death

Even after the saver has died, the complexity continues (see Figure 5). There are at least three different tax regimes impinging upon pension assets in respect of settling an estate, depending upon the timing of death, whether or not any post-retirement income had been taken before death and, if so, the form of income (unsecured income or an ASP).

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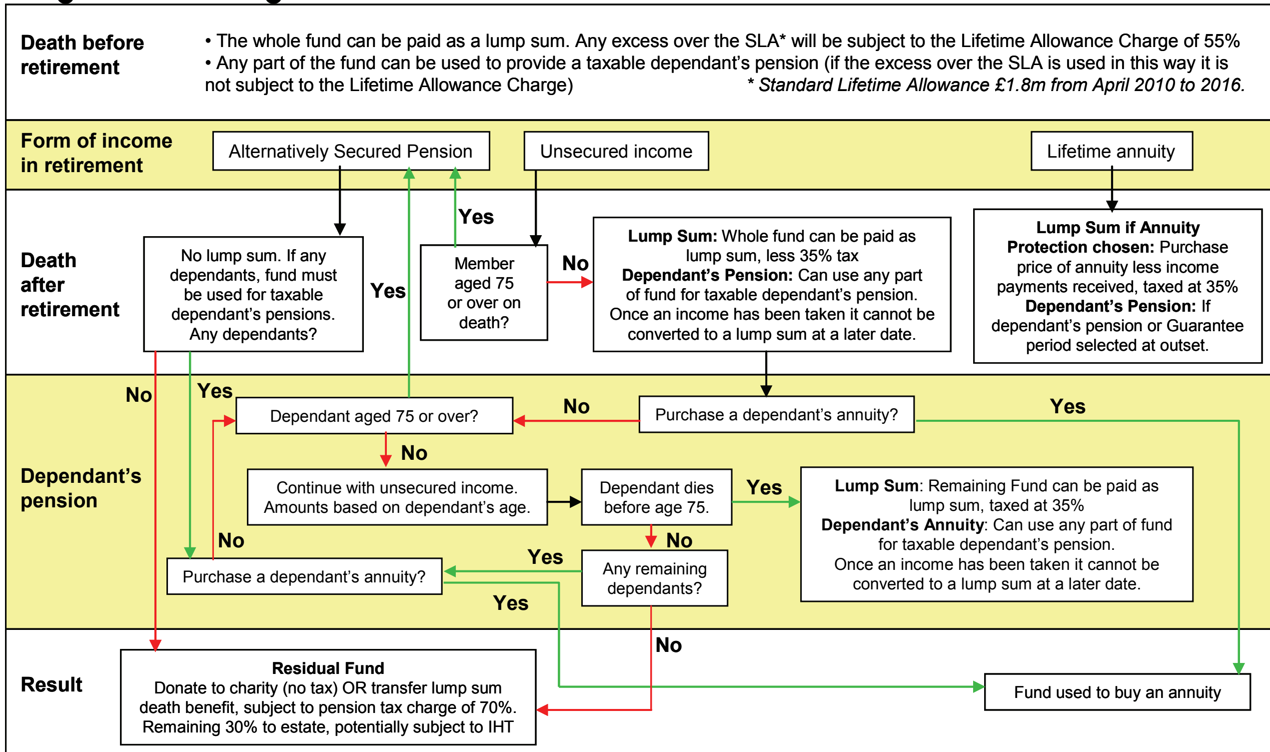
56 With thanks to St. James’s Place Wealth Management Group.

Figure 5: Settling an estate after death[57]



The tax treatment of an ASP can be particularly tough. Many of those who elect for an ASP will previously have had an unsecured income, in which case, depending upon whether they die before or after reaching 75, their tax treatment is very different. If the former, their estate suffers a 35% tax charge (and had they had uncrystallised pension funds, then usually the full fund is payable as a lump sum with no tax due, including Inheritance Tax). However, if they die after reaching 75 without a spouse,[58] the tax rate on residual ASP funds can be as high as 82%,[59] the consequence of a cat's cradle of provisions crammed into the Finance Act 2007[60] and the Inheritance Tax Act 1984.

2.6 The "cliff edge" at age 75: more uncertainty

As we have seen, the age of 75 marks a watershed for pensioners, requiring a decision in respect of compulsory annuitisation or an ASP. It also exposes the saver to timing risk and creates uncertainty in respect of the taxation of unused pension savings. Consequently, the age of 75 is an arbitrary, discriminatory and penal "cliff edge" which runs contrary to what the Government should be doing: actively encouraging pension

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57 With thanks to St. James's Place Wealth Management Group.

58 If the estate exceeds the nil-rate band for inheritance tax (IHT) of £325,000 (2009-10), doubled for couples (care of the automatic transfer of spouses' allowances).

59 See the Glossary for detail (under Alternatively Secured Pension).

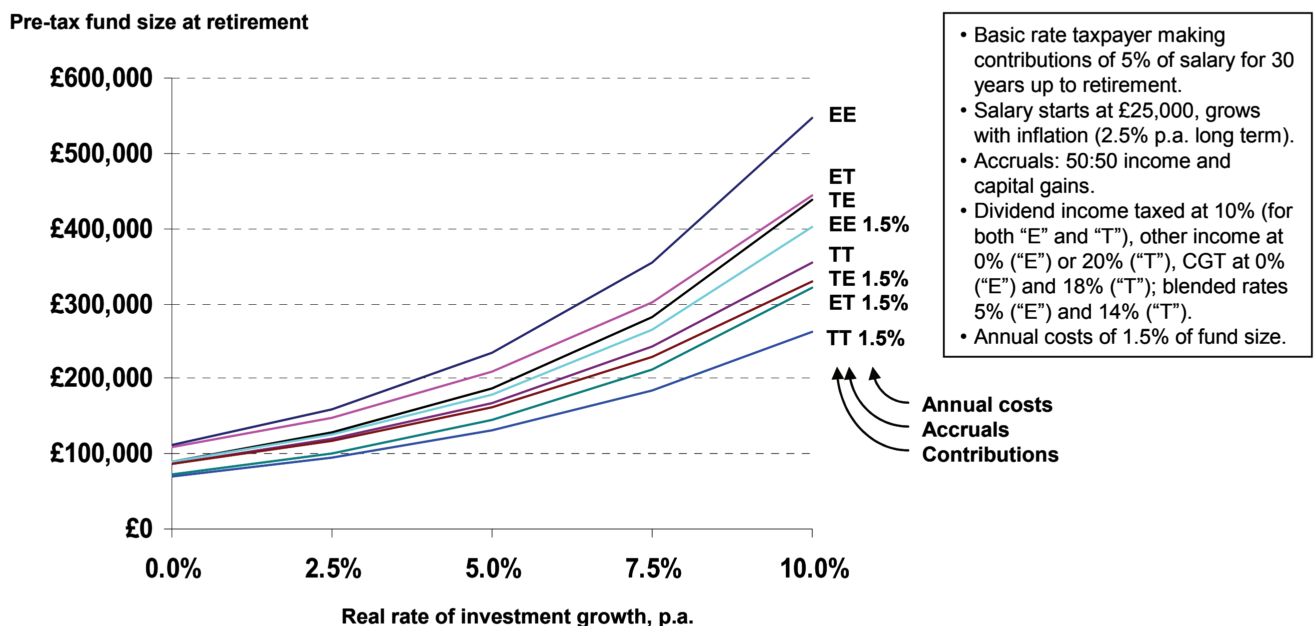
60 Paragraph 69 and Schedule 19.

savings by delivering a framework that is simple and flexible, permitting savers to make lifestyle choices with certainty. The recent Coalition Agreement (May 2010) does refer to ending compulsory annuitisation.

2.7 The unintuitive power of compounding

Our inability to grasp the power of compounding has huge consequences for the size of our long-term savings, and consequently our wellbeing in retirement. It works both for and against us. This can be illustrated (Figure 6) by comparing the impact of four different tax regimes on the fund size of a basic rate taxpayer saving for 30 years, with and without an annual management charge of 1.5%.

Figure 6: The power of compounding



Note that the focus of Figure 6 is the fund size at retirement. It does not consider the post-retirement realisation of assets and the different tax treatments of income in retirement; its purpose is solely to illustrate the pre-retirement power of compounding. EE (accumulation and accrual), for example, is inevitably followed by a "T" (i.e. income in retirement is taxed, as per a pension), whereas TE is usually followed by an "E", as per an ISA. Thus the true value of the assets accumulated at retirement depends upon the tax regime applied to withdrawals, which Figure 6 does not reflect.

Fund size growth accelerates as the real rate of return increases; this is caused by the power of compounding working productively. Figure 6 shows that the relative significance (and therefore cost to the Treasury) of any particular tax relief framework changes with the investment environment. In respect of fund size, tax relief on contributions ("front E") becomes less significant relative to tax-exempt accruals ("middle E") as the real investment returns rise; the cross-over between ET and TE is just beyond

a 10% rate of real investment return for basic rate taxpayers (and well beyond 10% for higher tax rate payers).

Conversely, the deduction of an annual management charge has a devastating impact on fund size (and any annuity subsequently purchased): this is the power of compounding working against the saver. Extracted from Figure 6, Table 7 shows that the fund would be 30% larger without annual charges of 1.5% (assuming 5% real investment growth). Even with no real growth, the difference would be 24% (and 36% with real growth of 10%).

Table 7: Annual charges and fund size (5% real investment growth)

Tax treatment (contributions, accruals)	Fund size 0% charges	Fund size 1.5% charges	Charges	Charges as % of fund size
EE	£234,420	£179,968	£54,452	30%
ET	£209,463	£161,934	£47,529	29%
TE	£187,536	£143,975	£43,561	30%
TT	£167,571	£129,547	£38,024	29%

One of the reasons behind this asset erosion is that charges are usually based upon fund size but, given the advances in IT, fund size is almost independent of the operating costs. A basic flat charge with additional charges linked to the number of different assets and transaction volume would perhaps be more appropriate, or a charge percentage that reduces as the size of the asset pot increases.

Successive governments have used the power of compounding to their advantage. In 1993 Norman Lamont first cut tax credits on share dividends paid into pension funds, a move completed by Gordon Brown in 1997, when he scrapped the remaining 10% rebate on dividends. Estimates vary as to how much the Treasury has subsequently benefited, with a corresponding reduction in the value of retirement funds, but one report puts the figure at between £150 billion and £225 billion,[61] to the detriment of millions of savers and pensioners.

2.8 Start saving early

It clearly pays to start saving early. Figure 6 is based upon 30 years of consistent saving, which produces a fund more than three times larger than 15 years of saving would have produced:[62] the power of compounding working to the saver's benefit. The importance of catching the saving habit early is reinforced by Figure 7, which shows that the persistency of non-savings behaviour increases with age. Once past the age of 40, non-savers become more determined *not* to start saving; the non-saving mindset becomes ingrained over time.

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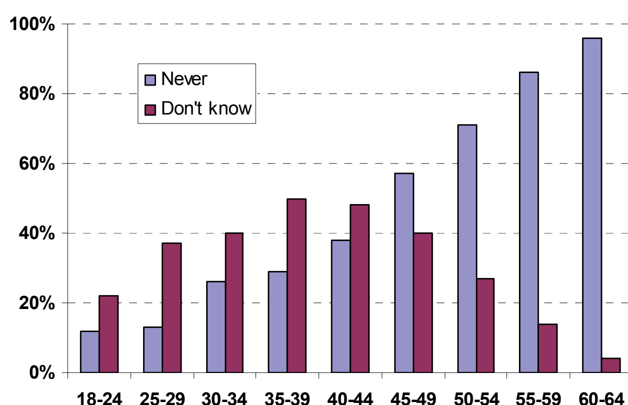
[61] The Taxpayers Alliance, *The UK Pensions Crisis,* November 2008.

[62] Assuming a 5% p.a. real rate of investment growth, with tax relief on contributions and exempt accruals (EE).

Figure 7: When non-savers might start saving, by age[63]



2.9 Long-term savings products compared

Table 8 compares four common forms of long-term savings products: an ISA, a life fund Maximum Investment Plan (MIP), a pension fund and a collective direct investment scheme (CIS, such as an OEIC or unit trust). Each is invested to achieve an asset pot of £100,000 after 30 years, which is then converted into 20 years of annuity income.

Table 8: ISA, life fund MIP, pension fund and CIS compared

	Annual contribution required*			
	CIS**	ISA	Life Fund MIP***	Pension Fund
Salary £25,000 pa (20% taxpayer)	£3,569	£3,151	£3,399	£2,640
Salary £50,000 pa (40% taxpayer)	£4,055	£3,375	£3,640	£2,640
	Post-tax annuity (20 years)			
	PLA	Gradual asset realisation	PLA	75% compulsory annuity + 25% PLA
20% taxpayer	£5,892	£6,115	£5,892	£5,142
40% taxpayer	£5,669	£6,115	£5,669	£4,169

**Over 30 years, to create a £100,000 asset pot **No CGT paid ***Assuming life fund tax rate of 18%*
All numbers in today's money terms; 2% real investment growth as 50:50 income and capital growth
NICs is 11% from Primary Threshold to UEL, 1% thereafter PLA = Purchased Life Annuity

Thus, for example, a 20% taxpayer would have to make annual contributions of £3,399 into a Life Fund MIP to accumulate £100,000 after 30 years. A 20 year PLA of £5,892 (post-tax) could then be purchased at retirement (assuming the saver remained a 20% taxpayer).

The ISA funds are not used to buy an annuity because to do so would lose the tax-free status of ISA accruals and withdrawals. However, the £6,115 figure in Table 8 does require the saver to have perfect foresight as to how to run down his assets over precisely 20 years.

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[63] Scottish Widows, *UK Pensions Report 2009*, June 2009.

Attempting a fair comparison (and any value-for-money assessment) of these four products is almost impossible because each product has attributes not shared by the others, and much depends upon the saver's future, unpredictable, tax status. A simple, very imperfect, approach is to compare the ratio of Table 8's annuity income to contributions: the higher the percentage, the better, as Table 9 shows.

Table 9: Ratio of annual annuity income to annual contributions

Tax status (working, retired)	CIS	ISA	Life Fund MIP	Pension Fund
20%, 20%	165%	194%	173%	195%
40%, 20%	145%	181%	162%	195%
40%, 40%	140%	181%	156%	158%

From Table 9 one could conclude that in respect of long-term savings, for those who are likely to be basic rate taxpayers throughout their lives, there is little difference between an equity-exposed ISA[64] and a pension. However, this does not "value" ISAs' instant access and post-retirement flexibility; once this is considered, it is clear that an ISA is the better route. The lure of 20% tax relief on pension contributions is a false friend. An industry survey[65] confirms that more people (38%) view cash savings (including ISAs) as a better route to a reasonable standard of living in retirement than personal pensions (30%).

The optimal approach for a basic rate taxpayer expecting to become a higher rate taxpayer later may be to save initially in an ISA and then move to a pension product once higher-rate tax relief can be obtained on all of the contributions. A higher rate taxpayer today, expecting to be a basic rate taxpayer when retired, should do better with a pension. This, however, is not clear cut. If, in retirement, taxable income is expected to exceed a limit (currently £22,900 a year), the pensioner's higher tax allowance starts to be lost. But income derived from an ISA does not count, because it is not taxable.

This crude analysis ignores sales commissions and annual management charges, which can have a negative huge impact on asset pot size, the power of compounding working against the saver. The tax treatment of assets following death after retirement is also ignored. In addition, this analysis has not attributed any value to the life fund MIP's life cover. Furthermore, life fund-derived annuities would fare better when compared to pension annuities if higher rates of investment return were used, because of their advantageous tax treatment.

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[64] Note that 57% of ISA assets are in cash, 43% in stocks and shares (April 2009); ONS, *ISA statistics,* Table 9.6, September 2009.

[65] Scottish Widows, *UK Pensions Report 2009,* page 20, June 2009.

There are other aspects to consider in the ISA versus pension debate. If the saver were to die before retirement, the value of their pension fund, if it has been written in trust, will fall outside their estate for inheritance tax (IHT) purposes, whereas an ISA might face IHT. Much depends upon the saver's tax status both pre- and post-SPA retirement.

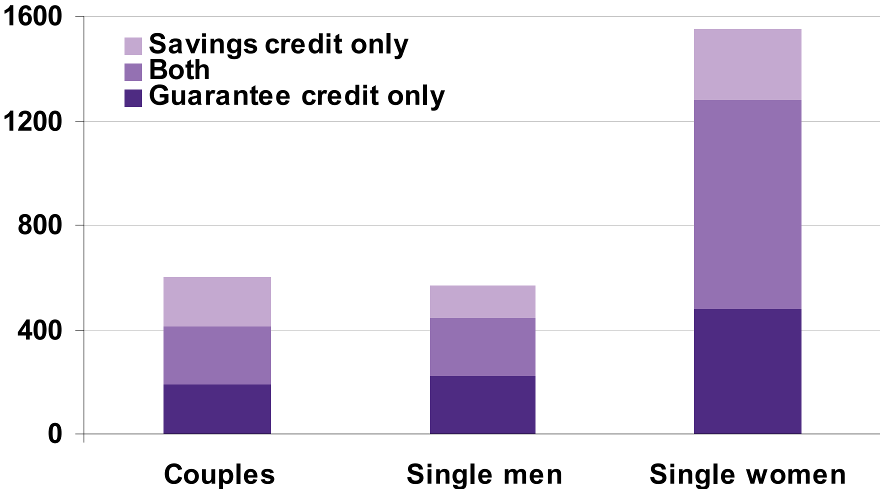
Finally, potential annuitants have to consider the nuances of annuity pricing, which the above analysis has ignored. Life funds, for example, price higher (i.e. lower annuity rates) than pension funds because of self-selection risk; people voluntarily buying annuities with life fund proceeds expect to live longer than those compelled to buy them with pension fund assets. In addition, there are pricing implications for pension funds because they include wider socio-economic groups.

2.10 The gender gap

Today 90% of men retire with a full basic State Pension, compared with only 25% of women, so it is no surprise that in retirement women are less well off than men. Amongst the over 65s, at least 5% more women than men live in poverty; this increases to 7% amongst the over 75s.[66]

Figure 8 shows the claimants for Pension Credit; single women are nearly three times more likely as single men to be in receipt of this benefit (although there are roughly 20% more women over 60 than men).

Figure 8: Pension Credit claimants, by type of claim (thousands)[67]



This poverty gender gap is expected to widen because women are lagging behind men when it comes to saving for their retirement.[68] In 2009, 59% of men are expected to have

[66] OECD, *Pensions at a Glance 2009,* Figure 2.11, August 2009.

[67] ONS, *Pension Trends,* Chapter 5, Figure 5.6, 23 June 2009.

saved adequately for old age, compared to 47% of women.[69] Furthermore, some 26% of women who could and should be saving are not saving anything for retirement, compared to just 15% of men. Women earn less than men,[70] so women who are saving in private pensions (DC and DB) contribute much less than men (£184 a month, compared to £331). Women also have more consumer debt than men. On average, they each owe just over £12,000 on credit cards, store cards and loans (men: £11,000); a further barrier to saving.

The origin of this gender inequality is that pensions follow waged work, and women are more likely to be taken out of the labour market with caring responsibilities (children, parents), and they still earn less than men. But some occupational pensions schemes do not readily accommodate part time workers (predominately women) and interrupted work patterns. Women in DC schemes contribute only £90 per month, compared with £168 for men, and many men with money purchase pots buy single life annuities, leaving any surviving spouse exposed after death. And to make matters still worse, women live longer than men so, at retirement, they need a larger asset pot.

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68 Notwithstanding the introduction of NI credits for carers of older people and grandchildren.

69 Scottish Widows, *Women and Pensions Report: Pensions for Today and Tomorrow,* October 2009.

70 Median weekly earnings of full-time employees for men and women were £531 and £426 respectively (April 2009). ONS, *2009 Annual Survey of Hours and Earnings (ASHE).*

3. THE EMPLOYERS' PERSPECTIVE

3.1 In retreat

Occupational pension schemes have been in retreat for many years. Employers remain under siege from increasing longevity, weak investment returns and a heavy regulatory burden. Furthermore, the accounting treatment[71] exposes risks that are outside of employers' control, and unrelated to their core business, to the discomfort of both management and shareholders. Pension provision is also an obvious area in which to cut non-core costs, not least because of intensifying business competition brought about by globalisation. Meanwhile, media attention has focused on the apparently inexorable rise in the present value of scheme liabilities.[72]

The demise in scheme quality has been accelerated by successive regulatory changes that have reshaped a pension expectation (which the company did its best to meet) into a hard commitment to the employee. The Pensions Act 1995 ushered in the minimum funding requirement (MFR) to help final salary schemes to offer their members more security, along with a funding obligation upon wind up ("Section 75 debt"). The Pensions Act 2004 then removed the MFR with scheme-specific funding based upon a calculation of the cost of funding the scheme (without a commercial buyout), on prudent assumptions. An actuarial estimate of the full buy-out cost also has to be disclosed, typically 30% higher than the non-buyout funding cost. The unintended consequence of this was to accelerate employers' withdrawal from DB workplace pension provision.

Today, open DB schemes in the private sector are all but extinct. 87% are closed to new entrants and 18% of these are closed to future accruals. A third of closed schemes are now under review, with changes in forward accrual (39%) and a move to career average

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[71] Notably FRS17 and IAS19.

[72] Whilst of concern, the substantial increase in the liability in recent years is primarily the result of falling interest rates, which could reverse. In 2005-06, for example, the liability rose by £120 billion, but some £100 billion of this was due to the discount rate being reduced in that year.

(35%) being considered. 75% of DB schemes are in deficit,[73] with the average ongoing funding level at 79%, down 8% in the last two years.[74]

3.2 Weak government support

In the 2007 Budget the Labour Government acknowledged that providing incentives for employer contributions is part of its strategy because "it is more efficient for pensions to be provided on a collective basis through the employer".[75] Yet the only direct incentive for employers to contribute to a pension scheme is a rebate on employer NICs (currently 12.8%). Employee contributions are not exempted from NICs[76] and the deductibility of employer contributions from corporate tax is not relevant as this applies equally to wages.

Clearly, little encouragement is given to employers to contribute to employees' pensions, despite repeated ministerial statements supporting quality workplace pensions.[77]

3.3 Defined contribution (DC) schemes[78]

DC schemes have largely replaced DB schemes, employees thereby assuming the longevity and investment risks. Less than 20% of employees understand the risks they are taking on and three quarters are "uncomfortable" with being in a DC scheme. This explains why over 80% of members invest in the now widely available default funds (85% of DC schemes offer them).

DC schemes will almost certainly lead to smaller pensions than DB schemes, mainly because contributions are lower. The average total contribution rate (member and employer) for open DC schemes was 9% of earnings in 2008, compared with 19.7% for open DB schemes.[79] The latter falls to around 15% once DB schemes' state second pension (S2P) contracted-out rebate is taken into account.[80]

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[73] The aggregate deficit (net of surpluses) of the PPF's 7,369 DB schemes stood at £51.9 billion at the end of January 2010 (January 2009: £183 billion), *PPF 7400 Index*.

[74] *The 2009 ACA Pension trends survey,* January 2010.

[75] HMT, *Budget 2007 Regulatory Impact Assessment, 10 Tax Relief For Pensions,* 2007.

[76] 11% for those earning up to £44,000, 1% thereafter.

[77] For example: "I want to send a clear message to employers with good DB schemes; we want you to continue". Mike O'Brien MP, when Minister of Sate for Pension Reform, Global Pension, January 2008.

[78] Data from *The 2009 ACA Pension trends survey,* January 2010.

[79] ONS *Occupational Pension Schemes Annual Report 2008*. October 2009.

[80] As most DC schemes are contracted in, employers (and employees) pay higher NI contributions, narrowing the contribution gap and providing a higher S2P to employees. Most DB schemes remain contracted-out, paying lower NI contributions.

When employees with DC funds retire, they then face the difficulty of deciding how to run down their capital at the right pace. Buying a lifetime annuity mitigates this risk, but this is currently prohibitively expensive for many people. Faced with inadequate DC asset pots, people are increasingly relying on realising other assets, including equity tied up in property, a risky strategy for those people likely to live into their 90s and beyond.

3.4 Cultural implications

Traditionally an occupational pension scheme was part of the employee retention and recruitment strategy, but the demise of DB has rendered this largely redundant. It has also brought about a major cultural change amongst employers, unsure of the nature of their responsibility towards their employees' pensions.

Employer attitudes are becoming less altruistic, more commercial. Many do remain committed to making contributions, but this is usually because they want to differentiate themselves within their business sector, to attract and retain the best talent. They no longer wish to act as pension providers, with the attendant administration and fiduciary responsibilities. Consequently employers are contracting out to third party providers, leaving themselves as merely the agent with a duty of care towards employees (having created the arrangement and appointed the provider); i.e. a slither of residual risk. This is the death-knell for the occupational scheme and sponsor-trustee model.

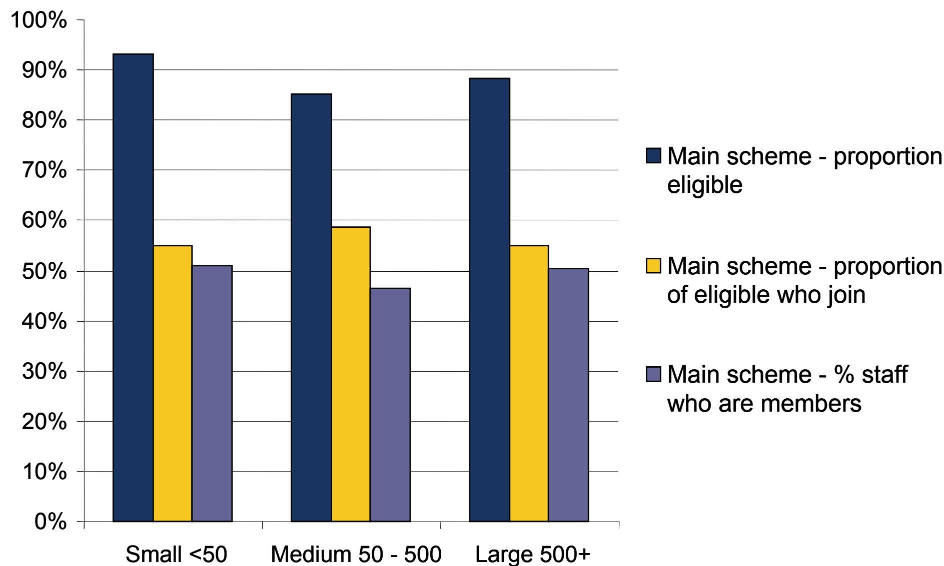
The question remains whether employers have a duty to encourage their employees to save. How should they react, for example, when employees opt out of a scheme that offers a 16% employer contribution, simply because they are required to contribute 4% (as has been reported)? Is the US model inevitably headed to the UK, with the progressive abandonment of sponsors' patrician oversight and the associated "social good", replaced by a tougher emphasis on individual responsibility? "New paternalism" is emerging amongst some employers whereby, rather than taking care of employees directly (DB schemes), they provide access to "good" DC savings products and education, and make contributions via the payroll.

3.5 The communication challenge

Many employers find it difficult to communicate with employees in respect of their pensions. Whilst trying to provide financial education in a manner that engages employees, they find that the technically-aware will look at on-line valuations, for example, but many (often older) employees will not engage at all. Simple automation does not overcome an educational deficit that is a generation wide, particularly when many employees now find themselves facing financial difficulties.

Figure 9 illustrates the difficulty that employers have in encouraging employees to participate in work-based DC pension schemes, even though employers offer to contribute.

Figure 9: membership of occupational pension schemes[81]



Of eligible employees, the take-up rate is only around 55% (with little difference amongst small, medium and large employers); pension saving, particularly amongst the lower paid, is not popular. Participation rates could be increased if auto-enrolment were introduced (with an option to opt out), perhaps to 80%, based upon evidence from the US 401k Plan (see Section 11.5).

Younger employees (sometimes referred to by the industry as “Generation Y”) present a different challenge because they tend to have a more transient approach to work, and a less loyal attitude towards employers, than previous generations. To them, the idea of putting disposable cash away for a distant, uncertain return in the guise of a DC fund-based pension is ludicrous when faced with college debt, the desire to own a home and to holiday abroad.

3.6 Where to next for employers?

Some employers have recognised that to attract young talent they have been fishing with the wrong bait, especially if it is labelled “pension”. The more enlightened employers have realised that many people are reluctant to save because, currently, it is logical to them not to do so. One approach is to harness employees’ fear of loss, by highlighting to them the post-retirement consequences of not saving, couched in terms of the lifestyles that employees have today.

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[81] Deloitte, *Pension reform in the workplace*, 2006.

More specifically, employers are now seeking positive emotional engagement by satisfying their employees' desire for flexibility, which means going further than simply offering to match employee contributions to group DC schemes. "Flexible benefits" programmes are being offered, which allow employees to direct employer contributions to benefits other than pensions (and buy or sell benefit components). At least two major employers (both are banks) are currently replacing their schemes' "pensions" label with "creation of wealth for retirement". They are offering platforms that include an ISA and a SIPP to receive the cash proceeds of maturing employee share plans (SAYE plans and options), alongside Group DC schemes.

Employee feedback has indicated that they like the portability of products, such as ISAs, that are not part of an occupational pension scheme, partly because they are not accompanied with the risk of a transfer value "haircut" when moving jobs. But many employees say that they miss the inherent paternalism that accompanies a scheme. The employer response to this has been to offer guidance to understanding outcomes, for example forecasts of what employees may expect to receive in retirement from a range of differently risked investments (e.g. low, medium, high).

Employers, subject to commercial pressures, are ahead of government in responding imaginatively to savers' needs. One initiative that the Government could take would be to allow scheme sponsors to formally re-characterise their pension schemes as lifestyle savings schemes, which is what they are becoming. Ideally this could be achieved without unhelpful interference, such as a reduction in trustees' flexibility and loss of control over schemes.

4. THE PENSIONS AND SAVINGS INDUSTRY'S PERSPECTIVE

4.1 Desperate for change

"Today's retirement income model is not fit for purpose; it's not working for anybody."[82]

"We, the actuarial profession, are working in a pensions environment that is broken. We all want something to happen."[83]

"Why would a basic rate taxpayer want to save in a pension framework? It's an expensive, inflexible vehicle relative to today's market; just open an ISA, start early and make sure you use it every year."[84]

These are some of the sentiments expressed to the author by people who earn their living from within the pensions and savings industry. The industry, under pressure from increasing longevity, poor investment performance and increasing costs (administration, compliance and regulation), is ready for change. It is well aware that overwhelming complexity deters savers, and less saving means smaller business volumes. The only beneficiaries of complexity are the providers of advisory services.

4.2 Two businesses, one client base

The long-term savings industry is characterised by a fundamental schism: two differently taxed businesses (pensions and savings) are competing for the attention of one population of long-term savers. Even within an insurance company, for example, savers ("policy holders") with units in a life fund (with an embedded life protection policy) face a different tax regime to other insurance company funds (although the underlying assets are often the same). As Chapter 2 illustrated, taxation is one of the roots of the complexity that defines the UK's retirement savings arena.

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[82] A director of a FTSE 100 insurer, 23 November 2009.

[83] A senior pensions actuary at a major consultancy, 18 November 2009.

[84] A director of one of the UK's leading life and pensions IT consultancies, 4 December 2009.

Both businesses do have important contributions to make to retirement saving, but savers would benefit from product unbundling. Ideally, fund managers should focus on asset performance ("manufacture"), with life insurers acting as IT and customer service providers, and addressing longevity risk (including the provision of annuities).

Historically, life insurers were major providers of longevity risk hedges in the guise of With Profits funds and deferred annuities, but when markets were strong they gravitated towards providing DC scheme platforms (which appeared relatively attractive at the time). But then DC performance declined and there was no way back to the With Profits world because, in the interim, the label had become tarnished (Equitable Life, et al). In addition, many in the industry have failed to make the necessary investment in IT systems (to cut costs).

4.3 Unsustainable costs

Over the last 15 years the cost of operating a self-administered pension scheme, for example, has nearly doubled, from 3.5% to about 6.5% of pensions in payment.[85] Without any changes, one would expect the cost to decline slowly with technological improvements, automation and the benefits of globalisation (such as off-shoring). The reasons why costs have risen include the cost of meeting pensions regulation, a result of successive governments' "wedding cake" (i.e. multi-layered) approach to regulation, and significant ongoing compliance burdens. The consequences are felt by the beneficiaries, the power of compounding costs acting to reduce their asset pots.

4.4 Unsustainable commission structures

High operating costs have forced part of the industry to focus on the short-term (sales volumes and market share), rather than executing a sustainable business model for the longer term.

An example should suffice. One report[86] highlighted the risks of the industry's approach to group personal pensions (GPP), some of which based their design on the flawed stakeholder pension structure. This requires the full fund value to be payable at any time, with penalty-free transfers, in return for an annual management charge. Unfortunately the widespread use of initial commission (to boost sales) initially puts providers out of pocket. The report combined financial modelling of GPP schemes with the real world experience of scheme persistency (with the same provider). It found the latter to be around four years

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[85] ONS, *MQ5*, 2008; and Con Keating and Andrew Slater, *Costs, Risks and Security for voluntary defined benefit pensions (Part 1),* BrightonRock Group, 2008.

[86] Cazalet Financial Consulting, *Polly put the kettle on,* 2006.

whereas the typical timescale for a scheme to move into profitability could be upwards of 20 years. Consequently it concluded that providers are highly unlikely to make money.

Notwithstanding poor strategy, the current environment of low investment returns net of charges has put retail annual management and fund management charges (totalling 2% or more) into stark relief.[87] Even retail stakeholder schemes look expensive, despite an annual management charge cap of 1.5% for the first ten years and 1% thereafter. Indeed, some of today's products have cumulative fees and costs that erode up to 40% of asset value,[88] more than wiping out the benefit of basic rate tax relief.

Historically, inflation has masked annual charges. But in today's low inflation environment, this is no longer the case. Savers, quite rightly, are now questioning why they are paying hundreds of pounds each year, often just for an annual statement, let alone a bid/offer spread of up to 5% on some funds.

4.5 Dismal fund management performance

Over the last ten years, the combined weighted average total return of the UK's mainstream unit-linked pension funds has increased by a paltry 21.8%; roughly 2% a year.[89] Particularly woeful performance by Managed Funds (accounting for half of the market value) and a lack of diversity are to blame (85% of all money invested is in the UK, so the emerging markets boom has been missed), along with excessive costs. By contrast, money market funds are up 40% over the same period, and investment trusts more than 90%.

Another source reports a similarly depressing picture for the last decade, stretching from the height of the dotcom boom to the current credit crisis. A pension scheme following a "typical" investment strategy[90] would have reported annual investment growth of 2.25% (before costs). By contrast, assets deposited in the bank during the same period would have grown at more than double that rate, earning an average of 4.7%.

Once increasing longevity, low interest rates and high charges are added to terrible investment performance, it is no surprise that the purchasing power of the average pension pot has slumped over the past ten years. In 2000, a £100,000 fund could buy an annuity worth around £9,000 a year; ten years later it would pay out less than £7,000 a

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87 Group pensions' charges are a lot less; typically 0.25% to 0.8% on a non-commission scheme and 0.6% to 1% on a commission scheme.

88 RSA, *Pensions for the people: addressing the investment crisis in Britain*, 2009.

89 Ten years to 31 August 2009. DMP Financial, *The Lost Decade,* October 2009.

90 According to the Mellon Caps Survey of pooled pension funds at the start of the decade.

year.[91] Clearly, there are considerable incentives to consider alternatives to a pension fund, particularly for basic rate taxpayers.

4.6 Retail distribution

The quality of the retail distribution of pensions and savings products has, for a long time, been poor. Many former insurance salesmen metamorphosed into Independent Financial Advisers (IFAs), peddling products that they often did not fully understand,[92] supported by opaque remuneration structures. Whilst not attached to any particular provider, some IFAs' independence was nullified by the pursuit of their own financial interests, at their clients' expense. Some, for example, continue to collect trail commission many years after a sale, yet are unobtainable for further advice. Consequently, the IFA label has developed, at best, a mixed reputation. It is perhaps unsurprising that few financial advice firms are profitable, and a significant number are poorly capitalised; some 40% have regulatory capital of less than £50,000.[93]

4.7 The Retail Distribution Review (RDR)

The industry now faces the Retail Distribution Review (RDR). The RDR is a fundamental review by the FSA of the effectiveness of distribution and associated regulatory issues, conducted via a variety of industry feedback sessions and consultation papers.[94] Its scope has been extended to include group personal pensions (GPPs), which makes sense given that many of the flaws in the individual pension market are mirrored in the GPP market.

Due for implementation in 2012, with significant one-off costs to the industry,[95] the RDR is intended to place a clear dividing line between sales and advice, and heralds major implications for the industry, particularly distributors. Its main proposals include:

(i) banning commission-based salespeople, to be replaced by fee-based professional advisers;

(ii) banning factoring, whereby providers advance funds to advisers to cover the initial cost of advice (so that consumers may pay over time). This should reduce

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[91] KPMG*, The lost decade for pensions?* December 2009.

[92] In should be noted that some industry participants have made considerable investment in helping advisers enhance their qualifications, notably SimplyBiz's not for profit New Model Business Academy.

[93] Ernst & Young, *The Changing Market Dynamics in Life & Pensions*, CFP Licensee Day, June 2009.

[94] Notably CP09/18 "Delivering the RDR", June 2009.

[95] Perhaps £500 million. 2012 may prove to be a "perfect storm" year for an industry already facing preparation for Solvency II, the arrival of the NEST (formerly the Personal Account) and implementation of "Treating Customers Fairly".

provider influence, thereby improving the prospect of advisers acting in their clients' interests, but does not address the fundamental problem that a one-off payment for advice (an alternative to factoring) can put people off seeking it;

(iii) imposing blanket requirements on qualifications (QCA Level 4 will become the benchmark), with no grandfathering (even if an IFA has many years of experience).

The RDR is expected to improve professionalism and public trust in the industry, but it leaves behind a generation harnessed with moribund, over-priced retirement savings products[96] and does little to help modest savers. The RDR is also unlikely to change the reality that banks currently do not want the costs and risks associated with retail distribution of, and giving advice for, long-term savings products.

When fashioning the RDR, the FSA tried to come up with proposals that will improve both the quality and quantity of financial advice available to consumers.[97] "Quality" has probably been addressed successfully and there will almost be clear blue water between "independent" and "restricted" advice; as for "quantity", the RDR is set to fail.

4.8 Consequences of the RDR

Some industry estimates suggest that up to 30% of the 30,000 IFAs are expected to leave the sector upon RDR implementation,[98] making end-2012 a "cliff edge" date, both for those within the industry and their (typically elderly) clients, who will then be without an IFA relationship.

One reason for these unintended consequences appears to be the FSA's misconception of what an IFA's role really is. Today many IFA's offer advice as a gateway to sales commission rather than as a service in its own right. If following the RDR the IFA is required to give higher quality advice and to charge the customer for it directly, then many customers who cannot afford this will drop out of the market or choose to buy simple products direct from banks and other distributors. As a result, the number of advisors is likely to drop, and the population they serve (and encourage to take on pension and other savings contracts) will decline.

Indeed, it will accelerate a trend that has already developed; in ten years time there may be only a few thousand genuine advice-giving IFAs left. They will be focused on the

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96 Such as FSAVCs with no access to a 25% tax-free lump sum at SPA.

97 Objectives laid out by Sir Callum McCarthy, FS Chairman, in a 2006 speech at Gleneagles.

98 A further 15,000 tied or multi-tied advisers are estimated to operate within banks.

elderly and the wealthy, not least because these clients will be the only ones able to afford high quality advice. The demise of access to advice does however invite the resuscitation of products that socialise risk which may be suitable for risk-averse savers. The industry is currently advocating collective defined contribution (CDC) pension schemes (in effect, re-branded With Profits funds, a label which now lacks the public's trust), but the DWP recently decided not to proceed with any UK legislative change to facilitate them.[99]

4.9 High tech platforms need distributors

The future for many IFAs is probably to act as relabelled agent-distributors, not advisers, supported by access to platforms that embrace modern technology, crucial to keeping distribution costs down. Indeed, assets on such platforms (Table 10) are expected to sharply increase from £90 billion (June 2009) to perhaps to £275 billion by 2013.

Table 10: The main platform providers, £ billion[100]

	Assets	Share
Skandia	£30	34%
Cofunds	£15	17%
FundsNetwork	£13	15%
James Hay	£12	14%
HL Vantage	£9	10%
Transact	£6	7%
Standard Life	£1.3	1.5%
Aviva	£0.8	0.9%
Nucleus	£0.6	0.7%
Ascentric	£0.3	0.3%
	£88	**100%**

The winners will be those that can present a truly integrated customer experience to the market. The losers are likely to include providers of packaged products, and fund managers who are slow to redesign products that are, today, unsuited to differentiating product and advisory charges.

Ideally the distributors (formerly IFAs) will focus on their local communities, in particular new savers and those who do not have access to employer-sponsored savings schemes. They would be greatly helped if the Government were to support a suite of savings product "quality kitemarks" that meet particular criteria, perhaps set by an industry body.[101]

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99 DWP Research Report No 623, *Employer attitudes to collective defined contribution pension schemes,* December 2009.

100 Ernst & Young, *The Changing Market Dynamics in Life & Pensions*, CFP Licensee Day, June 2009.

101 Similar to the Pension Quality Mark proposed by the National Association of Pension Funds in September 2009.

4.10 How can the industry engender trust?

The public's lack of trust in the pensions and savings industry has been summarised in a seminal report produced back in 2004.[102] Its lead conclusion was that:

> "The current system is not serving customers or the end beneficiaries well, be they companies or individual investors: a failure to align with customer needs and timescales, and a lack of transparency and accountability, are eroding trust in the system."

The industry has moved on since then, and the RDR will help to catalyse the cultural changes necessary to minimise the scope for scandals, boost transparency (for example, in respect of commissions and fees) and ensure that customers are treated fairly. But whatever the industry thinks of the RDR, it will have to embed it, not just implement it. Furthermore, the industry has to become demonstrably accountable; for too long it has abused its power of position as gatekeeper to the privileged savings world of products subsidised by tax relief, often charging an exorbitant entry (and recurring) price which it has subsequently failed to justify. It is this that has allowed life and pension companies to pay large commissions, and product complexity has translated into high cost factories with significant administration charges.

High fees are partly a symptom of continuing to under-invest in IT systems. The industry is now characterised by "old world" and "new world" providers, the former weighed down by legacy IT systems that cannot communicate across different client and product bases. Some of the latter are at the forefront of the growth in the SIPP market.[103]

Over the last 20 years the pensions and savings industry has surrendered the initiative to the regulator. If it is to rebuild its reputation, it needs to embrace the RDR and cut costs by driving for simplicity and investing in technology. It also needs to come up with its own plans to create a forum for self-regulation that sets standards and polices for good practice. Improved transparency over fees and charges, conflicts of interest and the basis for incentives and rewards, which are still biased to reward short-term behaviour, would all help. If this is done successfully, a virtuous circle will emerge in which trust in the industry is re-established. It can then work collaboratively with the FSA to reduce the regulatory burden, so that regulation is returned to its true purpose: protecting retail clients from information asymmetries.

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[102] Tomorrow's Company, *Restoring trust: investment in the twenty-first century*, June 2004.

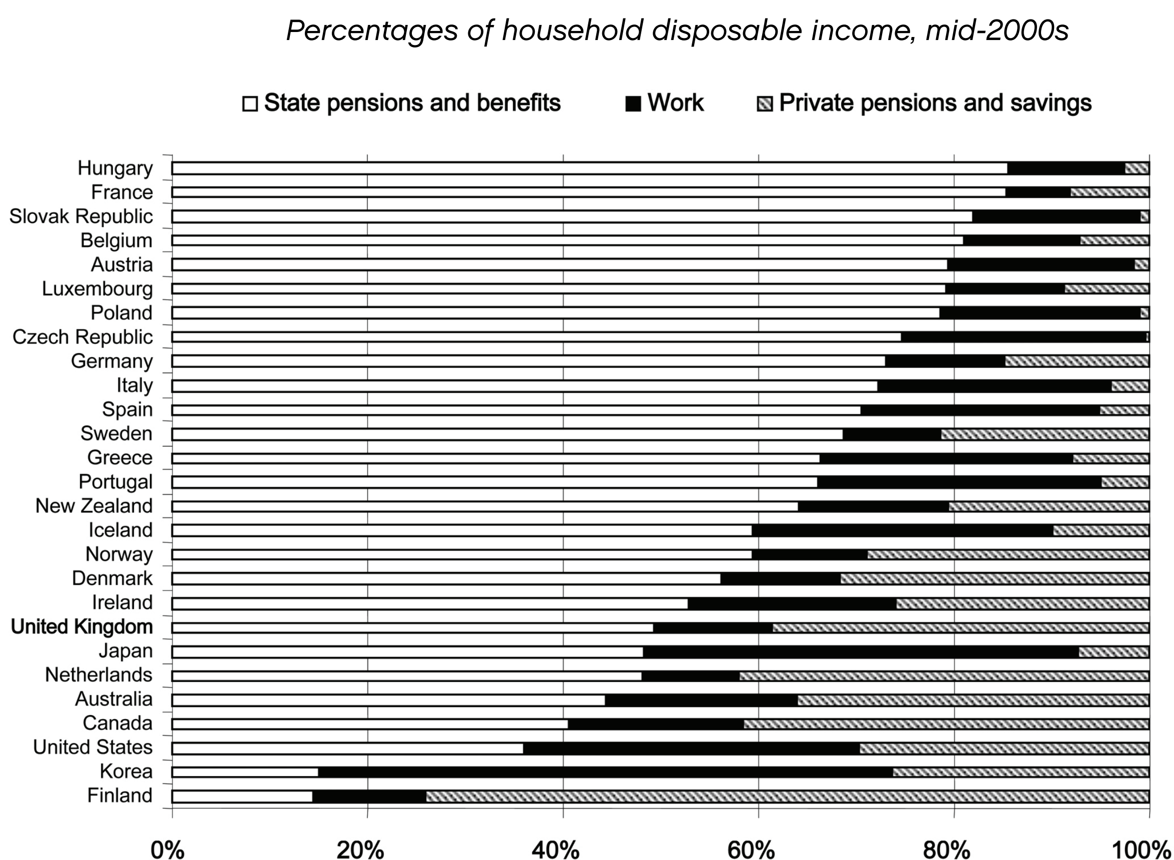
[103] The top eight SIPP providers by size of SIPP assets are James Hay, Standard Life, Aegon, A J Bell Group, Suffolk Life, Hargreaves Lansdown, IPS and Hornbuckle Mitchell. See *Pensions Management* June 2009.

5. THE TREASURY'S PERSPECTIVE

5.1 An international comparison

Figure 10 compares the sources of income of the over-65s across the OECD nations, comprising state and private (including occupational) pensions and benefits, and employment. Long-established cultural and societal differences explain the considerable variety.

Figure 10: Sources of incomes of the over-65s in the OECD[104]



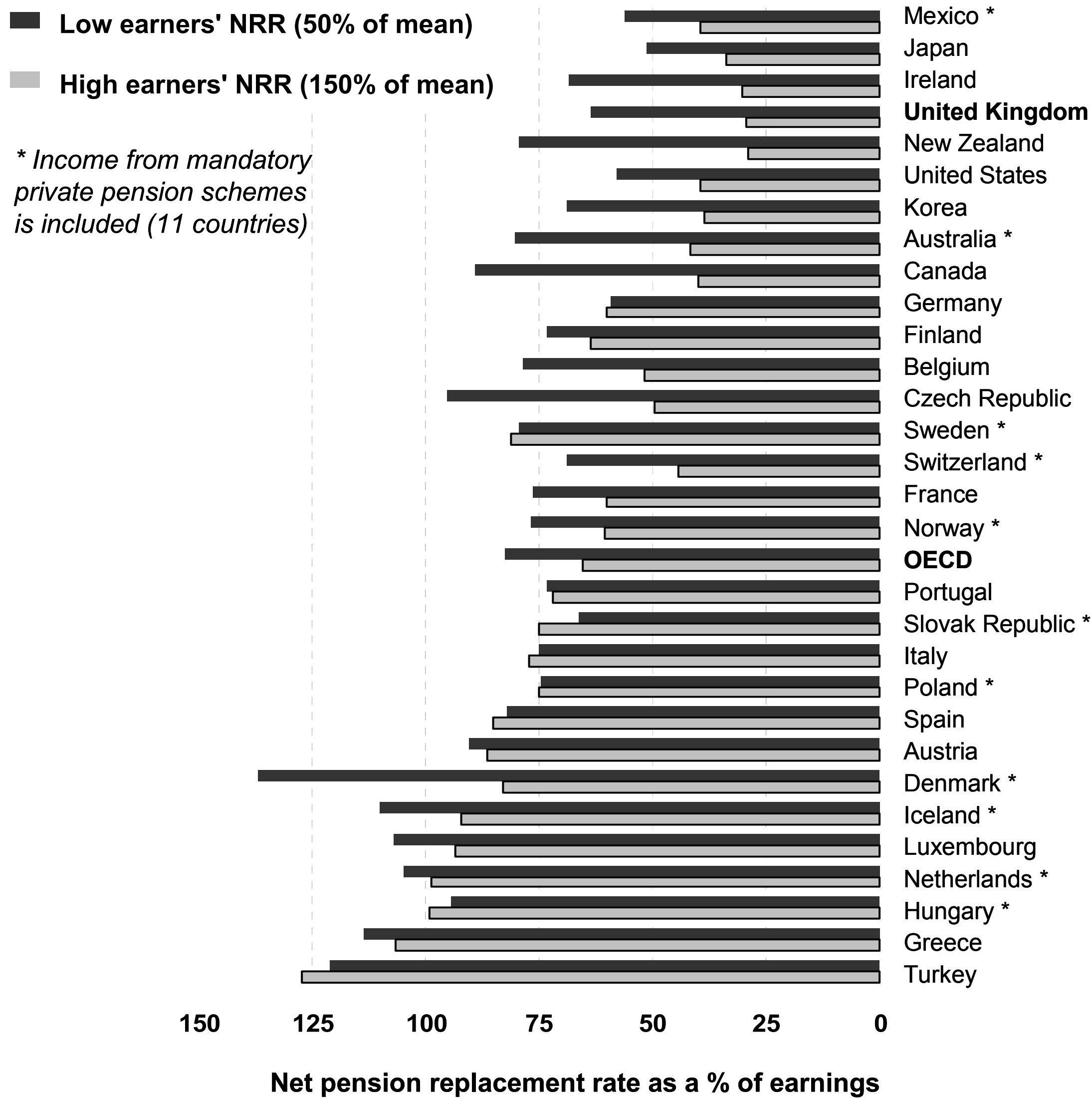
On average, across the OECD, public transfers (pensions and mean-tested benefits) represented 60% of total pensioner income, with the over-65s being most reliant on the

[104] OECD, *Pensions at a glance 2009,* Figure 2.3, 2009.

state in Hungary and France (85% of income). Conversely, only 15% of Finns' income is derived from the state, but participation in occupational plans is mandatory. The UK places a relatively heavy reliance on private pensions and savings (39% of income), partly because it has one of the lowest state pensions in the OECD, evident from looking at the state pension net replacement rate (NRR).

The NRR is the ratio of state pension income (including mandatory private pensions) to earnings, "net" meaning taking into account taxes and social security contributions. In 2006 it averaged 70% across the 30 OECD countries.[105] Figure 11 shows the NRR for people on 50% and 150% of average earnings, with the countries ranked in reverse order of the NRR of those on average earnings (i.e. Mexico the lowest).

Figure 11: Net pension replacement rates (NRR) by earnings levels



[105] For 2006. OECD, *Pensions at a Glance 2009*, 2009.

Whilst the UK's NRR for the mean earner is one of the lowest (41%), it is also has one of the most redistributive: the NRR of low earners (64%) is more than double that of high earners (29%). The three lowest NRRs for high earners are in the UK, Ireland and New Zealand but the latter two have flat-rate pensions systems.

UK pensioners make up their income by relying on private pension provision to a greater extent than every other country in the OECD (excluding those with mandatory private or occupational schemes). The state clearly has a strong vested interest in encouraging people to save. This is not least because those who lack income in retirement otherwise fall back onto the state, mostly through the (means-tested) benefits system.

5.2 Tax relief

Tax relief is delivered in three different ways (see Appendix IV), but whilst mechanics vary, the cashflow consequences are the same. In 2008-09 the Treasury "invested" over £36 billion, the primary bait being that contributions to pension savings attract full relief[106] ("front E", subject to the allowances).

Table 11: Registered pensions schemes' tax relief, £ billion[107]

	2007 - 08	2008 - 09
Tax relief in respect of:		
Occupational scheme contributions		
Employees	£4.4	£4.2
Employers	£12.9	£11.6
Personal pension scheme contributions		
Employees	£1.9	£1.6
Employers	£2.5	£2.5
Self employed contributions	£1.4	£1.2
Lump sum payments (unfunded schemes), other	£0.6	£0.6
NICs relief on employer contributions	£8.5	£8.2
Total up-front tax relief ("front E")	**£32.2**	**£29.9**
Tax privileges of being a registered pension scheme ("middle E")	£5.9	£6.7
Total tax relief	**£38.1**	**£36.6**
Less tax paid on pensions income ("back T")	£10.2	£9.5
Net cost to the Treasury	**£27.9**	**£27.1**

The £6.7 billion "cost" of the secondary bait in 2008-09 ("middle E", tax-free investment growth, 18% of total relief) is in respect of tax that was not collected by virtue of pension schemes' registered status, rather than a hard cash contribution. This cost is significantly underestimated because the data excludes capital gains, which is difficult to quantify.

[106] The tax treatment of pension savings is described as "EET" (exempt, exempt, taxed), referring to contributions, investment growth and income in retirement, respectively.

[107] HMRC, *Table 7.9 - Cost of reliefs for approved pension schemes,* September 2009.

Also, note that "middle E" is not a genuine "E" because the 10% tax credit on dividends is not recoverable.[108] Table 11 does not include the "cost" of other savings vehicles that permit assets to be sheltered from tax, notably ISAs (which are TEE).

5.3 What is the purpose of tax relief?

Tax relief is the Treasury's principal method of encouraging pension saving so that people, post-retirement, are less likely to fall back onto the state.[109]

Deciding the optimum distribution of tax relief is a complex issue. However unintentionally, tax relief can significantly influence social outcomes. What is fair and socially desirable? The (last) Labour Government's position following Pensions Simplification (April 2006) was that it wanted to:[110]

> "…maintain stability, fairness and encourage long-term saving, providing a transparent and flexible regime, enabling individuals to make informed choices about pensions saving. The following key principles, have guided, and continue to underpin the Government's approach to pensions tax relief:
>
> (i) generous tax relief is provided to support pensions saving to produce an income in retirement. Pensions saving is not however provided to support pre-retirement income, asset accumulation or inheritance; and
>
> (ii) pensions are provided with more favourable tax treatment compared to other forms of saving in recognition that these are less flexible than other savings and are locked away until retirement."

Accepting that tax relief is to encourage people to save, why do we want people to save for retirement? Is it actually:

(i) to reduce pensioner poverty; or

(ii) is it to save the Treasury some money by getting away with a smaller basic State Pension; or

(iii) is it to boost savings in the economy because of the macro-economic benefit of a higher savings ratio?

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108 The rebate was abolished by the new Labour government in its first Budget, in 1997.

109 Pension schemes need to be registered with HRMC before tax relief is given. Unregistered schemes have no restriction on the tax-free proportion of lump sums at SPA so benefits from them are usually taken as lump sums. Pension payments are taxable in both cases.

110 HMT, *Budget 2007 Regulatory Impact Assessment, 10 Tax Relief For Pensions,* 2007.

Currently, reducing pensioner poverty is clearly not the objective: tax relief is heavily skewed towards the well-off, not surprising given that they pay more into a pension and their relief is at the top rate of tax. Higher rate taxpayers (12% of all taxpayers[111]) get 60% of total tax relief[112] and, until the Budget of April 2009, 25% of tax relief went to the top 1% of earners.[113] (This could now roughly halve although predicting contributions from additional rate taxpayers is hazardous).

The abolition of higher rate tax (HRT) relief (i.e. at 40%) has been predicted for years, with the run up to past Budgets being accompanied by proclamations from the industry (keen to protect its most lucrative client base) that ending HRT relief would make little impact on the Treasury's finances. The 2009 Budget measures will save about £2.3 billion a year (in respect of additional rate, i.e. 50% taxpayers), but if 40% relief were also abandoned, the annual saving would be over £7 billion.[114]

5.4 How effective is tax relief?

Just how effective is the Treasury's £36.6 billion investment? Could the same spend be deployed in a different way that would lead to more people saving more for the long term? If savings with instant access, but which exhibit high persistency, count as "long term", ISAs can be compared with other forms of personal pension saving (i.e. personal pensions (PP), SIPPs and occupational schemes, excluding employers' contributions), as Table 12 does.

Table 12: Savings and tax relief, 2007-2008, £ billion[115]

	Amount saved	Tax relief "Front E"	Tax relief* "Middle E"	Amount saved ÷ total tax relief
Occupational schemes (employees only)	£14.6	£4.4	£1.1	2.7
PP schemes (employees only) + self employed	£10.3	£3.3	£0.8	2.5
SIPPs (to address under-reporting)**	£3.0	£0.9	£0.2	2.7
Total pension contributions excl. employers	**£27.9**	**£8.6**	**£2.1**	**2.6**
Cash and Stocks & Shares ISAs	**£35.7**	**n/a**	**£2.4**	**14.9**

** In respect of pension savings, "middle E" is an estimate based upon Table 11*
*** Tax relief based upon HMRC's reported 30% average rate of relief on contributions*

[111] ONS, *Table 3.4, Income tax liabilities, 2006-07,* December 2008.

[112] PPI, *Pension Facts, Table 26; Percentage of total tax relief on individual and employee,* December 2008.

[113] HM Treasury & HMRC, *Implementing the restriction of pensions tax relief,* page 5, December 2009.

[114] Using the latest tax relief distribution data available (HMT, *Income and Deductions 2006-07,* Table 3.5, 2008*),* 2,232,000 people earned at least £50,000 in 2006-07, and 1,856,000 of them claimed tax relief totalling £13.79 billion (all at 40%). Cutting this back to 20% would save £6.9 billion (considerably more in practice because the 40% tax threshold in 2006-07 was less than £39,000).

[115] HMRC, *Cost of reliefs for approved pension schemes,* Table 7.9, September 2009. ISA tax relief from HMRC's *Tax Expenditures Table 1.5*, March 2010. Amounts saved from ONS, *Pension Trends, Chapter 8, Table 8.14,* April 2010.

Employees saved £27.9 billion in pensions vehicles in 2007-08, with tax relief on contributions being £8.6 billion. In comparison, ISAs attracted £35.7 billion of new savings[116] at a cost to the Treasury of £2.4 billion[117] in respect of "middle E". The new savings/total tax relief ratio of ISAs was more than five times that of pensions saving.

Does this suggest that ISA tax relief is a more effective investment for the Treasury? Unfortunately, we are not comparing like with like, the tax treatment of pension savings being EET, whereas ISAs are TEE (contributions being made out of post-tax income). Consequently, the tax relief on ISAs is in respect of investment income on the existing pool of ISA assets, £221 billion at the end of the 2007-08 tax year. In addition, the "cost" to the Treasury of "back E" (tax-free withdrawals) is not included. That said, over the full lifetime of a basic rate taxpayer, the present value of tax relief cost of an ISA and a pension are comparable (assuming that in both cases a lifetime annuity is purchased at retirement, and taking into account pensions' 25% tax-free lump sum). This, however, is not the case for higher rate taxpayers because most of them only pay 20% tax in retirement.

We need to be able to "value" the instant access to assets that ISAs offer, or the "negative value" of having to tie up pension savings until at least 55 (from April 2010). Industry surveys suggests that instant access is worth a lot (in terms of attracting savings), but it is hard to quantify the value. We also need a better understanding of the extent of the motivational benefit of upfront tax relief, but there is evidence that many people (particularly amongst the low paid) do not even appreciate that it is available.

Indeed, the Treasury has a vested interest in savers' asset performance because when it provides upfront tax relief on pensions contributions (EET), it is effectively co-investing with the saver, enjoying a funding advantage as the cost of Gilts issuance is likely to be less than the long-term investment growth rate. But the Treasury only recoups its investment, and maybe even realise a "profit", when it taxes the income derived from post-retirement asset realisation. It does, however, collect tax on the realisation of 75% of all of the assets, having funded only 20% to 40% of them.

5.5 Alternative approaches to tax relief

Table 13 models a variety of alternative tax treatments of registered pensions schemes and compares them with the actual net cost to the Treasury (using EET) for 2008-09.

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[116] ONS, HMRC, *Table 9.4 for 2007–08*.

[117] HMRC, *Tax Expenditure,* Table 1.5 for 2007–08*,* April 2009 (included PEPs). ISA tax relief (on accruals, "middle E") in 2008-09 was £2.2 billion (est. £1.6 billion in 2009-10), these reductions being due to falling interest rates (HMRC, Table 1.5, March 2010).

Table 13: Net cost of tax relief under alternative tax treatments for pensions savings, £ billion (based upon 2008-09 outturn)[118]

	Tax relief on			Pensions	Net cost	Saving
	Contributions	NICs*	Accruals	in payment	to Treasury	vs. actual
Actual cost (EET)	£21.7	£8.2	£6.7	-£9.5	**£27.1**	-
TEE	£0.0	£8.2	£6.7	£0.0	**£14.9**	£12.2
$E^{20\%}$ ET	£14.7	£8.2	£6.7	-£9.5	**£20.1**	£7.0
$E^{20\%}$ $ET^{20\%}$	£14.7	£8.2	£6.7	-£8.1**	**£21.5**	£5.6
$E^{20\%}$ EE	£14.7	£8.2	£6.7	£0.0	**£29.6**	-£2.5
ETE	£21.7	£8.2	£0.0	£0.0	**£29.9**	-£2.8
$E^{20\%}$ TE	£14.7	£8.2	£0.0	£0.0	**£22.9**	£4.2
TTT	£0.0	£0.0	£0.0	-£9.5	**-£9.5**	£36.6

Front $E^{20\%}$ means that upfront tax relief is limited to 20% for everyone
Back $T^{20\%}$ means that all pensioners pay income tax at 20%
** NICs rebate in respect of employer contributions*
*** Some 30% of pensioner income tax is paid at 40% (ref. HMRC Table 3.4)*

Thus, had pension products been taxed as TEE, for example, the Treasury would have saved £12.2 billion in 2008-09. Cutting back upfront relief to 20% for everyone (i.e. $E^{20\%}$ET, would have saved £7 billion and if all pensioner income had been taxed at 20% (i.e. $E^{20\%}ET^{20\%}$, higher rate income tax for pensioners having been abolished), the saving would have dropped to £5.6 billion.

Table 13 does not take into account the changes to tax relief introduced in the 2009 and March 2010 Budgets, which are expected to produce a net yield of £3.5 billion per year from 2012-13.[119] The underlying assumptions as to how additional rate (i.e. 50%) taxpayers are expected to change their behaviour in respect of contributions to pension savings are not disclosed. Some of them might be expected to view pension saving as unattractive in future, and abandon pensions altogether; this may provide a further tax relief saving to the Treasury, depending upon whether other tax-advantaged savings products are taken up (such as Venture Capital Trusts).

Table 14 compares an ISA with pension saving for a standard rate taxpayer who subsequently pays 20% income tax in retirement.

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118 HMRC, *Cost of reliefs for approved pension schemes,* Table 7.9, September 2009.

119 The 2009 Budget Report suggests the yield from 2012-13 will be £3.1 billion (page 153, Table A1, note 4). The 2010 Budget Report suggests that changes to the earnings threshold will save an extra £600 million from 2012-13 (page 121, Table A2, row f). However, Table A2's footnote 4 states that the net yield will be £3.5 billon (i.e. not £3.7 billion), once the 2009 Budget measures are taken into account.

Table 14: comparison of ISA and pension saving

	ISA (TEE)	Pension (EET)	Pension with 25% lump sum withdrawal
Contribution from post-tax income in first year	£1,000	£1,000	£1,000
plus initial tax relief	-	£250	£250
= Amount invested (including tax relief)	£1,000	£1,250	£1,250
plus cumulative return over 25 years*	£1,000	£1,250	£1,250
= Amount invested after 25 years	£2,000	£2,500	£2,500
less tax-free withdrawal	-	-	£625
less tax payable as remaining fund withdrawn	-	£500	£375
= Fund value after tax, excluding withdrawal	£2,000	£2,000	£1,500
Total after-tax value	**£2,000**	**£2,000**	**£2,125**

** Assume 100% over 25 years (after deducting witholding tax)*

Perhaps counter-intuitively, an ISA and a pension work out to deliver the same post-tax value (excluding the pension savings' 25% lump sum), albeit that this is a somewhat crude analysis. ISAs, however, offer instant pre-retirement access.

Alternative One: a tax system based upon ISAs?

A single, unified, tax system could be based upon ISAs (TEE). Ostensibly, TEE is the same as EET from the Treasury's perspective: 40% (or 20%) relief on the way in is cancelled out by 40% (or 20%) income tax on the way out (ignoring the 25% tax-free lump sum usually associated with pensions' EET). But in reality this is not the case. Less than one in six of those who are higher rate taxpayers when working will continue to be HRT payers post-SPA,[120] so with the current system of EET the Treasury is unlikely to get a good return on its investment in HRT payers. Furthermore, many 20% relief receivers become nil-rate income taxpayers in retirement.

Consequently, from the Treasury's perspective, TEE is a much more attractive tax framework than EET. The Treasury gets its cash earlier, and more of it ("front T" is far bigger than "back T"). However, one significant unintended consequence of moving to TEE is that NICs relief (£8.2 billion) on employers' contributions to employees' pension funds would cease (there are no other state-provided incentives). This raises questions such as whether we want to discourage the generosity of employers to their employees. Assuming not, we should probably retain NICs relief (with employer contributions as a deductible business expense); the net saving of moving from EET to TEE would then be £12 billion.

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[120] This assumes all higher rate pensioners were previously higher rate payers when working. 12% of the workforce (3.1 million) pay HRT and there are 210,000 HRT payers amongst the UK's 11.8 million pensioners (1.8%). Data from Ian Pearson MP, *Hansard,* 23rd March 2009, Col 95W, and HMRC, *Income Distribution,* Table 3.4 December 2008.

TEE would be hugely attractive to pensioners as it provides them with tax-free income, although some people would remain sceptical, concerned that the state may subsequently be tempted to revert back to a “final T”.

Alternative Two: 20% upfront relief for everyone?

If upfront tax relief were limited to 20% (i.e. $E^{20\%}ET$), irrespective of the saver’s marginal rate of tax, the Treasury would save roughly £7 billion per year.[121] This saving opens up the intriguing prospect of reintroducing the rebate on the 10p tax credit, so that “middle E” becomes genuine (again). A crude calculation of the cost of restoring the rebate is to assume income (interest and dividends) of 2% on all of the UK’s pension fund assets (£2,000 billion, say): £40 billion. A 10p tax on this comes to £4 billion. If the rebate were restored, the Treasury would be exposed (i.e. a lost income opportunity) to future rises in fund income (likely given how low interest rates and dividends are today).

However, limiting tax relief to 20% would not provide a pension savings incentive to those who expect to pay 40% income tax in retirement (who are probably paying 40% or 50% income tax whilst working). This could be addressed by limiting income tax to 20% for all pensioners (i.e. $E^{20\%}ET^{20\%}$); had this tax structure been in place in 2008-09, the Treasury would have saved £5.6 billion in tax relief costs (compared to EET; see Table 13).

If income in retirement were to become tax-exempt (i.e. $E^{20\%}EE$), there would be a relatively small additional cost to the Treasury compared to today (£2.5 billion); not very palatable in current circumstances.

Alternative Three: consider ETE?

An ETE framework preserves the upfront incentive and tax-free post-SPA income. Within the context of today’s tax treatment of pension savings (EET), the cost would not be large because introducing “middle T” would save £6.7 billion and making pensions tax free would cost £9.5 billion. The cost of exempting capital gains is currently ignored, and should remain so because of the practical difficulties of taxing unrealised capital gains within a fund. ETE does diminish the benefit to the saver of the power of compounding of accruals, but given that most savers do not appreciate the value that this creates, they may welcome ETE rather than EET (some capital gains annual allowance would have to be retained).

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[121] Upfront relief (excluding NICs’ £8.2 billion) was £21.7 billion in 2008-09, some 60% of which went to HRT payers. 60% of £21.7 = £13 billion. Add £0.9 billion for SIPP under-reporting = £13.9 billion. Cutting this relief in half (from 40% to 20%) saves about £7 billion.

Alternative Four: In extremis... end all pension savings tax relief?

Many people believe that the primary purpose of tax relief should be to reduce pensioner poverty, and that there is a strong case for ending all pension savings tax relief (i.e. move to TTT). They argue that the total tax relief spend could then be redeployed to boost the basic State Pension (BSP) by 70% (or 56% if we retain the NICs rebate on employer contributions).[122] Irrespective of how a revised BSP is financed, it is crucial that it is set at (or above) the level of means-testing for Pension Credit purposes;[123] i.e. at least £130 per week for single people (£198.25 for couples) in 2009-10 terms (and 36% and 30% higher than today's BSP, respectively). Given that many people do not understand tax relief, but value employer contributions, it may be sensible to redirect some tax relief to further encouraging employers (in additional to preserving their NICs rebate).

Furthermore, increasing the BSP would catalyse a virtuous circle because the cost of Pension Credit would fall significantly (from £8.3 billion[124]). A saving in administration costs should also emerge, thereby releasing more funds to further increase the BSP.

Such an approach would certainly represent a huge simplification of the savings landscape. It would put an end to the distortion in resource allocation, whereby decisions are made based up tax lures rather than investment fundamentals or personal need, and would pressurise the industry to provide real added value. In addition, the Government could then claim to be meeting what perhaps should be its only pensions objective; to address pensioner poverty by increasing the basic State Pension to a level above the means-testing threshold (for the purpose of assessing eligibility for Pension Credit).

It does, however, prompt the question of how people would change their savings behaviour in the absence of upfront tax relief. With a significantly higher BSP, many people may stop (or not start) saving[125] for retirement, thereby reducing their options once in retirement, such as being able to afford care home costs. This raises the spectre of compulsory saving for retirement; there are already eleven "mandatory private" schemes amongst the OECD nations.[126]

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122 Based upon 2008-09s total pensions tax relief spend of £36.6 billion (this includes £8.2 billion of NICs relief on employer contributions; see Table 11) and the BSP cost of £50.5 billion in 2008-09.

123 Comprising Savings Credit and Guarantee Credit; see Glossary for detail.

124 Expected outturn for 2009-10; HMT, *Budget 2009,* DWP Expenditure Table 4, 2009.

125 This would present the Government with a conflict of interest because increased consumer spending in a time of recession would be welcomed, but this would be a short-term gain.

126 Australia, Denmark, Hungary, Iceland, Mexico, Netherlands, Norway, Poland, Slovak Republic, Sweden and Switzerland; OECD, *Pensions at a Glance 2009,* 2009.

5.6 Tax treatment: international perspective[127]

Internationally, the tax treatment of privately-managed pension schemes varies widely. Broadly, there are five models in use, summarised in Table 15, but this is by no means precise because some of the "Es" and "Ts" are partial.

Table 15: Other countries' private pension schemes' tax treatment[128]

Tax model	Countries	
EET	Austria, Belgium, Canada, Finland, France, Germany Ireland, Ireland, Japan, Korea, Netherlands, Norway Poland, Portugal, Spain, Switzerland, UK, US	Most favourable to investors
TEE	Hungary, Luxembourg	↓
ETT	Denmark, Italy, Sweden	↓
TTE	Australia, Greece, New Zealand	↓
TET	Czech Republic	Least favourable to investors

5.7 Reducing financial arbitrage

A simpler system will reduce the incentive and scope to "play the system". The losers would be the army of bankers, financial advisers, fund managers and lawyers who are currently employed (primarily by better off clients) to avoid taxes. This kind of non-productive financial "arbitrage", conducted at the Treasury's expense, is not in the national interest.

5.8 What should the state do to promote long-term saving?

Numbers matter, but it is also important to understand how to influence behaviour, and attune policies accordingly. And many people are not rational with money, a trait reinforced by a lack of financial wherewithal, an inability to envisage the financial consequences of retirement and, in some cases, an abdication of personal responsibility.

That said, there is still insufficient focus on the savings "demand" side; there is no point seeking the perfect design of a savings product if people do not recognise a need to save. Consequently, policy makers should consider what incentives are required to persuade people to save an amount sufficient to keep them happy in the future. But before deciding how much to spend on such initiatives, we should have a sense of how much it is worth (to the state) to encourage people to save.

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[127] For more detail, see HM Treasury / HMRC, *Implementing the restriction of pensions tax relief, Annex B page 59.* December 2009.

[128] CEA, November 2007, and OECD Economics Department Working Paper No. 393, *Long-Term Budgetary Implications of Tax-Favoured Retirement Plans,* page 38, June 2004. Note that Australia was TTT when this paper was written; it has subsequently moved to TTE.

To some extent the Government has a right to "encourage" saving for retirement because some people do fall back on the state through the benefits system in retirement. A society with a savings culture would lead to less pensioner poverty and more (long-term) investment. This would improve economic growth, leading to a better quality of life for our citizens.

But how strongly should the Government exercise this right? Auto-enrolment, relying on inertia, is now increasingly acceptable (NEST, for example). But introducing any form of true compulsion is politically difficult. It is no coincidence that those countries where there is compulsory (employee) saving tended to have authoritarian governments at the time it was introduced (notably Chile in 1981 and Hong Kong[129] in 2000). The debate is not new in the UK; in 1940 Keynes advocated that instead of raising taxes, the government should require compulsory savings contributions from all taxpayers (to pay for the war).

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[129] The Hong Kong Mandatory Provident Fund requires contributions of 5% of income from both employee and employer (subject to maximum and minimum levels of monthly income, currently $20,000 and $5,000 respectively).

PART II THE PROPOSALS AND THEIR IMPLICATIONS

6. THE PROPOSALS

The following proposals are intended to help catalyse a savings culture by making it easier for people to save, particularly for the long term.

One step towards doing this is to bring together ISAs and pension saving into a simpler and more flexible lifetime savings framework. A single annual contributions limit for tax-incentivised saving is envisaged, encompassing ISAs and pension savings. Such a limit would enable industry providers to offer customers a simple savings continuum, perhaps under a "lifetime savings" banner, from a single platform.

The proposals are designed to be at least tax neutral relative to the post-2009 Budget regime. They are followed by a discussion of four alternatives for a single, unified tax framework for ISAs and pension savings products. The common tax treatment of ISAs and pension savings is fundamental if we are to achieve a radical simplification of long-term savings, a prerequisite to encouraging more people to save more.

Furthermore, this could reduce the upfront tax cost to the Treasury without risking a reduction in savings. This would release funds which could be used to help fund a more generous basic State Pension, for example. As has been pointed out in the Foreword, these proposals depend upon having a secure foundation of basic State Pension income, pitched at or above means-tested Pension Credit level, thus ensuring that even for those with very modest resources, it will pay to save.

Proposal 1: a contributions limit consistent with lifetime saving

There should be a combined ISA and pension savings contributions limit[130] for tax-advantaged savings of £45,000 per year, with a maximum annual contribution to pension savings of £35,000. This limit, combined with tax relief on pension saving contributions being provided at the saver's marginal rate, would not increase the cost of pension savings tax relief (compared to today). The Standard Lifetime Allowance (SLA) should be abolished.

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[130] A "limit" is simpler than an "allowance" (used today in respect of pension savings); a limit cannot be exceeded, whereas contributions can be made in excess of an allowance, with tax relief not provided on the excess.

The annual limit would replace the existing annual ISA limits and pension saving allowances. The new tax penalties for pension contributions on high earners (introduced in the 2009 budget) would become redundant and should be abandoned.

Proposal 2: simplify the ISA

The distinction between the ISAs' two components (Cash ISA and Stocks & Shares ISA) should be ended. There should simply be "an ISA" that can hold any combination of assets, including cash, bonds and shares, to which there is instant access. The minimum age to have an ISA should be set at 16.[131] The tax treatment, for now, should remain TEE-based.

Proposal 3: permit pre-retirement asset mobility from the ISA into pension savings, with standard rate tax relief

ISA assets should be allowed to be re-nominated as pension savings with tax relief being provided at the standard rate (20%), subject to Proposal 2's £35,000 annual limit and with an individual's total tax relief being limited to income tax paid in that year.[132] However, if the re-nomination were made at retirement, no limit should apply, and the amount of basic rate tax relief should not be limited to the amount of income tax paid in that year. At retirement, re-nominated assets in excess of £35,000 would not be eligible for pension savings' 25% tax-free lump sum. Re-nominated assets would subsequently be treated as pension assets for tax purposes.

Tax relief on re-nominated assets is limited to 20% so that basic rate taxpayers are not encouraged to delay pension saving on the premise that one day they may become higher rate taxpayers (and therefore eligible for higher rate relief).

Proposal 4: include ISAs in employee auto-enrolment legislation

The ongoing DWP initiative to auto-enrol all employees into an occupational pension scheme or NEST should be extended to allow employees the alternative option of auto-enrolling into an ISA. Initially, the employer obligation (under auto-enrolment) to contribute to employees' savings should be restricted to pension savings (to ensure funds retention).

Proposal 5: permit limited pre-retirement access to pensions savings

Savers should be given a one-off pre-retirement opportunity to withdraw, tax-free, up to 25% of their pension savings. This would be deducted from their subsequent 25% lump sum entitlement upon retirement. There should be no restrictions on the use of funds withdrawn. Larger withdrawals could be permitted, but penalised by incurring tax at the individual's highest marginal tax rate over the period of their having made pension contributions.

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131 The minimum age to have a Stocks & Shares ISA is 18 (it is already 16 for a Cash ISA).

132 Except for the basic rate of tax relief (20%) that non-taxpayers receive on contributions of up to £2,880 in a year, for a total contribution of £3,600.

Proposal 6: post-retirement, amend access to pension savings

Savers should be free to draw down their pension savings assets as required (taxed conventionally at the saver's highest rate), without an annuitisation requirement, provided that a minimum of £50,000[133] of investments (at the SPA) is not accessed until the age of 75. Savers who have already secured an income equivalent to 40% of median earnings, say, from the State Pension, lifetime annuities or guaranteed private pensions, should be exempt.

Proposal 7: annuities purchased with ISA funds should be tax-free

Annuities purchased with ISA-derived funds should be exempt from income tax, consistent with the tax-exempt status of withdrawals from ISAs.

Proposal 8: permit pension savings flexibility within couples

To avoid the income-in-retirement disadvantage often suffered by women, couples[134] should be able to contribute to one another's pension savings irrespective of the recipient's earned income. Tax relief should be granted at the contributor's marginal rate, limited to the amount of tax paid in aggregate by the couple in that year. To limit the Treasury's tax relief cost, intra-couple contributions should be deducted from the annual limit of both parties. Furthermore, assets should be transferable between the couple's pension savings, but without tax relief.

Proposal 9: encourage wealth transfer into pension savings

Contributions to pension savings could be permitted without being supported by earnings, for example up to a limit of £400,000, divided into two sub-limits.

(a) £200,000 Primary Residence Limit, from proceeds of the sale of the primary residence; and

(b) £200,000 Business Sale Limit, from proceeds of the sale of a business.

Contributions made within these limits should fall outside of capital gains and inheritance tax limits (and the seven year rule should not apply), but they should not attract tax relief. Each limit should be subject to review every five years, say; the Primary Residence Limit could, for example, be indexed to average house prices.

Proposal 10: inter-generational wealth transfer between pension savings upon death, free of inheritance tax

Savers should be able to bequeath unused pension savings assets to third parties free of inheritance tax (perhaps limited to £100,000), provided that the assets only go into recipients' pension savings. Such bequests should not attract tax relief.

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[133] After deducting the 25% tax-free lump sum that they are entitled to withdraw (net of any pre-SPA tax-free withdrawal), as per Proposal 5.

[134] Including civil partnerships.

Proposal 11: permit regular pre-retirement access to pension savings

An extension of Proposal 5 (permitting a one-time pre-retirement tax-free withdrawal of up to 25% of pension savings) would be to permit pre-retirement access every five years, say, with an "escalator" arrangement to prevent tax "gaming".[135] Appendix V illustrates how such an escalator could work.

Proposal 12: encourage employers to match employees' ISA contributions

Low earning[136] under-25s could be encouraged to catch the saving habit (early) by permitting employers to make contributions to an employee's ISA with limited NICs relief (e.g. 5%) for the employer, provided contributions are matched by the employee. Concerns over savings persistency may require an initial leap of faith, but ISA assets are more "sticky" than many would expect.

Proposal 13: introduce a Junior ISA

The ISA should be extended to the under-16s, perhaps branded as a "Junior ISA", with an annual savings allowance of £1,200 (equivalent to £100 per month). When the saver reaches 16, the Junior ISA should automatically become an ISA. Introduction of the Junior ISA would complete the association of the ISA brand with lifetime saving.

Proposal 14: abandon arbitrary age watersheds[137]

The upper age limit (75) for contributing to pension savings should be abandoned, given improving longevity.

Proposal 15: fold the forthcoming Saving Gateway into the ISA framework

To simplify the savings landscape, the Government should consider folding the Saving Gateway, planned for 2010 as a cash savings account for low earners (with a government contribution of 50p for each pound saved), into the ISA framework. Further simplification could be achieved by automatically re-nominating existing Child Trust Funds (CTF) as Junior ISAs when the CTF product is abandoned in January 2011.

Proposal 16: promote the benefits of long-term saving

The Government should do all it can to promote the benefits of long-term saving. Illustrations as to the power of compounding in the context of saving, for example, should be part of the school mathematics curriculum.

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[135] The concern is that someone could make a contribution to pension savings, receive tax relief, then withdraw a lump sum (tax-free) and make another contribution, receiving further tax relief.

[136] E.g. annual earnings below £15,000.

[137] The May 2010 Coalition Agreement proposed the abandonment of the Default Retirement Age (DRA), along with compulsory annuitisation at 75.

7. TAX SIMPLIFICATION: SOME OPTIONS

For simplicity to be achieved, a single, unified tax framework for all tax-incentivised saving products is required. This would include tax harmonisation between products with and without embedded life insurance.

This could take one of a variety of options listed below. Further detailed analysis is required, including mapping out the transition strategy. The logistics of migrating the existing tax regimes into a single one are particularly complicated.

Option 1: gravitate to the ISA world of TEE

ISAs are viewed by many as an inherent part of their retirement savings, exhibiting considerable persistency, and this has been achieved without an upfront tax incentive. Some politicians, irrespective of political hue, are in favour of ending (or certainly limiting) upfront tax relief, although their motives vary (and include affordability and social justice concerns). Had TEE been in place for pension savings in 2008-09, the Treasury would have saved £12 billion in tax relief costs.

A wholly TEE framework does, however, present at least one significant challenge; the lack of an upfront incentive to save for the long term.

Option 2: retain some upfront tax relief

A compromise approach is to retain EET for pension savings but cap upfront tax relief to the standard rate of tax (20%), irrespective of the saver's marginal rate of tax. In 2008-09, the Treasury would then have saved some £7 billion in tax relief costs. However, those who expect to pay 40% income tax in retirement would then lack an incentive to put any money into pension savings whilst working (and probably paying 40% or 50% income tax). This risk could be addressed by limiting income tax to 20% for all pensioners (i.e. $E^{20\%}ET^{20\%}$); in 2008-09, the Treasury would then have saved some £5.6 billion in tax relief costs.

Option 3: universal upfront tax relief with a lock-in

An alternative would be to migrate to a more "pension-like" world incorporating some ISA-like features. The ISA brand could be adopted as a "hook" to attract savings, accompanied by one of a number of alternative upfront incentives to save. These could

include tax relief (a flat rate of 25%, say), up to an annual contributions limit (which may be more or less than £45,000, depending upon the Treasury's financial position), or a persistency bonus that grows over time as funds are left within the ISA.

If such a structure were adopted, pre-retirement withdrawals would require repayment of the upfront tax relief (25% of the amount withdrawn, and therefore independent of fund value), or would be ineligible for any persistency bonus. The net tax effect would then be TEE, as ISAs today.

Post-retirement withdrawals, perhaps to provide retirement income or meet care-related costs, would not require repayment of the incentive, but would be taxed (ideally at a flat rate of 20% or 25%); the ISA would then be taxed as EET. Thus, assets that ended up being locked away for the long-term would be taxed as a pension savings product is today. Post-retirement contributions would no longer receive an upfront incentive, but withdrawals of such contributions should be tax free.

This approach could lead us to a single product that combines ISAs' instant access (as TEE) with pension savings' upfront incentive (EET). The event that determines which world one is in (ISA or pension) is withdrawal, and the timing thereof. However, such a tax framework would require more data tracking and IT capability than an "ISA only" TEE world (described in 7(a)). It would also incur a significant upfront tax cost (albeit that this could be less than today's upfront cost, depending upon the level of the annual contributions limit).

Option 4: reduce the 25% tax-free lump sum

Given the need to reduce the public deficit over the next few years, the Treasury may consider reducing the 25% tax-free lump sum that is available from pension savings upon retirement. In 2008-09 this cost £2.5 billion.[138]

A note on capital gains tax (CGT)

The tax exemption of accruals on assets held within ISAs and pension savings ("middle E") means that any increase in CGT (a prospect raised in the Coalition Agreement of May 2010) reinforces their attraction relative to holding assets elsewhere. From the Treasury's perspective, the "opportunity cost" of "middle E" (i.e. foregone CGT) increases substantially, more so if the CGT exemption threshold were to be reduced (from £10,100 a year).

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[138] HMRC *Table 7.9, footnote 3*.

8. THE IMPLICATIONS FOR SAVERS

Implementation of these proposals would open up a much more attractive savings environment for individuals.

8.1 Flexibility

One less decision to make

Currently, someone who has decided to save has to immediately make a second decision: do I want instant access to assets, thereby foregoing an upfront tax incentive to save, or am I prepared to lock funds away for the long term, the pain being eased by upfront tax relief? For many people, this is a difficult choice and it provides an excuse not to save for the long term or, worse, they defer the decision to some other time and end up not saving at all.

These proposals are intended to reduce the scope for procrastination because, at the time of saving, a simultaneous decision would no longer be required as to whether the funds are to be readily accessible or locked away until retirement. This offers savers flexibility that is not available today.

Rolling ISA assets into pension savings

These proposals allow savers to move “precautionary” savings, accumulated in an ISA, into pension savings (perhaps years later), with tax relief then being credited at the standard rate[139] (and retaining the £3,600 limit for non-earners). Furthermore, the £35,000 annual contributions limit to pension savings should not apply to savers re-nominating ISA assets at retirement, and tax relief (at the standard rate) should not then be limited to the amount of income tax paid in that year. This would allow savers to re-nominate a substantial amount of assets prior to purchasing an annuity, for example. Re-nominated ISA assets

[139] Tax relief on re-nominated ISA assets is limited to the standard rate so that basic rate taxpayers are not encouraged to delay pension saving on the premise that one day they may become higher rate taxpayers (and therefore eligible for higher rate relief).

would subsequently be treated as pension assets for tax purposes, but those re-nominated at retirement should not be eligible for pension savings' 25% tax-free lump sum.

This feature provides ISA savers with an ability to act on the benefit of hindsight, severing the current link between the year in which pension savings are made and the ability to claim tax relief in respect of tax paid in that same year. This may prove particularly valuable to those who have accumulated some ISA savings but may not have made contributions to a pension because they were not working (and not paying tax). Women, in particular, may have had career breaks to have children (and subsequently care for them), or they have been caring for elderly relatives. There are also likely to be some people who chose not to save in a pension because they did not trust them, or to whom retirement always seemed to be just too far away.

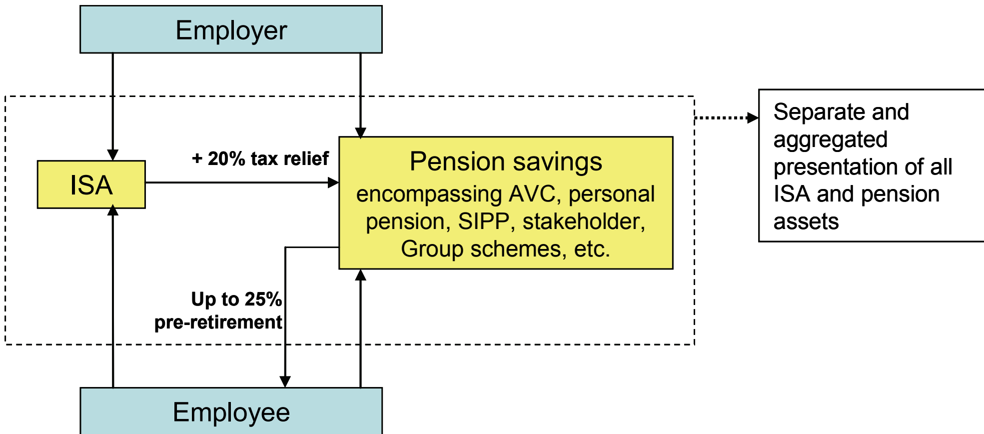
ISA asset re-nomination, not sale and purchase

Permitting ISA assets to be re-nominated as pensions savings (perhaps on a lifetime savings platform) means that savers would not incur the costs associated with selling ISA assets and then repurchasing them within a pension savings wrapper. This would represent a simplification, and would reinforce the close proximity of ISAs and pension savings. The standard rate of tax relief should be added automatically to the pension savings.

Early access to pension savings

Proposals 5 and 11 introduce the ability to access, pre-retirement, up to 25% of assets locked into a pension savings wrapper. This should benefit savers who may be facing cashflow difficulties, but have significant accumulated pensions savings. They could then perhaps avoid home repossession, pay health-related costs or meet other, perhaps unexpected, expenses.

Figure 12: enhanced savings flexibility



The higher rate taxpayers' perspective

It should be noted that the proposals for additional savings flexibility (between the ISA and pensions worlds) are likely to primarily benefit standard rate taxpayers, both whilst working and in retirement. Higher rate taxpayers could, of course, sell ISA assets and contribute conventionally to a pension, thereby obtaining higher rate tax relief.

People who expect to be higher rate taxpayers in retirement, and looking to secure an annuity income post-retirement, for example, would probably be better off retaining their ISA assets rather than re-nominating them as pension savings pre-retirement (receiving 20% tax relief), only to then pay 40% income tax. Leaving their assets in an ISA would allow them to take advantage of Proposal 7 to use their ISA funds to purchase a tax-free annuity (consistent with the tax-exempt status of withdrawals from ISAs). Conversely, those who expect to pay no income tax in retirement, but who are paying income tax now, would probably benefit by moving their ISA assets into a pension savings product just before reaching retirement, to receive the upfront 20% tax relief.

Gender inequality and reinforcing marriage

Proposal 8 (that couples may contribute to one another's pension savings irrespective of the recipient's earned income), introduces much more flexibility to save for the long term within couples. The objective is to address gender inequality and help reduce female pensioner poverty (although males would equally benefit from the proposal). This proposal should also reinforce the merits of marriage and civil partnership. It ends the distinction between the sources of income within couples and significantly extends the ability of non-taxpayers to receive tax relief on pension saving,[140] provided that their partner pays tax. The requirement that intra-couple contributions be deducted from the annual limit of both parties is to limit the Treasury's tax relief cost. Thus, a couple comprising a 40% taxpayer and a non-taxpayer could not obtain tax relief at 40% on their combined annual contribution limit.

Anomalies

Inevitably some anomalies will emerge from these proposals, but we should not allow this to distract ourselves from the "higher" objective, that of encouraging the majority of people (i.e. 20% taxpayers, both whilst working and in retirement) to save for the long term, which includes encouraging ISA assets to be re-nominated as (long term) pension savings.

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[140] Today, non-taxpayers can pay into a personal pension scheme and benefit from basic rate tax relief (20%) on the first £2,880 a year. The Government then tops up the contribution to £3,600. There is currently no tax relief for contributions above this amount.

8.2 A meaningful annual contributions limit

The proposed annual contributions limit of £45,000, with a maximum contribution to pension savings of £35,000, should be sufficient to accommodate almost everyone's lifetime savings ambition. It should also be large enough to overcome a particular frustration with today's ISA limits, that once the maximum investment has been made in any given year, withdrawals cannot be replenished in that same financial year.

This annual limit, considerably smaller than today's £245,000 tax-incentivised allowance, justifies the abolition of the Standard Lifetime Allowance (SLA).[141] This would also address an injustice because the SLA is based upon pension fund asset value, not contributions, which penalises successful investors. Consequently, savers would no longer have to guess at future asset values when making a decision to save in a pension product, a simplification of the pensions arena (albeit not one that would concern most people).

It should be noted that introducing an annual contributions limit would have to be accompanied by a methodology for valuing DB (final salary) accrual (which HMRC is currently grappling with for 2011-12). Appendix VI contains a suggestion as to how this could be done.

8.3 Harness the ISA brand

The proposal to include ISAs in the DWP's auto-enrolment initiative for all employees is a direct response to how people behave in practice. Pension saving, particularly among the lower paid, is not popular. Figure 9 illustrated the surprisingly low participation rate (around 55%) in work-based DC pension schemes, even though employers offer to contribute.

Conversely, the participation data (Table 4) provides clear evidence of mass engagement with ISAs (over 19 million people in total), and employee auto-enrolment would add to this success. Furthermore, ISAs are popular with low earners; 61% of ISA savers earn less than £20,000. Indeed, the ISA brand should be harnessed to encourage people to take the first step towards longer-term saving. The additional flexibility (Proposal 3) to re-nominate ISA assets as pension savings should help make such a progression less challenging than it is today, particularly if ISAs and pension saving wrappers were available on a commonly managed platform.

8.4 A common platform for ISAs and pensions savings

Savers want simplicity, and being able to access the ISA and pension saving worlds through a single portal would provide this, thereby encouraging saving. Such a platform would be personal to the saver and bear his name, with employer contributions

[141] £1.75 million for the tax year 2009-10, then frozen at £1.8 million from 2010 to 2015-16.

segregated from any employer-sponsored scheme; portability issues (i.e. job mobility) would disappear, reinforcing the platform's lifetime theme.

A single platform would greatly enhance savers' access to portfolio information and enable providers to reduce their administration costs (Chapter 9), leading to less erosion of asset value. The tools currently available for portfolio management would allow the total accumulated funds in pension, ISA and other funds to be aggregated to show what level of post-tax retirement income they may deliver (see also Section 10.2). When retirement is reached, the ISA and pension savings could then be pooled to produce an integrated income stream that could be managed to suit the saver's income needs and tax position.

Appendix VII provides a vision of how someone may, in future, interact with a financial planning website. The technology to achieve this is readily available, and a number of providers are currently developing websites to offer this sort of capability to their customers.

8.5 Lifetime saving: easy to understand

Surveys conducted by major providers have found that the concept of lifetime saving is easy to understand, the positive sentiment increasing with income. It particularly appeals to women and the younger age groups, the two groups that surveys have found to be most out of touch with pension saving. Indeed, younger females (aged 25 to 34) emerge as having particularly weak knowledge of pension position.

"Flexibility", "control" and "instant accessibility" are seen as particularly salient messages in respect of encouraging people to review their savings and think about their potential retirement income. Respondents indicated that they would be much more likely to use a lifetime savings platform than a collection of disparate accounts (three times the industry norm for new concepts), and would also invest more, by about 14% on average (when compared with contributions into company pension schemes). The main negative responses concerned inertia and cynicism about cost, mostly from the hardest to reach; older respondents with minimal financial assets.

The surveys also suggest that the ability to view and analyse all of one's assets in a single document (or website) is appealing, particularly if a simple tool (ideally online) were available to assist the planning of where, financially, the saver may want to be at some future date. This should include the ability to project the effects of different asset allocations and performance scenarios.

Analytical tools aside, a single platform would offer other, more basic, attributes. Survey respondents like the prospect of being able to receive a variety of reminders, such as

not having used the platform for a while, or having reached a savings target, or a timely suggestion to save a pay rise[142] directly into one of the funds available via the platform.

8.6 The wealthy

The introduction of the £45,000 contributions limit would not wholly satisfy the wealthy, but it would provide access to some 50% relief whereas, following the April 2009 Budget, there will be none from 2011.

The wealthy could be expected to welcome the proposal to end the Standard Lifetime Allowance (SLA) because, today, pension funds that exceed the SLA are heavily taxed: 55% if the excess benefits are taken as a lump sum and 25% if taken as income. Income is then subject to income tax at the saver's marginal rate. Penalising successful savers in this way is unjust; asset realisation should simply be taxed at the savers' marginal rate.

A further consideration for high earners is the forthcoming Finance Act, the consultation for which was issued in December 2009. This is likely to introduce an annual tax charge of 30% on any excess DB scheme accrual over the annual allowance (currently £245,000). Furthermore, the current multiplier[143] of ten is likely to become age-related and could be as high as 25. Consequently many high earners are likely to leave their DB schemes (before April 2011) for unapproved schemes, or forego employer pension contributions for cash in lieu. Introducing a contribution limit as proposed, as an alternative to the 30% accrual-based tax charge as described would, from a high earners' perspective, be preferable.

8.7 Easing embedded equity into retirement income

Proposal 9, for a £200,000 Primary Residence Limit, is in acknowledgement of the strength of the emotional link between home ownership and long-term saving. "My home is my pension", "it's the children's inheritance" and, increasingly, "my home will pay for my long-term care, if needed" are maxims that are deeply rooted in the British psyche (notwithstanding their incompatibility). Introducing the Primary Residence Limit provides a mechanism for these sentiments to be made real; it enables substantial embedded equity to become retirement income without consuming capital gains and inheritance tax allowances.

A further step would be to permit the primary residence to be sold into a pension savings product so that it could act as an equity release vehicle.[144] This would, however,

[142] What the employee has never had he is less likely to miss.

[143] Increases in pension accrual, arising with additional years served and pay rises, are multiplied up before being measured against the annual allowance.

[144] Individual residential properties cannot currently be held within a SIPP (but property funds can be).

represent a further step down the path of complexity and it raises governance issues, albeit that SHIP-based schemes[145] have now addressed the main historic concerns with equity release. A trust-based structure may be required to enable the saver to remain in the home rent-free ("middle E"). There is also a risk that such an equity release feature may put working people off saving, when they may otherwise have done so.

The proposal for a £200,000 Business Sale Limit is to accommodate people whose wealth is tied up in their own business. It should appeal to, and benefit, entrepreneurs.

8.8 Wealth trickle down between the generations

Proposal 10, to enable savers to bequeath unused pension savings to third parties' retirement funds free of inheritance tax (perhaps limited to £100,000), should encourage a wealth cascade down the generations and reinforce the sense of personal ownership of pension savings. It also would greatly assist, for example, a carer looking after a parent who, in the interim, is not making contributions to their own pension savings.

8.9 Encouragement to develop a savings habit early: the Junior ISA

The intention behind proposing the extension of the ISA to the under-16s is to complete the association of the ISA brand with lifetime saving. An annual savings allowance of £1,200 (equivalent to £100 per month) should be sufficient for the under-16s (and accruals would of course be tax exempt, as "middle E"). The transition from Junior ISA to full ISA when the child reaches 16 years old should be automatic (ideally without having to change the passbook).

8.10 Tidying up the savings landscape

Existing Child Trust Funds (CTF) could automatically become Junior ISAs when the CTF product is abandoned in January 2011. Similarly, the Saving Gateway, planned for 2010 as a cash savings account for low earners (with a government contribution of 50p for each pound saved) could be folded into the ISA framework. The challenges are primarily administrative, but these two simple initiatives would simplify the savings landscape by reducing the product count by two, without penalising savers.

[145] Safe Home Income Plans (SHIPs) now represents the majority of the equity release market. SHIP has a code of conduct dedicated to the protection of the consumer; for example, negative equity is no longer permitted within a SHIP scheme.

9. THE IMPLICATIONS FOR EMPLOYERS

As we have seen (Chapter 3), many private sector employers have, for many years, progressively watered down their commitment to pension provision, but some do remain prepared to make contributions. These proposals provides employers with the opportunity to continue to do so, but without the accounting, administrative, compliance and other regulatory baggage (not to mention management time) that accompanies occupational pension schemes.

In some ways these proposals are an extension of an ongoing development, whereby corporate scheme sponsors are more conscious of individual employees' savings needs. Historically, the focus has been on "the scheme" rather than the individual, with actuarial consultancies, for example, treating the employer as their client, rather than the needs of individual employees. Today, employers' internal communication is more personalised, emphasising "lifetime savings" rather than "the pension scheme".

These proposals should provide an opportunity for smaller employers, in particular, to cut the operational costs of pension provision, by harnessing the economies of scale that some (more IT-advanced) platform providers should be able to offer. And whilst employer contributions to an employee's savings platform are, from a cashflow perspective, no different to contributing to an employee's personal pension or an occupational pension scheme, the platform should be able to offer presentational advantages which may encourage employees themselves to make matching contributions.

Some regulatory changes, concerning the FSA's financial promotion rules, would be required to permit ISAs to be promoted in the workplace.

10. THE IMPLICATIONS FOR THE PENSIONS AND SAVINGS INDUSTRY

10.1 Aligned with the government

The industry's interests are aligned with the government's: both want more people to save more. These proposals facilitate a single lifetime savings umbrella which would help achieve this common objective, confirmed by industry soundings.

A common legislative framework for ISAs and pension savings[146] would simplify the pension and savings landscape and facilitate the common management of both asset pools. That said, these proposals do not depend upon the structural integration of ISA and pension savings products.

There is also a recognition that, in time, it makes sense for a common tax framework to emerge: such simplification would encourage saving and therefore an increase in business for the industry.

10.2 Account management and presentational benefits

A common legislative framework for ISAs and pension savings products would encourage providers to offer savers an aggregated view of all of their assets. On-line tools are already available to savers for account management and to perform analysis on a portfolio basis (by asset class and value, currency of exposure, etc), irrespective of different product wrappers. They could also provide a history of contributions and tax relief, downloadable guides on various retirement planning topics, a range of investment funds and managers, FAQs and occasional helpful hints and reminders highlighting useful information and news.

Savers should also be able to project potential retirement income incorporating all of their assets (ISA, pension savings products and other), under a range of different assumptions for future asset performance and personal taxation. Websites could also be interactive, whereby savers request product suggestions to meet cashflow criteria, for example. A well-designed online tool should encourage engagement, education and planning, and there should be scope for user-led innovation.

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[146] Including AVCs, ISAs, personal pensions, SIPPs and stakeholder pensions. Currently, registered pension scheme assets have to be ring-fenced from other assets (including those within an ISA).

Ideally a single platform should be able to accommodate the whole panoply of retirement savings products, including life insurance products (including life bonds), OEICs, unit trusts, employer share purchase schemes and DB pensions.

10.3 Lower costs

A common legislative framework would give providers an additional incentive to embrace technology, not just to serve customers better but also to cut administration costs. This is essential if savers are to retain a larger proportion of the benefit of the power of compounding of accruals.

10.4 Off-line customer communication

A lifetime savings platform would offer providers a single customer interface through which to communicate, and this would assist distribution, but only to the more financially and IT literate. Traditional phone and paper support would still be required by most of the population, and some in higher income brackets may require a more interactive service than could be delivered online (perhaps from a private banking business).

10.5 Distribution

Provider surveys[147] suggest that if the lifetime savings concept were made manifest in a simple and accessible manner, more people would save more. For asset managers, insurers and platform providers, that translates into more management fees and further economies of scale.

In respect of company-sponsored pension schemes, those surveyed typical responded that the presentational benefits of placing such schemes onto a lifetime savings platform could increase employee contributions by 15% (and nearer 20% amongst those earning £30,000 to £60,000). Providers would have (product) cross-selling opportunities if employer contributions were to go directly into employees' savings products (rather than into group schemes).

10.6 Rebuilding trust

Lifetime savings platforms would provide the industry with an opportunity to restore trust in itself. The industry could, for example, develop a set of principles and standards for the operation of a lifetime savings platform, to help it achieve an industry-wide culture change, the objective being to put customers (rather than shareholders) first, and deliver better value to them.

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[147] The author was granted access to surveys conducted privately by three life and pensions FTSE 100 companies.

Such principles would have to ensure that an unscrupulous provider could not irresponsibly harness the power of the trusted ISA brand[148] for example. Tarnish the ISA brand, and the interests of the whole industry would be damaged – as providers of With Profits Funds discovered to their cost.

10.7 Operational considerations

There should not be any technical barriers to implementing these proposals, although some providers may have to make a step-change in their IT capabilities. Data tracking would be required in respect of transactions such as early access to pension savings and fund movements within couples, not least to minimise the scope for gaming the tax framework.

A number of legislative changes would be required to facilitate the envisaged increase in flexibility, such as the transfer of ISA assets into a pension savings product. It should not be necessary, for example, to have to go through the two-step required today (divest the ISA, then reinvest in the pension, completing the necessary ISA discharge and pension saving application forms to do so).

It is not envisaged that these proposals raise any significant regulatory issues, but to the extent that there are any, they should not be allowed to distract attention from the vision: more people saving more, for longer.

[148] There are indications that this is beginning to happen because of the very low rates of interest being paid on Cash ISAs.

11. THE IMPLICATIONS FOR THE TREASURY

11.1 The annual contributions limit

Introducing an annual contributions limit with tax relief at the saver's marginal rate enables the Government to appease, to some extent, additional rate (i.e. 50%) taxpayers, and the industry. This could be achieved without increasing the overall cost of tax relief, and also provides a simple mechanism to save money, depending upon where the limit is set. Basic rate taxpayers, and most higher rate taxpayers, would be unaffected by the limit.

A model, summarised in Appendix VIII, was built by Hewitt Associates to examine the impact of different annual contribution limits and tax relief rates on the total cost of tax relief to the Treasury. It is solely focused on pension savings: it excludes ISAs, for example. Inevitably some simplifying assumptions were required but, to reduce the scope for inaccuracy, a comparative approach was adopted. As such, the model compares alternative contributions limits' cost of tax relief using with a projection of the post-2009 Budget EET framework,[149] using the same underlying assumptions. It can also determine, for a given contributions limit, the cost of a universal rate of upfront tax relief (as opposed to relief at savers' marginal rate). Figure 13 illustrates some of the results.

Two key observations from Figure 13 are that:

(i) an annual pension savings contribution limit (i.e. excluding ISAs) of approximately £35,000, with tax relief at the saver's marginal rate, produces a similar total cost of relief as today. A £55,000 limit would cost another £2 billion per year; and

(ii) introducing a 20% universal rate of upfront tax relief (i.e. ending relief at 40%), combined with the proposed £35,000 contribution limit for pension savings, would save some £6-£7 billion a year.

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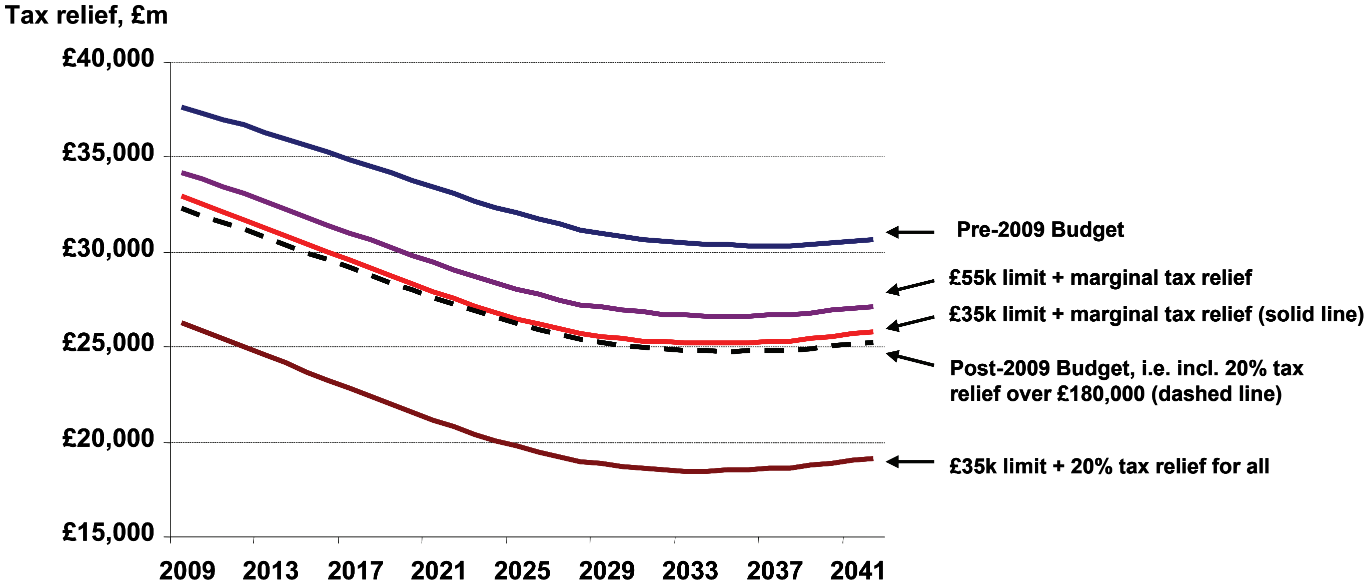
[149] I.e. taking account of the April 2009 Budget's impact on additional rate taxpayers. Note that the March 2010 Budget's changes to the earnings threshold is expected to increase the yield to the Treasury by an extra £600 million from 2012-13 (HMT, *Budget Report 2010,* page 121, table A2, row f, 2010).

Figure 13: The cost of pension saving tax relief (i.e. excluding ISAs), £ million[150]



In Figure 13 the graph lines slope down because pensions in payment (and therefore income tax) increase quicker than tax relief on contributions and investment accruals, reducing the cost to the Treasury. This flattens out in later years. The model's results are fairly consistent over a range of different real rates of investment return (a reflection of the comparative approach to the modelling).

The proposed annual limit for tax-incentivised saving of £45,000 is the result of adding, approximately, the current limit for ISAs[151] contributions to the proposed £35,000 limit for pension saving. An annual contributions limit would provide the Government with a simple lever with which to control the cost of tax relief, and it would only impact upon a very small proportion of the population (the wealthy).

11.2 The tax relief consequences of applying ISAs' TEE regime to pension savings

Figure 14 illustrates the cost of tax relief (net of income tax paid by pensioners) if the current tax framework for pension savings (EET) were changed to TEE (with no change to today's contributions allowance). There would be an immediate saving of about £30 billion on upfront tax relief (see Figure 13's post-2009 Budget graph line), so the net cost would initially drop to about £7.5 billion for 2009-10 (the dotted line in Figure 14).

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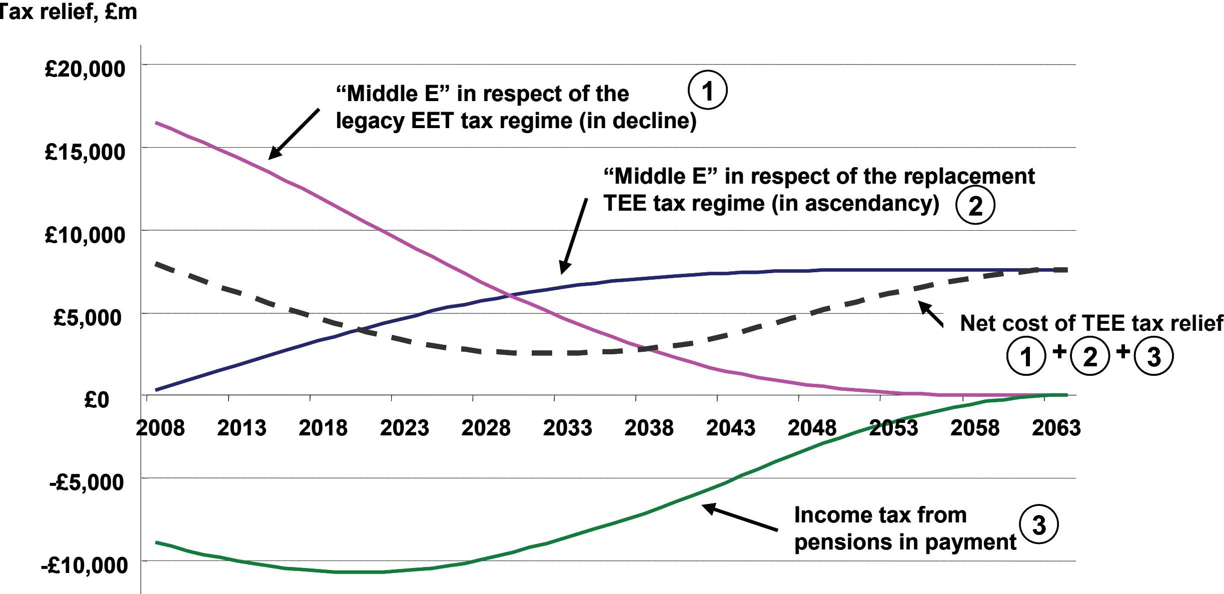
[150] Expressed in 2007 terms and based upon a long-term rate of real equity return of 2% p.a. Given the asset mix of the modelled portfolio, this equates to an overall real rate of investment return of about 1.5% p.a.

[151] The ISA contributions limit is £10,200 from April 2010. The tax relief on ISAs cost some £2 billion in 2008-09; HMRC, *Tax Expenditure, Table 1.5,* 2010.

Thereafter, the legacy EET regime slowly dies, income tax receipts from pensioners disappear, and TEE comes to the fore. Based upon a 2% annual real rate of return for equities, the "steady state" annual cost of tax relief settles down at around £8 billion, being the tax exemption on assets accruals (i.e. tax relief-exempt investment income and an estimate for "foregone" capital gains tax).[152]

Figure 14: The cost of tax relief with a TEE tax framework for future pension saving[153] (no change to today's contribution allowance)



The cost of tax relief is very sensitive to the assumed rate of real return on assets. Figure 15 compares the net cost of tax relief under two different long-term annual rate of return scenarios for equities (2% and 3.5%), and two different contribution environments; today's contribution allowance and the proposed £35,000 limit for pension savings.

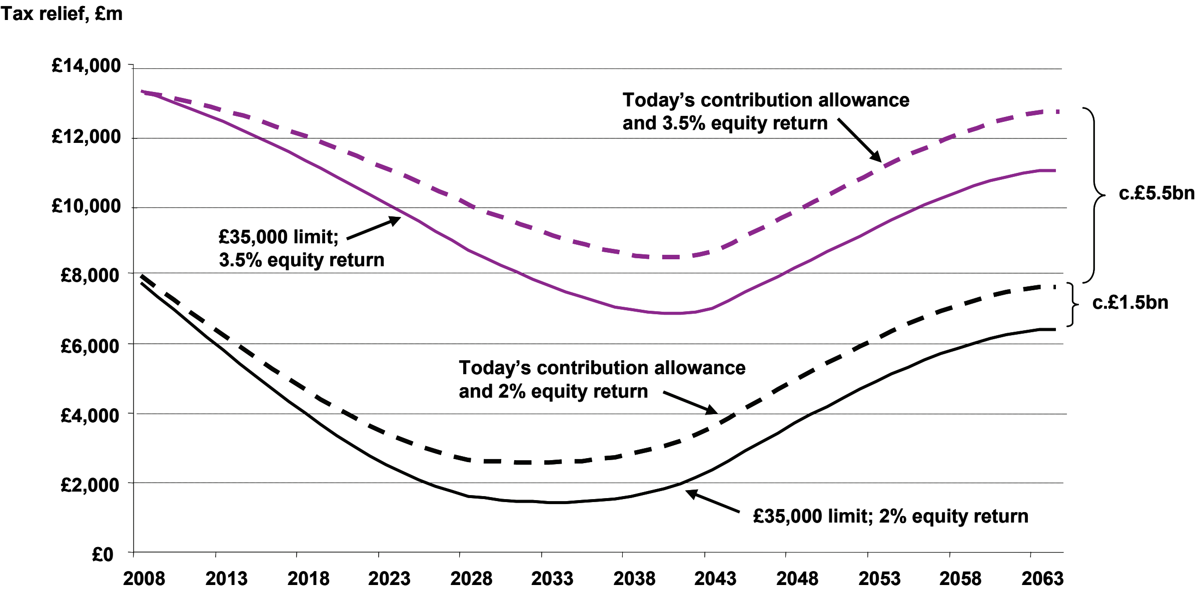
As Figure 15 shows, with a TEE regime, introducing a £35,000 limit on pension savings cuts the annual cost of tax relief by c.£1.5 billion in the long term (compared to today's contribution allowance), but this is dwarfed by the impact of the real rate of return on equities. If this turns out to be 3.5% rather than 2%, the additional cost to the Treasury is c.£5.5 billion per year in "lost" tax income on investment accruals, derived from the vast

[152] Note that if capital gains tax were increased to 50%, as was proposed in the May 2010 Coalition Agreement, "middle E's" opportunity cost to the Treasury rises significantly.

[153] Assuming 2% p.a. real rate of return on equities.

pool of underlying pension assets (roughly £2 trillion[154]). Note that this applies equally to an EET tax regime.

Figure 15: The cost of tax relief: comparing different contribution limits and real rates of equity return, in a TEE world with EET in run-off



One of the Guiding Principles behind this paper is that any proposals should not rely on costs being deferred, in keeping with generational fairness. One could argue that moving from EET to TEE does defer a cost (the loss of income tax on pensions in payment being a "cost"), but this is more than offset by the saving in upfront tax relief. Furthermore, this saving is more immediate (and would therefore be, presumably, of great interest to the Treasury).

11.3 ISA saving could substitute for pension savings

The proposal for the £45,000 combined ISA and pension savings annual limit is premised upon retaining the different tax treatments (TEE and EET, respectively) and approximate tax relief cost "breakeven". However, given the popularity of ISAs, and dislike of pensions (particularly amongst basic rate taxpayers), following ISA auto-enrolment it is quite likely that ISA savings will increase at the expense of pension products. The cost of tax relief would then fall, there being no upfront tax relief on ISA savings, to the Treasury's benefit.

If, for example, 25% of all employee (i.e. not employer) contributions to funded occupational schemes and personal pension saving were to divert to ISAs, there would

154 The size of the asset pool is quite static around £2 trillion in a 2% return scenario; if a 3.5% real return is assumed, it rises to about £2.5 trillion in the long term.

be an annual reduction in upfront tax relief of approximately £1 billion (based upon 2008-09 tax relief data). Subsequently there would be a smaller reduction in tax receipts, ISA-derived income being tax-free.

11.4 Early access

The inability to access funds tied up in pension savings products is a significant deterrent to saving. These proposals are designed to introduce more flexibility, including some early access, and would certainly appeal to people, pre-retirement, who may be pension asset rich but cash poor and facing, for example, eviction from their home.[155]

In 2007-08 it is estimated that over £11 billion[156] in lump sums were drawn down at retirement; offer this facility to everyone over 50, say, and the cash injection into the economy could be multiples of this figure. Mortgage arrears (averaging roughly £5,500) could be extinguished and there would be many billions of pounds still left over for increased consumer spending, which the Government would welcome.

A number of studies have been conducted[157] into different early access structures and the evidence is inconclusive, although all agree that early access would attract more savers, higher contributions and considerably better persistency than one might expect (i.e. fewer withdrawals).

But early access should be introduced cautiously. Experience gleaned elsewhere is mixed; there are, for example, increasing concerns over excessive borrowing from 401(k) plans in the US. Providers are finding themselves burdened with administrating millions of small loans, and many people (on lower incomes) have become locked into a succession of loans. Furthermore, long-term returns are being compromised as savers miss out on the power of compounding; for example, a loan of just $5,000, taken out by a worker on average earnings, would trim future retirement savings by up to 22%.[158]

Consequently, when people who have borrowed from their 401(k) plans reach retirement they can find themselves with negligible retirement savings, which belies the whole point of the 401(k) program. Plan operators have realised this and are pulling back from making loans available. Their emphasis is now on offering the more restrictive "financial

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[155] It is estimated that 48,000 homes were repossessed in 2009 (0.43% of all mortgages) and around 53,000 (0.48%) will be in 2010. The Council of Mortgage Lenders (CML), 9 November 2009.

[156] Steve Webb and Jo Holland, *Setting Pensions Free,* Centre Forum April 2009.

[157] Notably the PPI's *Would early access to pension savings increase retirement incomes?* November 2008, and research by the US Government Accountability Office (GAO).

[158] The Center for American Progress, a Washington-based think tank.

hardship" facility, whereby cash can only be used for college fees, meeting emergency medical costs and purchasing the primary residence. Given these concerns, our proposals suggest a 25% limit on early access.

The ideal is, of course, to offer pension savers the early access feature and attract more savings, but subsequently not to have it taken up. Furthermore, if greater flexibility is offered, the Government could justify cutting tax relief because it has made clear that tax relief is partly to compensate for the lack of flexibility: "pensions tax relief is provided to recognise that pensions are less flexible than other forms of saving, requiring individuals to lock away their savings to produce a retirement income." [159]

11.5 Employer engagement[160]

A key feature of the 401(k) program is employer engagement in pushing auto-enrolment. Robust communication from employers to encourage employee participation, reinforced by face-to-face enrolment meetings, an active HR department and telephone support are all part of a package of measures deployed. Take-up rates of 80% to 90% are the result (60% if employer engagement is weak), with higher rates in SMEs than big employers. The latter is the result of a more personal involvement from the CEO (there may be no benefits staff in an SME), and in the recent recessionary environment, employees in larger firms, in particular, have become sceptical of employer intentions.

The message from this US experience is that auto-enrolment and employer engagement boosts saving, so opening up employees' ISAs and other pension savings to employer engagement is sensible. Perhaps surprisingly, the level of employer contributions (in the US, at least) makes little difference to employee participation rates; wrapping financial education into the employer support package has had a far bigger impact.

11.6 Protecting the state

The proposal to end any annuitisation requirement will appeal to libertarians, but the state still has a right to protect itself from people reaching retirement, emptying their retirement funds and then claiming benefits. The proposal that savers put to one side at least £50,000[161] of investments at retirement, until the age of 75, is intended to mitigate this risk (and also helps protect the saver from himself). Clearly, savers who have already

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[159] HM Treasury & HMRC, *Implementing the restriction of pensions tax relief,* page 5 December 2009.

[160] Larry Zimpleman, Chairman, President and CEO and of Principal Financial (the largest 401(k) operator); interview with author, 29 January 2010.

[161] After deducting the 25% tax-free lump sum that they are entitled to withdraw (net of any pre-SPA tax-free withdrawal). Ireland has already adopted this approach: the Approved Minimum Retirement Fund (requiring at least €63,500 to be put to one side, unless the retiree has guaranteed annuity income of at least €12,700 per year).

secured an income equivalent to 40% of median earnings, say, via lifetime annuities or guaranteed pensions, should be exempt.

The proposal that annuities purchased with ISA funds should be income tax-free (consistent with the tax-exempt status of ISA withdrawals) is also intended to help protect the state by encouraging the purchase of annuities.

Early access introduces the risk of tax gaming, withdrawals being recycled as new contributions to secure tax relief (again). The proposed one-off early withdrawal addresses this risk (and should keep the administration burden low).

11.7 Interaction with the State Pension

It is assumed that the basic State Pension will continue to provide the foundation layer of retirement income. The core proposals outlined in this paper do not interact directly with the State Pension, but clearly any changes to the tax relief framework could have implications for the basic State Pension. Adopting TEE for pension savings, for example, would save the Treasury £8.5 billion per year from 2012-13;[162] this could then be used to increase the basic State Pension by over 16% (and there appears to be widespread agreement that it should be increased).[163] Alternatively, some of the saving could be directed to other purposes, such as reinstating the rebate on the 10p dividend tax credit (see Section 5.5 (ii)).

11.8 Interaction with NEST

NEST, due to arrive in 2012, is primarily aimed at "low earners" and those who may not save *at all* for retirement. Policy makers may see people in different income layers, but that is not how people see themselves, and some will aspire to save more than the annual contributions cap of £3,600 which serves no customer need whatsoever. It is there simply because the Government buckled under the onslaught of the industry's vested interests.

One consequence of the cap is that those who wish to save more will have to also engage with at least one other retirement savings vehicle (more complexity), or opt out of NEST. This reinforces the division between workers and management; far better that everyone participates in a common pension savings environment, not least so that management can empathise with their workers. Indeed, perhaps NICs rebates should not be paid on employer contributions unless all the staff share the same, or similar,

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[162] Calculated as £12 billion as per Table 13, less the subsequent savings detailed in the 2009 and 2010 Budget Reports totalling £3.5 billon a year.

[163] Returning the Basic State Pension to earnings-indexation will help.

occupational pension scheme benefits (in proportion to salary).[164] As an aside, the NEST contributions structure[165] invites occupational schemes to "dumb down" to a 3% level of employer contribution.

The division between NEST and other savings vehicles is entirely artificial, care of the contributions cap. The result is an additional savings layer that adds unnecessary complication; as currently constructed, NEST is not required, albeit that its objectives are laudable.[166]

Given that the ISA is as good a product as any to encourage first-time savers, perhaps future NEST costs could be redirected to subsidising the operational cost of the private sector offering an auto-enrolled, low-cost ISA, for example? The private sector should not be required to expend capital on low or nil margin activity, but currently the state ends up paying the bill for many of those who do not save, via means-tested benefits.[167] Consequently, the state has a vested interest in "sponsoring" the first few thousand pounds of savings. Perhaps the £600 million being spent on NEST's systems would be better deployed as an incentive for people to develop a savings habit, perhaps focused on the young (see Section 2.8 concerning the merits of starting to save early).

11.9 Risk sharing as an alternative to advice

The Retail Distribution Review (RDR) will lead to a reduction in the availability of (affordable) advice. One response from the industry could be to offer advice-free funds that incorporate risk-sharing (or smoothing) features[168] to compensate for the lack of advice (see Section 4.8). Such funds, effectively rejuvenated With Profits funds, albeit under a different (untarnished) brand, would help shield the individual from some of the vagaries of financial markets (including timing risk).

Alternatively, should the Government step into the breach and encourage (i.e. "sponsor") participation in an advice-free default fund that includes a broad range of asset classes, including internationally diversified equities? Could this be an extension of the National Savings brand which, in time, could become our sovereign wealth fund?

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[164] This is, admittedly, idealistic but it would help further align management and workforce pension scheme objectives.

[165] 4% from the employee with 1% tax relief, and a minimum 3% from the employer (band-earnings based).

[166] As further discussed in *Don't let this crisis go to waste*, CPS, September 2009.

[167] An issue largely addressed if the basic State Pension were increased to a level at or above the means-testing threshold.

[168] One purpose of advice is to mitigate risk; risk-sharing, as an alternative, partly achieves this.

Crucially, the costs of any such scheme should be borne by the state (capable of harnessing huge economies of scale) so that savers fully benefit from the power of compounding. Administration and fund management should be contracted out to the private sector, but there would, of course, be some governance issues to address.

11.10 Simplification is the key

These proposals are intended to make it easier to save, particularly for the long term. Simplification is a recurring theme in this paper, and the Government could encourage widespread standardisation of retirement product benefits (perhaps by setting some benchmarks to which to aspire). Furthermore, it could greatly help by not commingling incentives for pension saving (and some aspects of the State Pension) with unrelated objectives, notably wealth redistribution. Ideally, that should be confined to the income tax framework.

CONCLUSION

We would save more, for the long term, if it were simple to do so. But the complexity of today's retirement savings products, their incompatibility, lack of pre-retirement access and post-retirement inflexibility encourage procrastination. Savers want certainty, and simple, trusted products. The former (in the form of annuities and final salary pensions) is increasingly expensive, but the latter is achievable, provided that policy makers respond to how people behave in practice, and acknowledge the success of ISAs.

Essentially, what is proposed is a closer collaboration between what are currently two distinct savings worlds: pensions and ISAs. This would enable savers' lifetime saving needs to be met from a single platform, with improved access to (long-term) savings whilst retaining tax incentives on contributions. A new savings product is not being advocated; savers are already confused by the current breadth of choice.

There is another problem. Changing people's attitudes towards long-term saving cannot be shoehorned into a one-off, big bang initiative. It is likely to require a generation to achieve the necessary cultural adjustment, involving repetitive, clear and concise communication and minimal policy interventions.

In the meantime, successive governments will need to retain the trust of the people. Savers are increasingly fearful that such is the state of the deficit, a government some day may have to introduce changes to the ISA or pension savings tax framework that effectively withdraw what is perceived (rightly or wrongly) to be a past promise. Consequently, any tax-related changes should only be related to future savings.

The vision of a single, unified tax framework for ISAs and pension savings products should be pursued. Many proposals for change flounder on transition difficulties (i.e. accommodating the legacy framework of what is in place today); this should not deter us. We cannot undo the past, so it is inevitable that to achieve long term simplification we will have to endure a period of increased complexity as the legacy and new worlds co-exist. The reward could be a "win-win", the resultant simplification attracting more long term saving, with a reduced tax relief cost to the Treasury.

Indeed, a leap of (political) faith may be required, not least because the word "pension", increasingly accompanied by false expectations, may eventually disappear from the savings language, perhaps replaced by "lifetime saving". "Pension" comes from late Middle English, meaning "payment, tax or *regular sum paid to retain allegiance*"; this perhaps alludes to the political challenge. Hopefully, implementation of these proposals, or variants thereof, would not be imperceptibly slow merely to be politically palatable.

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APPENDIX I

Summary of proposals from *Don't let this crisis go to waste: a simple and affordable way of increasing retirement income*[169]

1. **The State Pension should be substantially increased ten years after the State Pension Age (SPA)** to coincide with the onset of "senior citizenship". This increase should be large enough to lift all eligible pensioners above the Guarantee Credit limit (thereby reducing means-tested benefit payments) and out of poverty.

2. **State Second Pension (S2P) accruals should cease** (with accrued rights preserved). In time, S2P would disappear (a huge simplification step) although National Insurance contributions (NICs) would continue to be paid. S2P and S2P NIC cashflows would be re-engineered to help finance the additional cost of the larger State Pension for senior citizens. Financing is also assisted by more people contributing full rate NICs (contracting out having ended).

3. **The NEST contributions should be increased to 7% of *gross* earnings** (3% employee with a 1% tax credit, and 3% employer). The NEST currently is based upon 8% of NI *band* earnings, an unnecessary complication and meaningless to most people. The employee tax rebate rate would therefore be 25% for everyone, irrespective of their marginal rate of tax: "pay £3 and get £1 free". This would provide a significant incentive for 20% taxpayers to contribute more than the 3% minimum.

4. **The NEST contributions of the low paid should be enhanced by the state,** perhaps up to 3% of median earnings (c. £750 per year). Their asset pools would then be likely to produce a post-SPA income that would materially help them to be self-reliant in later life, rather than falling back on the state for Pension Credit.

5. **Savers should be free to bequeath their unused NEST assets to third parties free of any inheritance tax liability**, provided that the assets go into a retirement savings scheme. This would encourage a cascading of wealth down the generations and reinforce the sense of personal ownership of NEST assets.

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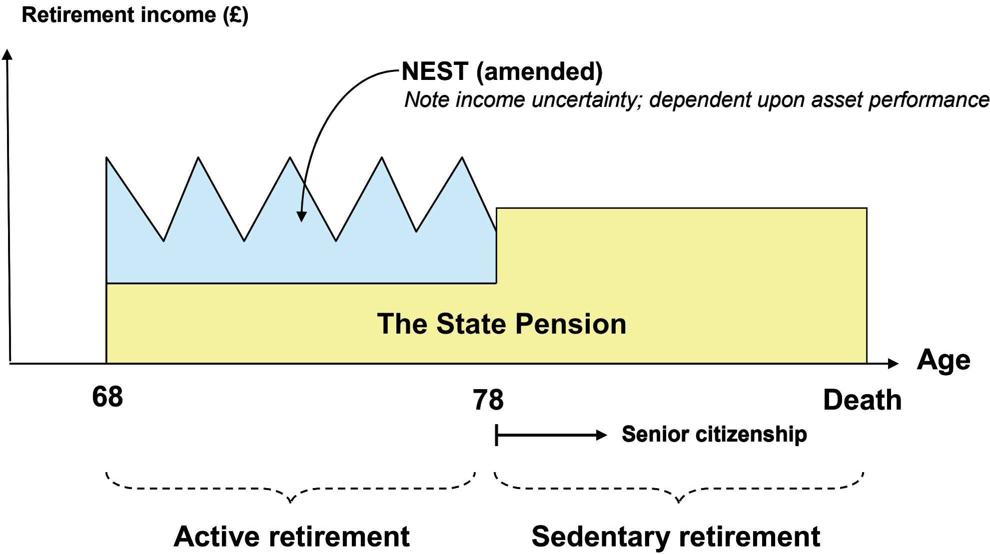
169 Michael Johnson, Centre for Policy Studies, September 2009.

Confident that the state would sustain them in their later years, care of the increased State Pension, NEST savers would then be free to concentrate their NEST-derived income on ten years of active retirement immediately following the SPA, rather than having to stretch it out until they die, via a compulsory annuity (which penalises those with shorter life expectancy, often the less well-off).



6. **Unfunded public sector pensions should be cashflow self-sufficient.** Currently the Treasury has an open-ended exposure to the shortfall between pensions in payment (and retirement lump sums) and contributions; an insignificant £200 million in 2005-06, a frightening £4.6 billion expected for 2010-11, a 23-fold increase. Worse, this gap will widen with the coincidence of the recruitment bulge (up 16% since 1997) entering retirement (i.e. more pensions) and likely, future, workforce reductions (fewer contributions).

7. **All public sector employees with unfunded pension schemes should be compelled to pay at least 3% of gross earnings into a NEST (contributions to unfunded schemes could be reduced pro rata),** with employers' contributions determined by negotiation (set against the backdrop of their being required to achieve pensions self-sufficiency).

8. **More clarity about future public sector pension liabilities.** There should be a new chapter in the Budget Report which includes forecasts of future public sector pensions in payment and a description of how they will be financed.

APPENDIX II

Value of assets in private pension funds and public pension reserves as % of GDP, 2007

	Private pension funds	Public pension reserves	Total
Netherlands	138.1		138.1
Iceland	134.0		134.0
Switzerland	119.2		119.2
Australia	105.4	4.9	110.3
United States	76.7	16.6	93.3
United Kingdom	78.9		78.9
Finland	71.0		71.0
Canada	55.3	7.9	63.2
Ireland	46.6	11.5	58.1
Japan	20.0	26.2	46.2
Sweden	8.7	31.7	40.4
Denmark	32.4	0.3	32.7
Korea	3.1	23.9	27.0
New Zealand	11.1	7.8	18.9
Portugal (2006)	13.7	4.3	18.0
Mexico (2006)	12.1	0.9	13.0
Poland	12.2	0.3	12.5
Norway (2006)*	7.0	5.2	12.2
Spain	7.5	4.5	12.0
Hungary	10.9		10.9
Austria	4.8		4.8
Czech Republic	4.7		4.7
Slovak Republic	4.2		4.2
Germany	4.1		4.1
Belgium	4.0		4.0
Italy	3.3		3.3
France	1.1	1.9	3.0
Turkey	1.2		1.2
Luxembourg	1.0		1.0
Greece	0.0		0.0
Total OECD	**74.5**	**14.5**	**89.0**
Unweighted average	33.1	9.9	43.0

** Excluding the Oil Fund*

Source: OECD, *Pensions at a Glance 2009: Retirement-Income Systems in OECD.* Last updated 10 August 2009.

APPENDIX III

ANNUITIES

There is a wide range of annuities for savers to choose from, including:

(i) Traditional (or conventional) annuities; single or joint life (the latter with a choice of annuity incomes to be paid to the survivor), with or without RPI escalation, fixed rate escalation, annuities with different income frequencies (which can be paid in advance or arrears), and postcode annuities (priced to reflect people living in a particular location in the UK);

(ii) investment-linked annuities; including with-profits and flexible annuities;

(iii) deferred annuities;

(iv) limited period (temporary)annuities;

(v) enhanced annuities;

(vi) “third way” annuities;

(vii) income drawdown with guarantees; including variable annuities and fixed term annuities; and

(viii) impaired life annuities (for people with shorter life expectancies, including smokers, the overweight and certain occupations).

As if this is not confusing enough, the tax treatment of an annuity partly depends upon the source of the cash with which it was purchased.

(i) Pension annuities are bought from the capital accumulated in approved pension funds; they are taxed as earned income at the recipients’ marginal rate.

(ii) Income derived from a purchased life annuity (PLA), bought with a tax free lump sum, is treated partially as a return of capital (the capital element, tax free) and partially as "interest" returned on the investment (the income element, taxed as earned income). The amount of the capital element varies,

depending upon age at the time that the annuity was purchased; it is (approximately) equal to the original capital sum divided by life expectancy at that time. The proportion of income subject to tax under a PLA therefore depends on the annuitant's age at purchase.

(iii) Whilst not "an annuity", income derived from capital held in an ISA is tax-free because the original contributions to the ISA were made from post-tax income. For example, the ISA could be invested in a corporate bond fund yielding (tax-free) income of 4% per annum.

APPENDIX IV

TAX RELIEF MECHANICS[170]

Tax relief for pension saving is delivered in one of three different ways.

1. Tax relief at source

Relief at source typically applies to contributions made to personal pensions. The saver contributes £80 into his personal pension, which then receives basic rate of income tax (£20) from HMRC, so £100 ends up in the pension pot. Higher rate taxpayers then claims £20 via their Self Assessment tax return (or through a PAYE coding adjustment), so the net cost is £80 - £20 = £60.

2. Relief through net pay arrangements, via the payroll

Employee contributions to occupational pension schemes are normally given tax relief via net pay arrangements. The employer deducts an employee's pension contributions from their income before operating Pay As You Earn (PAYE) to collect income tax. This means that PAYE is operated on their net pay. This automatically delivers tax relief at an individual's marginal rate of tax.

3. Via a claim on the tax return

Some pension contributions are not tax-relieved at all on payment. The saver pays the full amount of their pension contribution from taxed income and claims back the tax relief from HMRC. Thus a saver making a £100 contribution into an AVC scheme from post-tax income would subsequently claim back £20 (basic rate taxpayer) or £40 (higher rate taxpayer) from HMRC, for a net cost of £80 or £60, respectively.

[170] HMT & HMRC: *Implementing the restriction of pensions tax relief,* December 2009.

APPENDIX V

PRE-RETIREMENT ACCESS TO PENSION SAVINGS: ILLUSTRATION OF AN ESCALATOR

Assuming a saver is permitted to withdraw up to 25% of his pension savings' prevailing asset value of £X, the next £X of contributions would then not be eligible for upfront tax relief. The saver's ability to make tax-free withdrawals is "restacked" by subsequent asset growth and contributions.

Consider an example with a five year withdrawal interval:

(R-15 = Retirement age less 15 years, etc)

Age	R-15		R-10		R-5		Retirement
Asset value	£200		£260		£200		£300
25% of asset value	£50		£65		£50		£75
Less cumulative *actual* withdrawal	£0		£20		£45		£45
Maximum permitted withdrawal	£50		£45		£5		£30
Actual withdrawal	£20		£25		£0		£30
Post-withdrawal asset balance	£180		£235		£200		£270
Interim asset growth		£50		-£55		£60	
Gross contributions		£30		£20		£40	
of which, tax relief on		*£10*		*£0*		*£35*	
Tax relief overhang*		£0		£5		£0	

* The tax relief overhang is to prevent withdrawals being round tripped into new contributions on which relief is gained. If there are no subsequent contributions, any overhang becomes irrelevant.

This structure does not address the risk of asset prices falling in a period to the extent that cumulative withdrawals then exceed 25% of the asset value. This is only an issue at retirement; if so, the post-retirement lock-in amount could be increased by the shortfall.

APPENDIX VI

VALUING DB (FINAL SALARY) PENSION ACCRUALS[171]

The introduction of an annual contributions limit to pension savings would require a methodology for valuing DB (final salary) accruals. One approach is as follows:

- ignore DB accruals to-date, which would only be permitted to increase at a maximum rate of, say, RPI plus 2% (or simply RPI);
- base all future DB accruals on career average salary, with an obligatory transformation of final salary schemes onto this basis, going forward;
- value the accrual limit on a simple factor of 20 (as is done for today's lifetime limit), so that in any given year the accrual would be valued as 20/60ths multiplied by pensionable salary (assuming a 1/60th basis of pensionable salary);
- pensionable salary should be capped at £105,000 so that future DB accrual at this level is valued at £35,000 (i.e. 20/60 of £105,000, with a 1/60th scheme); and
- if the accrual rate is higher than 1/60th, the salary cap should be reduced so that the maximum accrual remains at £35,000.

[171] Provided by Brian Wilson of Hewitt Associates.

APPENDIX VII

FINANCIAL PLANNING TOOLS: A VISION OF THE FUTURE[172]

Mr Andrews is a family man in his early 40s, earning around £45,000 per year. Over the last few years he has begun to take more interest in his provision for retirement, and set his aspiration at having a retirement income of at least £20,000 a year (after tax) available at age 67 if, as planned, he stops full-time work at that point.

His company operates a group retirement savings plan, and he has been enrolled in that for the last five years. The company's savings and retirement website planner show him that the contributions his company make to the group pension scheme should accumulate to a pot of around £120,000 by his retirement date, providing an annuity of around £7,700 a year on top of his basic State Pension.

He has also contributed to the group scheme (as required to qualify for the employer's contribution), but he chose to put his contribution of £2,000 a year into a group ISA provided by his employer. He chose this option rather than the pension scheme because he preferred to have the flexibility to access his savings if required, and was aware that the income he would already have in retirement from his pension fund and the State Pension would exceed his personal allowance (so that any further pension fund income would be taxed at the standard rate). The financial planner website showed this could accumulate an ISA fund of a further £100,000 by age 67, which could yield an income of £4,000 free of tax in retirement.

In addition he had received an inheritance from his grandparents' estate of £80,000. He had fed this into his ISA account over a period of three years to add to his retirement fund. The planner showed that to reach his target he should save an additional £1,000 to £1,500 a year into his ISA, and he had asked his employer to deduct an extra £100 per month from his salary for this purpose. He was reassured in doing this that if he needed

[172] With thanks to Lord Blackwell.

to draw on this money to help fund his children through university he would be able to draw on it without penalty, and make it up again later.

He looked at his employer's financial planning website regularly to check that he was on course and found it reassuring to know he was building up the savings he needed. He felt in control and no longer worried about whether he was doing the right thing.

APPENDIX VIII

THE MODEL[173]

- The model projects 35 years of consistent savings history (2008 to 2042) for each taxpayer group (basic, higher and additional), except for TEE calculations, in which case it runs to 2064.
- The model shows all results in 2007 price terms and therefore assumes no real increase in salaries, i.e. wage inflation is 0%.
- RPI of 2.5 % p.a., used to establish the gross return on assets, and then the net return to different classes of taxpayer.
- Employee and employer contributions, overall, are split roughly 36%:65% of the total, respectively. More specifically:
  - 50% employee/50% employer for basic rate taxpayers;
  - 35% employee/65% employer for current 40% taxpayers (excluding future 50% taxpayers); and
  - 20% employee/80% employer for future 50% taxpayers.
- Pensioner support ratio (earning workers to pensioners) assumed constant; the retreating State Pension Age roughly achieves this.
- Contributions:
  - The distribution of contributions across the income spectrum is per an industry assessment of pension saving.
  - Made from gross income with 20% basic rate relief going into the pension pot and any additional tax relief being reclaimed via the tax return (and not going into the pot).

[173] Built by Brian Wilson, with assistance from Peter Williams, both of Hewitt Associates.

    - Increased 1% p.a. for 20% taxpayers, 2% p.a. for 40% taxpayers (from age 36) and 3% p.a. for future 50% taxpayers (from age 41). This approaches is intended to represent expected wage increases by age as individuals move up pay scales and obtain promotion.
    - When an annual contributions limit is applied, all base case contributions in excess of the limit are cut back to the limit, there being no other behavioural change in respect of contributions.
- Assets:
    - 2007 base case pension wealth of £1.955 trillion distributed as 35%, 45% and 20% of the total for basic rate, higher rate and additional rate taxpayers, respectively.
    - Portfolio composition; UK equities 26%, overseas equities 30%, UK fixed interest 26%, property 7%, overseas fixed interest 4%, cash 7% (as per PPI Pension Facts, Table 24, December 2008).
    - Return: four long-term equity return scenarios; -2%, 0%, 2% and 3.5% p.a., then adjusted to reflect the portfolio composition. The model assumes constant annual rates of return which are, of course, not reflected in the real world year by year.
- 25% tax-free lump sum taken at SPA.
- 2% p.a. gross rate of return on UK Gilts/bonds; used for annuity rates when converting a fund into a pension.
- Taxation:
    - Accruals are split 50:50 between income and capital gains. In respect of the latter, a (notional) CGT loss to the Treasury of 18% is applied to 0%, 15% and 30% of capital gains in respect of basic rate, higher rate and additional rate taxpayers, respectively.
    - Pensions in payment average income tax rate of 17% (on income above the basic State Pension), as per Note 4, HMRC Table 7.9.

A comment concerning HMRC's Table 7.9

HMRC's Table 7.9 provides the model's starting point for tax relief and income tax from pensions in payment. It show figures going back to 1998-99 and the methodology for deriving the table appears not to have changed. But it should have done, because after A Day in 2006 the tax regime changed from FURBS/UURBS (FURBS = Funded Unapproved Retirement Benefits Scheme; UURBS = Unfunded Unapproved …) to EFRBS (Employer Financed …). It is assumed that continuing to use what is now a defunct methodology has not had a material impact on post-2006 data.

GLOSSARY

Term	Definition
Alternatively Secured Pension (ASP)	The ASP was introduced on A-day (April 2006), with changes in the Finance Act 2007, as an alternative to the more traditional annuity purchase. Essentially: • at 75, if the saver elects for an ASP to take income from his asset pot, he can take between 55% and 90% (reviewed annually) of the GAD Rate, currently 4%; • if the minimum income is not taken in a pension year, the balance between the minimum income and the income taken is taxed at 40%; • if the saver dies pre-75, the estate (or widow) receives 65% of the assets after paying 35% tax; and • if saver dies at 75 or later, the estate may have to pay 82% tax on the residual ASP funds, unless the ASP is gifted to charity (then no tax). o Residual ASP funds are first subject to IHT at 40%. The remaining 60% is then subject to a further 70% tax, as: ▪ a 40% unauthorised payment charge; ▪ a 15% unauthorised payments surcharge; and ▪ a 15% scheme sanction charge. o This leaves 18p; an 82% tax rate.
Band earnings	In respect of contributions to NEST, this refers to National Insurance band earnings between the Primary Threshold and the Upper Earnings Limit (£5,720 and £43,888, respectively, for 2009/10).
Basic State Pension (BSP)	The basic (or "old age") State Pension is a government-administered flat-rate pension based on the number of qualifying years gained through National Insurance contributions (NICs), paid throughout working life. It is a basic flat-rate pension funded on a pay-as-you-go basis, which aims to provide a pension of approximately 20% of national average earnings. The BSP is increased each year in line with the Retail Prices Index (RPI). The Pensions Act 2007 restores it to being indexed to earnings, by the end of the next Parliament at the latest (in 2015). To receive the full basic State Pension, men and women need 44 and 39 qualifying years, respectively. After 6 April 2010, this reduces to 30 qualifying years for men and woman. For 2009-2010, the weekly full basic State Pension is £95.25 (singles) and £152.30 (couples).

Cash ISA	Cash ISAs can be invested in National Savings, Cash Unit Trusts, UK and European bank deposits and building society deposits. Up to £3,600 can be invested in a Cash ISA (2009-10 tax year; £5,100 for the over-50's), and £5,100 for those aged 16 and over from April 6th 2010.
Collective Investment Scheme (CIS)	A CIS is an arrangement that enables a number of investors to 'pool' their assets and have these professionally managed by an independent manager. Investments may typically include gilts, bonds and quoted equities but, depending, on the type of scheme may go wider. For example some investments may be in unquoted investments or property. Investors in such schemes are able to reduce risk by spreading their investments more widely than may have been possible if they were investing in the assets directly. The reduction in risk is achieved because the wide range of investments in a collective investment scheme reduces the effect that any one investment can have on the overall performance of the portfolio.
Defined Benefit (DB) occupational pension schemes	DB, or final salary, pension schemes entitle employee members to pension benefits defined by a formula linked to their length of pensionable service and salary when they leave the scheme. Employees are typically provided with 1/60 of final salary for each year of service up to a maximum of 40/60, i.e. two thirds of final salary. At retirement a tax-free lump sum may be taken at the expense of a reduced pension. DB pension promises are unrelated to the contributions made to the underlying fund. Many schemes now face large deficits as liabilities (due to such factors as increased longevity) have outgrown the funds' assets. Consequently, many sponsors, struggling to meet their statutory funding requirement and deterred by the increase in company accounts volatility (care of accounting standard FRS 17), are closing their DB schemes in favour of (less costly) DC schemes.
Defined Contribution (DC) occupational pension schemes	DC, or money-purchase, schemes are pension schemes into which an employer pays a regular contribution, fixed as an amount or percentage of the employee's pay. The employee may also make contributions into the scheme. Contributions are invested to provide employee retirement benefits, with investment risk and investment rewards assumed by each employee/retiree, and not by the sponsor/employer. Employers increasingly favour DC schemes over DB schemes because they cost less to run and result in a predictable cash outflow. The "cost" of a DC scheme is readily calculated, but the benefits are dependent upon the amount of contributions and investment performance. Consequently, participants bear the risk of outliving their assets. This risk can be mitigated by using accumulated savings to purchase an annuity upon retirement (a legal requirement before reaching 75), to provide a regular income until death. Although DC scheme participants typically have control over investment decisions, the sponsor retains a significant degree of fiduciary responsibility over investment of plan assets, including the selection of investment options and administrative providers.
Guarantee Credit	This guarantees anyone over 60 an income of at least £130 per week if single, £198.45 for couples. Thus, a single person with weekly income of £90 would receive Guarantee Credit of £40. "Income" is defined as including basic State Pension and State Second Pension payments, some state benefits, private

	pensions and earnings, but excludes Disability Living Allowance, child tax credit, child benefit, etc. Guarantee Credit is up-rated in line with earnings.
Higher rate tax (HRT)	Higher rate taxpayers are those who pay tax at 40%, i.e. excluding the much smaller population of additional rate taxpayers (50%).
Independent Savings Account (ISA)	An ISA is a tax efficient savings and investment product that was introduced by the Government back in April 1999 to replace Personal Equity Plans (PEPs) and Tax Exempt Special Savings Accounts (TESSAs). An ISA can be made up of one or two components, a “Cash” ISA component and a “Stocks & Shares” ISA component. From April 2010 the annual contributions limit will be £10,200. Funds can be withdrawn from an ISA at any time and any such amounts are not subject to Capital Gains Tax (CGT). Any interest or interest distributions from investments and accounts in an ISA are tax free.
Maximum Investment Plan (MIP)	The Maximum Investment Plan is a tax-efficient savings plan with embedded live cover, requiring regular payments for at least 10 years. Its performance is related to funds of the investor’s choosing, and it provides a lump sum at the end of the savings term free of any personal liability to tax. The contract can be extended beyond the ten years by continuing to invest contributions, whilst taking flexible, regular, tax-free income. The assets are subject to life assurance company taxation, which will affect the investment growth achieved.
National Insurance Contributions (NICs)	NICs, collected through the pay-as-you-earn (PAYE) income tax collection system, are paid into the National Insurance Fund (NIF) by most employers, employees, self-employed, and some unemployed people. The amount paid depends upon earnings and employment and marital status. NICs, via the NIF, finance a range of benefits, including state pensions (but not the means-tested pension credit), incapacity benefit, widows’ benefits, maternity allowance, guardian’s allowance, jobseeker’s allowance and the Christmas bonus. Part of the contributions is not paid into the NIF but goes towards the cost of the National Health Service.
NEST (National Employment Savings Trust)	NEST, formerly the Personal Account, is intended to encourage employees without access to work-based pension schemes to save for retirement; the target audience is clearly the low paid and those in intermittent work. There will be auto enrolment but workers will be able to opt-out if they choose not to participate, i.e. “soft” compulsion. Employees will pay contributions of 4% on their National Insurance band earnings, with employers required to contribute 3%, plus roughly 1% from the Government through normal tax relief. Contributions are limited to £3,600 per year (based on 2005 earning levels), up-rated by earnings year on year. There will be a choice of investment funds, including social, environmental and ethical investments, as well as branded funds, as well as a (lifestyle smoothing) default fund for those not wishing to make an investment choice. The maximum administration charge likely to be capped at 0.3% of the fund under management. There has been much debate around this issue, not least because the low take-up of Stakeholder pensions is partly blamed on the lack of incentive for the financial services industry to push the product. When savers reach the State Pension Age they are required to purchase a lifetime

	annuity with their account proceeds, having assumed the investment risk in the interim, (akin to a defined contribution ("DC"), or money purchase, scheme). There is a general ban on transferring rights into and out of the scheme. NEST will be regulated in much the same way as existing trust-based DC schemes.
Primary Threshold	Also referred to as the "earnings threshold", an amount set each year by the government which triggers liability for an employee and his or her employer to pay National Insurance contributions (NICs). In the tax year 2009/10, the Primary Threshold is set at £110 per week (£5,720 p.a.).
Retail Distribution Review (RDR)	The RDR was launched by the FSA in June 2006 to address persistent problems in the retail investment market, notably insufficient consumer trust and confidence in the products and services supplied by the market. The FSA is seeking to go beyond simply treating the symptoms of the problems and address the root causes. The RDR is intended to modernise the industry. In Consultation Period (CP)09/18 the FSA set out the changes that it is proposing, notably to: • improve the clarity with which firms describe their services to consumers; • address the potential for adviser remuneration to distort consumer outcomes; • increase the professional standards of investment advisers. In December 2009 the FSA published CP09/31, "Delivering the Retail Distribution Review: Professionalism; Corporate pensions; and Applicability of RDR proposals to pure protection advice". This consultation is open until 16 March 2010.
Savings Credit	Savings Credit is intended to reward people who have saved for their retirement. Entitlement to Savings Credit requires a single person to have weekly income of between £96.00 and £181.00 (£153.40 and £266.00 for couples). Pensioners over 65 receive a credit of 60p for each £1 derived from a source other than the State Pension. Savings Credit is limited to £20.40 per week, determined as 60p x (the Guarantee Credit ceiling of £130.00 - £96.00) for singles, £27.03 for couples. Beyond this, and Savings Credit is withdrawn at the rate of 40p in the £1. Thus when income reaches £181.00 no Savings Credit is payable (calculated as £130.00 + £20.40 / 0.4).
State Pension Age (SPA)	The State Pension Age (SPA) is 65 for men and 60 for women. However, the SPA for women is changing; it will gradually rise from 60 to 65 from 2010 to 2020. The SPA for both men and women is to increase from 65 to 68 between 2024 and 2046, with each change phased in over two consecutive years in each decade. The first increase, from 65 to 66, will be phased in between April 2024 and April 2026; the second, from 66 to 67, will be phased in between April 2034 and April 2036; and the third, from 67 to 68, between April 2044 and April 2046.
State Second Pension[174] (S2P)	S2P is the successor to SERPS and was effective from 6 April 2002. It is based on an earnings-related system similar to SERPS but with different accrual rates. As well as providing an additional state pension for the employed, S2P for the first time gives an additional state pension based on earnings of £13,900 (2009/10) to:

[174] As explained by Scottish Life.

- those with earnings above £4,940 but below £13,900;
- carers with no earnings or earnings below £4,940 for any year that they:
  - receive child benefit for a child under six, or
  - are looking after an ill or disabled person in circumstances which qualify for Home Responsibilities Protection, or
  - have an entitlement to Invalid Care Allowance (even if the benefit is not claimed because of entitlement to another greater benefit); and
- those who are entitled to long-term incapacity benefit or severe disablement allowance, provided that they have worked for and paid Class 1 NI contributions for at least one tenth of their working life since 6 April 1978.

S2P is not available to those earning less than £4,940, the unemployed, students, those caring for children older than six and the self-employed.

Accrual rates

Initially there were three S2P bands of accrual to ensure that the principle aim of government was met (that low and non-earners received a greater benefit from S2P than its predecessor, SERPS).

The bands based on the 2009/10 tax year are as follows:

- **Band 1**: covers earnings from the Lower Earnings Limit LEL, £4,940) up to the Low Earnings Threshold (LET, £13,900). Benefit accrues at a rate of 40% (twice what SERPS provided). As previously mentioned those earning less than the LET are treated as though they had earned the LET.
- **Band 2**: earnings between the LET (£13,900) and the Secondary Earnings Threshold (SET, £31,800). The accrual rate is 10% for earnings within this band (half what SERPS provided).
- **Band 3**: covers earnings from the SET (£31,800) to the Upper Accrual Point (UAP) (£40,040). Benefit in this band accrues at 20% (the same as SERPS).

Note - The LET is announced each year by Government in the same way that the LEL and UEL are. The SET is calculated separately using these figures and is the sum of (3 times the LET) less (2 times the LEL rounded to the nearest £100 rounding down any exact sum of £50).

These bands apply to everyone with a SPA on or after 6 April 2009. Individuals reaching SPA before 6 April 2009 had enhanced accrual (as previously mentioned) under SERPS. These transitional arrangements were extended to S2P by increasing the accrual rate in each band. An additional 1%, 0.25% and 0.5% of earnings is added to each band respectively for each year that SPA is earlier than 6 April 2009.

So, if your SPA is before 6 April 2009 you will not receive less under S2P than you would have done under SERPS.

Pensions Act 2007 and National Insurance Contributions Act 2008 changes

The Pensions Act 2007 put in place legislation to reform the State Second Pension so that it would become a flat-rate top-up to the Basic State Pension by 2030. The National Insurance Act brought these reforms forward and a decision was made to start these changes in 2009 when the UAP was established. The upper accrual point will be cash fixed from the point it is introduced. This will mean that from 6 April 2009 employers and employees with occupational pension schemes contracted-out of

	State Second Pension will receive contracted-out rebates on earnings between the lower earnings limit and the upper accrual point. Employers and employees will pay National Insurance contributions at 12.8% and 11% respectively on earnings between the upper accrual point and upper earnings limit (UEL). The UEL is £43,888 for the 2009/10 tax year. Starting in 2010, band 2 (10% band) and band 3 (20% band) will be merged so that all earnings between the LET and the UAP will accrue additional pension at a rate of 10%. From an unspecified future date, the band 1 (40% band) will be replaced by a weekly flat-rate accrual of £1.50 (£78 p.a.). The 10% accrual component will be withdrawn around 2030, leaving a wholly flat-rate benefit. Also in 2010, National Insurance credits will be introduced for those with long-term disabilities and people with caring responsibilities so that they can build up some additional pension entitlement.
Stocks & Shares ISA	The Stocks & Shares component of an ISA can be invested in shares listed on any recognized stock exchange, Bonds & Gilts, Unit Trusts, Investment Unit Trusts and Life Assurance. Up to £7,200 can be invested in a Stocks & Shares ISA (2009-10 tax year, £10,200 for the over-50's) less any amount saved in a Cash ISA. This limit rises to £10,200 for anyone aged 18 and over from April 6th 2010 (again less any amount saved in a Cash ISA).
Tax relief	The cost of tax relief on registered funded pension schemes can be thought of as the tax that would have been paid were the schemes not registered. It has several components: (i) the front-end relief on employee and self-employed contributions; (ii) plus contributions by employers on the basis that they are not taxed as a benefit-in-kind for the employee; (iii) plus employees' part of the National Insurance rebate to registered personal pensions (including stakeholders); (iv) plus funds' investment income; and (v) less tax liabilities on pensions in payment in the year in question. In addition there is the cost of relief for unfunded schemes, notably the tax relief on lump sum payments to, for example, civil servants. Revenue-based Taxes and Benefits: Pensions - Personal and Stakeholder Pensions, 30 September 2009
Upper Earnings Limit (UEL)	The UEL is an amount set by the government each year for the purposes of calculating National Insurance contributions (NICs) payable by employers and employees. In the tax year 2009/10, the UEL is set at £844 a week (£43,888 p.a.). An employee must pay NICs at rate of 11% of earnings between the Primary Threshold and the UEL, plus 1% of earnings above the UEL. His or her employer must pay NICs at rate of 12.8% of the employee's earnings above the primary threshold. Note that from April 2009 the Upper Accrual Point (UAP) replaces the UEL for the purpose of calculating (and capping) entitlement to S2P. The UAP has been frozen

	in cash terms, i.e. fixed at £770 a week, £40,040 p.a. (the level of the UEL for 2008-09) and it will remain at that level, leading to an erosion of earnings-related S2P accrual. By 2030, S2P will become a flat-rate top-up to the Basic State Pension.
401k plan	401k plans are the American form of stakeholder-type defined contribution retirement savings scheme. They allow earnings to be "deferred" and put into an Individual Retirement Account (IRA) and savings may be drawn down from age 59.5 onwards (or on earlier retirement) and are taxable as income on withdrawal. The plans are open to all companies and the self-employed, but not government bodies. Over 77% of eligible workers participate and 95% of plans involved some form of company contribution. The average 401k participant saves between 5% and 7% of pre-tax salary. The key features of 401k schemes are: • Draw down is allowed from age 59.5 or upon retirement if earlier. There are no limits on the rate of drawdown but by age 70.5 an annuity must be taken or a percentage of funds (based on life expectancy) must be withdrawn each year. 10% penalties are applied to withdrawals before 59.5. • Company contributions at the discretion of the employer but are limited to $15,000 (2006). Employers offer 401k plans as a way of attracting employees. • The over 50's may make additional catch up contributions of $5,000 p.a. (pre-tax) and can make additional contributions on an after-tax basis. • Pre-tax contributions are taxed on withdrawal. • Equality amongst executives and other staff. If executives want good schemes for themselves, they have to offer similar terms to all employees. For example, executives' contributions cannot be more that 2% above the average percentage contribution of low paid workers. • Most schemes are set up on the basis that employees can choose from a selection of mutual funds. The trustees determine investment strategy in respect of schemes set up under trustee arrangements. • If the participant dies before distribution commences, the benefits are distributed to the beneficiary either over a five year period or over the expected lifetime of the beneficiary (depending on the plan rules). The beneficiary pays tax on the withdrawals.

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The UK savings industry is barely trusted and excessively complicated, in part due to the different tax treatment of ISAs and pensions. This matters. We are saving far too little, particularly given the decline in occupational pensions. Fewer savings mean lower growth and more pensioner poverty. But it need not be like this.

This report makes radical recommendations to encourage the growth of a savings culture by bringing ISAs and pensions closer together. An annual contribution limit of £45,000 is proposed for all tax-incentivised saving, along with limited pre-retirement access to pension savings. Auto-enrolment should be extended to include ISAs. Pension assets should be able to be bequeathed free of inheritance tax.

The proposals meet people's desire for more savings flexibility, address gender inequality, restore some intergenerational fairness and could provide the Treasury with an opportunity to make substantial savings in tax relief.

Price £15.00