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DEFINED AMBITION AND THE SINGLE-TIER PENSION: JOINING UP THE DOTS

PENSIONS

The single-tier pension means the end of contracting out. The end of contracting out will lead to a review of pension provision by employers who still offer contracted out defined benefit schemes. Will that review provide an opportunity for the realisation of defined ambition?

The DWP has just published its proposals on the single-tier pension. It is expected that the State second pension (S2P) will be phased out by 2017, along with the basic state pension and a raft of means-tested benefits used to compensate for the inadequacy of the basic state pension.

To many, it can't come too soon. Means-testing of pension benefits is toxic for the savings industry. It also makes auto-enrolment a misselling scandal in waiting. (For more on auto-enrolment click here).

An inevitable simplification linked to the introduction of the single-tier pension will be the end of contracting out. Since the 1960s some form of contracting out has been offered to encourage employers to provide pensions. Contracting out allows employers who provide a pension scheme meeting certain quality standards (currently the defined benefit (DB) reference scheme standard) to pay lower National Insurance contributions. Employees also pay lower National Insurance contributions and do not earn rights under S2P. The employer's pension scheme is treated as an alternative to S2P and the saving to the State in not having to provide S2P is acknowledged through the reduced National Insurance contributions.

In short, the single-tier pension means the end of S2P which means the end of contracting out which means higher National Insurance contributions are to be paid by employers and employees who currently have a contracted out pension scheme. The hike is 3.4 per cent of band earnings for employers and 1.4 per cent of band earnings for employees. All this just as auto-enrolment reaches full implementation with 3 per cent and 5 per cent contributions.

In recognition of the fact that employers have been induced by National Insurance contribution savings to commit to a DB pension scheme meeting the reference scheme standard, the DWP proposes to allow employers to reduce the rate of accrual in their DB pension schemes and to give them a statutory power to do so unilaterally where they would otherwise require the consent of trustees.

So, employers with active DB pension schemes will now have two reasons to review their pension arrangements between now and 2017-18: auto-enrolment and the hike in National Insurance contributions from the end of contracting out.

Some may just reduce the DB offer or even maintain it and accept the additional costs. But a wider review seems at least sensible, particularly if the DB scheme does not cover all employees so that a two-tier workforce issue exists.

In this review, will defined ambition be the winner? It is suggested defined ambition legislation should be accelerated to take advantage of this review opportunity.

The difficulty with defined ambition is that it hasn't yet been defined. The paper Reinvigorating workplace pensions published in November 2012 floated a number of ideas:

- career average;
- cash balance;
- longevity adjustment factors;
- conditional indexation;
- converting to defined contribution (DC) on leaving service;
- discretionary supplements with guaranteed core benefits; and
- linking normal pension age to changes in state pension age.

The very range of ideas makes defined ambition extremely difficult to define. The only thing these ideas have in common is that they carry more guarantees than pure DC and are something less than fully guaranteed final salary with statutory indexation.

Guarantees have a cost which means that on average, for the same spend, they will deliver less than well-managed DC. On the other hand, stability and predictability have a value which some employers and employees will value.

The paper also fails to acknowledge that many of the DB features that it is proposed to remove under defined ambition arise from legislation. What is needed for a scheme where benefits switch to DC on leaving service or indexation is conditional on funding or where normal pension age can rise with state pension age is simply to roll back years of intervention.

Originally, DB schemes had safety valves, in the termination and amendment provisions, in case costs got out of hand. These were disabled.

Actuaries generally designed DB schemes with conditional or discretionary indexation - as is now suggested for defined ambition. Compulsory indexation was imposed by statute. There is hypocrisy in removing most of this on transfer to the Pension Protection Fund (PPF) while condemning pension increase exercises (PIEs) prior to insolvency.

Trustees are being told by the Pensions Regulator that they cannot carry any risk in their investments, regardless of the wide range of their investment discretion and trustee duties, unless the employer can underwrite any downside risk. This follows from the creation of the PPF (a good thing in itself) and statutory guarantees (section 75 of the Pensions Act 1995). The inevitable is that the generous benefits are unaffordable.

DB started out as defined ambition and was often (though not always) described as such. Many employers issued booklets stating that the benefits were not guaranteed (the trust deed included no funding guarantees) but that the employer intended in good faith to fund the pension scheme to ensure the benefits could be paid in full.

What is missing from the DWP's proposals for defined ambition is any acknowledgment of the consequences of rewriting other people's bargains. Defined ambition promises were converted by legislators into unaffordable DB. Why would this not happen again?

Even DC schemes are at risk of being reclassified as DB, and becoming subject to the DB regulatory burdens, by the proposed retrospective change to the definition of "money purchase" in the Pensions Act 2011: a legislative change enacted following the Supreme Court's ruling against the government on what the current definition means.

How can a government earn back the trust of employers? Will employers ever be trusting enough to offer anything more than DC again?

Without far greater clarity on defined ambition and commitments over future legislative change, the future is a single-tier pension, with some DC benefits and ISAs on top.

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