

Adair Turner

Seamus Creedon interviews Lord Turner, chairman of the Pensions Commission.

Seamus Creedon: Future longevity is uncertain, but it is at least possible that factors such as developments in pharmaceuticals and medical techniques will sustain continued accelerating improvement in average life expectancy – what effect would this have on the recommendations of the commission?

Adair Turner: The Pensions Commission has recommended reforms to the state pension system to make it more generous and less means-tested. The inevitable consequence of this will be either an increase in public expenditure on state pensions and/or an increase in the state pension age (SPA). To keep increases in public expenditure within reasonable limits, the commission proposes that the SPA increases broadly in line with increases in life expectancy so that each generation of the population can on average expect to live the same proportion of their lives working and in retirement. If life expectancy goes on rising then this will require further proportionate increases in the state pension age.

The Pensions Commission has recommended that a permanent Pensions Advisory Commission should be established to study long-term trends in life expectancy and advise government on any further increases in SPA.

Average life expectancy is just that, with considerable variation around the average variously attributed to personal habits, to occupation, to social status, and even to geographic latitude. Are the recommendations of the commission unfair to (for example) Scottish workers, as has been alleged?

Statements that lower socio-economic groups have dramatically lower life expectancy and would lose out on a significant proportion of their retirement if the SPA increases are often based on mistaken methodology which takes period estimates of life expectancy at birth and deducts the state pension age from that figure rather than cohort life expectancy at 65. In fact, analysis from the Government Actuary's Department which we published alongside our second report shows that if the SPA was raised to either 67 or 68 in 2050, male workers in all parts of the UK would still be predicted to spend a higher percentage of their adult life in receipt

of state pension than a 65-year-old today.

The Pensions Commission is, however, sympathetic to the argument that raising the SPA could disproportionately affect the lower socio-economic groups who have lower life expectancy. Men in socio-economic class V face life expectancy that is about five years lower than socio-economic class 1. We believe that the long-term aim of government policy must be to narrow this gap rather than treat it as a permanent barrier to raising pension ages. But until such policies are implemented and successful, we suggested two possible areas of flexibility that would help to protect those groups with lower life expectancy. First, the Guarantee Credit could be made available at an earlier age than the basic state pension. Second, it would be possible to set different pension ages for the basic state pension and the second state pension with the basic state pension age rising more slowly. And we propose that the permanent Pensions Advisory Commission, which we mentioned above, should analyse how differences in life expectancy by socio-economic group evolve over time.

An argument can be made that some of the present financial difficulties of defined benefit occupational pension schemes are attributable to exceptionally low real interest rates which have inflated values of liabilities, but which will at some point rise to a more 'normal' level. Is the commission too pessimistic about the future of defined benefit provision?

The fall in real interest rates is only one of a number of causes of the decline in defined benefit pension schemes. As we described in our first report, defined benefit, and in particular final salary schemes, emerged in the 1950s and 1970s in the context of conditions specific to that era: high marginal tax rates and prices and incomes policies. They were introduced at a time when estimates of life expectancy were much lower than today, and when uncertainties in life expectancy estimates were not well understood. They also initially left trustees with significant discretion to vary benefits in line with fund performance. In the 1980s and 1990s, this discretion was removed by statutory requirements for leavers' rights, spouse benefits, and pension indexation, and life expectancy increased significantly; the underlying cost of DB pension provision, and the risks of providing DB pensions, therefore increased, while some of the factors that had driven the growth

of DB pensions schemes disappeared. Only exceptionally high equity market returns made these increases in cost and risk appear acceptable. When irrational exuberance came to an end, the slow retreat from DB became a torrent. Now that employers have realised the risks involved in running DB schemes, a return to 'normal' levels for interest rates may not necessarily improve the future of DB provision.

Some of the debate about pensions, including the views attributed to the Treasury, reflects a tension between pragmatic shorter-term considerations and the longer-term picture. Given all the inevitable uncertainty regarding future economic and demographic conditions, is longer-term pensions stability really feasible at all? Are there any examples of countries which have sustained a stable context for pension provision?

Lack of consensus on pensions in the past has driven a lack of policy continuity which has created what we described in our first report as 'the most complex pensions system in the world'. To ensure future stability it is important that our recommendations be subject to extensive debate which aims to achieve as much consensus as possible on the direction of change. The overall framework of the policy should therefore be maintained as much as possible even though precise policy will have to adapt to reflect changes in the available information on demography, pension provisions, employment, and retirement patterns.

Sweden is one example of a country that has created a reformed pension system which enjoys a large degree of consensus and is designed to be flexible, yet robust in face of change. The US social security system has been a remarkably stable system for 70 years, with changes agreed on a cross-party consensus basis, and announced decades in advance. It is a peculiarly British delusion that simply because we have not achieved continuity in pension policy that is inevitable.

The additional savings expected to be generated as a result of implementation of the commission's recommendations will improve our position only if invested so as to achieve real economic returns – where might the opportunities for such investment be?

It is not for the commission to specify where increase savings should be invested, and our proposed National Pension Savings Scheme

(NPSS) does not entail a group of wise men making savings decisions. Asset allocations should and will be driven by individual choice, between funds provided in a competitive capital market. But there are many opportunities to invest for good return, whether in the UK (increasing GDP) or overseas (increasing GNP).

The commission's recommendation to establish the new NPSS has attracted unsurprising criticism from parts of the financial services industry. How can the recommendation be implemented in such a way as to keep to a minimum duplication of infrastructures and costs?

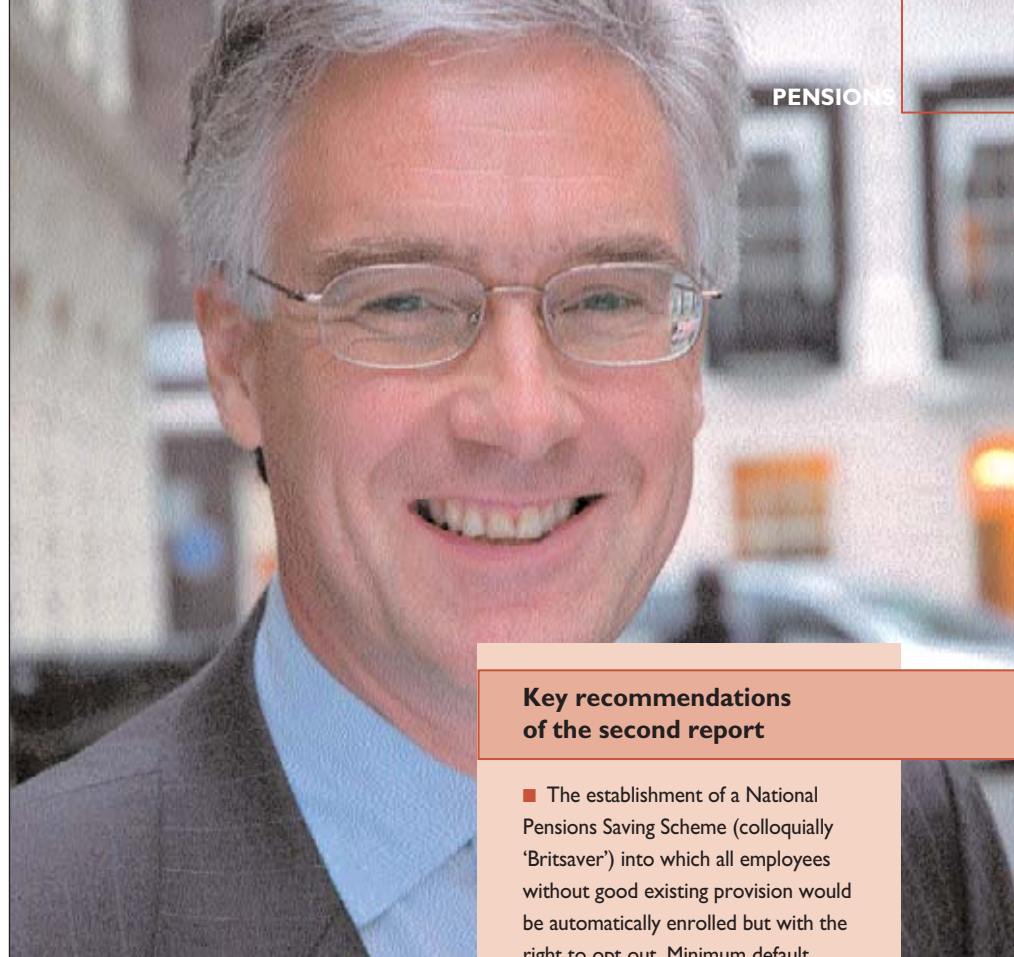
There will need to be a major implementation, planning, and consultation exercise before the NPSS is launched and its implementation would need to be carefully planned out. Where at all possible it should seek to avoid duplication of existing infrastructures and keep costs to a minimum and even if the system is run on a national basis, administration of some functions could be outsourced to make use of existing capabilities.

The model for the NPSS which the Pensions Commission has set out should not be seen as a finalised blueprint. What is important is that we find a way of providing a good value, easy-access savings vehicle for those individuals on low incomes in small businesses who are not served by the current market and that this should be done in the most efficient way possible.

The envisaged costs of the NPSS do not include any allowance for advice. This carries with it the risk that savers in the scheme will react badly to adverse equity market fluctuations. How can consumers be educated both to express their real risk tolerances and to review these in the light of changing circumstances?

The NPSS is designed as a 'no-advice' scheme. At the minimum default rate of 8%, the employee effectively pays a 4% contribution from their net pay which is match by 1% of tax relief and a 3% compulsory employer contribution. Through matching the individual's contributions, the scheme should ensure that the individual will make a return on their own investment.

Individuals will, however, need to make the final decisions on whether to opt out, and on the choice of fund. But these decisions are already faced today by many members of defined contribution occupational schemes,



Key recommendations of the second report

- The establishment of a National Pensions Saving Scheme (colloquially 'Britsaver') into which all employees without good existing provision would be automatically enrolled but with the right to opt out. Minimum default employee contribution rates would be 5% of gross pay above £5,000, of which 1% is effectively paid by tax relief: employers would be required to make matching contributions of 3%. Both employers and employees would be able to make additional voluntary contributions, and the self-employed would be able to join on a voluntary basis. The design of the scheme should aim for low costs, eg 0.3% per year, thus boosting the value of pension saving by up to 30%. The scheme aims to encourage people to save for a pension and to enable them to do so at low cost.

- Reforms to the state system to ensure a sound foundation on which pension saving can build. These involve a gradual move towards a more generous state pension with the state pension age also increasing over the long term. In essence a higher pension at a later age.

- Measures to improve the position of people with interrupted work records and caring responsibilities, who are disadvantaged by the existing contributory system.

- Measures to facilitate later working and flexible retirement for those who want it.

where there is typically no advice provided to people on an individual basis. Individuals will need to be informed of the risks involved in saving through funds in the NPSS and to be regularly informed about the performance of their funds. There will need to be clear descriptions of funds available in the NPSS characterising their different combinations of possible risk and return and annual statements on the performance of funds. Again, however, existing occupational DC schemes provide the model of the sort of information which will need to be made available.

Actuaries and the actuarial profession have played a significant part in the evolutionary history of present pensions arrangements. What does the commission see as the principal challenges facing the profession as its recommendations are implemented? What should actuaries be doing differently in future?

The actuarial profession's core and distinctive expertise lies in its understanding of risks, whether relating to investment returns or to mortality rate assumptions. But too often in the past, actuaries have been seen by their clients as authorities with single-point answers, providing a false sense of certainty. It is vital that actuarial advice continually illustrates the range of different results that are possible, helping public policy and corporate decision-makers to devise appropriate strategies in an inherently uncertain world. □