Institute and Faculty of Actuaries

Intergenerational Commission's call for policy solutions

IFoA response to Intergenerational Commission

15 December 2017

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Institute
and Faculty
of Actuaries

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15 December 2017

Dear Fahmida,

IFoA response to Intergenerational Commission's call for policy solutions

The IFoA welcomes this call for evidence, and the work completed by the Intergenerational Commission over the past year into the subject of intergenerational fairness (IF). The IFoA has long been an advocate for policymaking which considers longer-term time horizons, rather than being constricted by five year electoral cycles. We continue to believe that considerations of IF should be a standard feature of policymaking across all Government departments, and that the impacts of public policy should be assessed across all current generations.

Throughout 2017 we have released a series of three bulletins on IF which have brought together experts from a range of fields to give their view on the issue, from academia and research, charities and think tanks, members of the financial services sector, including actuaries, as well as those in Parliament and those working closely with the Government. What has been made clear from this work is the broad range of issues which touch on IF and the consensus which is emerging around the idea that IF should be taken seriously by policymakers from across a range of disciplines.

Actuaries are experts in understanding financial and demographic risk, and the range of potential long-term impacts of decisions made today. Throughout the Commission's work we have seen much discussion of intergenerational transfers, and indeed the call for evidence identifies 'transfers within families' as a key theme for exploration. However as actuaries we feel that there could be more of a focus on the transfer of *risk* between generations, from within the family, from someone's employer, and from the Government, as this risk transfer is crucial to many of the problems of IF, and should be properly considered.

Through recent changes in pensions and social care (which are our particular focus throughout this response), as well as other areas, the responsibility for shouldering these risks has changed dramatically. Changes to the pensions system have forced individuals to take responsibility for risks associated with longevity and investment. A similar story is true for social care, with individuals generally living much longer in poor health and increasingly having to take responsibility for funding their social care needs. These changes have not been supplemented with adequate levels of financial education, and people are often ill-equipped to take these important decisions. The Government should take a lead role in delivering improvements in financial education through the new single financial guidance body, so that all generations understand the how best to make the decisions they will be expected to make.

Care will also be required to ensure that actions aimed at removing perceived unfairness between generations do not lead to greater unfairness within some generations. No generation is or will be completely homogenous and there needs to be some transfer of risk and value within generations as well as between them.

The UK pension system needs to be affordable in the long term and it is important that no one experiences poverty in retirement, now or in the future. The current Baby Boomer generation is the wealthiest the UK has seen as they approach retirement, but there are serious concerns about how younger generations will fare when they reach older ages. This is particularly the case as the status quo in occupational pensions shifts from DB to DC. The issues here are two-fold: partly that the size of defined contribution provision is typically much smaller and partly, as mentioned, that the risks for members of defined contribution pension arrangements are much bigger.

The number of people with care needs in later life is rising and, worryingly, so is the number of people with unmet care needs. 1.2 million people do not have access to the social care they need – a 48% increase from 2010.[1] This should not be seen as older people creating a 'burden' on health and care services, but a demonstration that the system is inadequate.

It is important that we meet these needs, but that in doing so we do not place an unfair burden on future generations. This could be achieved by introducing policies that mean those who are able to meet some of their care costs do so within a framework that is sustainable in the long term. It may be that we need both immediate solutions designed for current older generations to use their assets without having to sell their home, such as innovation in the pensions and equity release markets, alongside longer-term solutions for the current working age population that have an element of pre-funded solutions for social care.

Our policy recommendations to address the above points are as follows:

- The Triple Lock is unnecessary if the level of the New State Pension has been properly set. Instead, the State Pension should be set at a pre-agreed minimum income standard and regularly reviewed against this.
- The Government could consider asking those over State Pension Age (SPA) to continue to pay National Insurance contributions in an attempt to improve IF.
- A range of possible SPAs should be given to younger generations, with a mechanism for providing increasing certainty as each generational cohort nears retirement.
- The working age benefit system should ensure those who are unable to work up to SPA receive the necessary benefits to meet their immediate needs and the necessary National Insurance Credits to claim State Pension when they reach SPA.
- The role of the Secretary of State in regularly reviewing SPA should be replaced with an independent person, or cross-party body, that would make decisions on not just SPA, but on all of the associated cost levers.
- Pension adequacy could be improved by removing the age criteria in automatic enrolment. Employers could also be encouraged to reward individuals who are saving over the minimum contribution rate. Introducing a method of auto-escalation could help to further harness the innate behavioural biases that have helped to make automatic enrolment a success.
- The rates of income tax on pensions in payment (currently the same as those on earned income) could be altered so that retirees start paying tax at a lower income. Alternatively, a limited level of National Insurance contributions could be introduced on pension payments.
- G20 governments should honour their long-standing commitment to phase out fossil fuel subsidies. Improved climate-related financial disclosure should also be encouraged, to allow a greater understanding of the financial and strategic implications associated with climate change.

[1] Age UK, *Care in Crisis,* 13 October 2017 https://www.ageuk.org.uk/our-impact/campaigning/care-in-crisis/

- Definitive action is needed on social care and the big questions around the balance of state and individual funding must be addressed.
- The use of housing equity to fund social care must be addressed in the Government's anticipated social care Green paper.
- Financial education will be crucial as changes to the financial decisions being made by individuals become embedded, and they are expected to take on new and increasing levels of risk.

These recommendations are explored in greater depth in the pages that follow.

Should you want to discuss any of the points raised please contact Catherine Burtle, Policy Analyst (catherine.burtle@actuaries.org.uk / 0207 632 1471) in the first instance.

Yours sincerely,

M. Ngwenya

Marjorie Ngwenya
President, Institute and Faculty of Actuaries

State Pension

Purpose

Before deciding how State Pension can operate in a way that is fair across generations (and within a generation), the long-term purpose of State Pension needs to be agreed. The purpose of State Pension provision has changed frequently since its introduction in 1909. The current purpose of the new State Pension is to provide a universal, minimum income in old age that is neither means-tested nor a disincentive to private pension saving.

The State Pension has also gone from being a non-contributory system to a pay-as-you-go (PAYG), contributory system, with national insurance contributions (NICs) levied on the working population of the day to pay for the pensions of those currently in receipt of the State Pension.

The importance of the State Pension means that its sustainability and affordability will be key to ensuring that future generations benefit from the same level of security that current generations experience. We are already seeing a level of pessimism amongst younger generations in their expectations of the State Pension. A recent survey from the IFoA suggested that many UK respondents (compared with those from the USA and Australia) expect to rely on the State Pension for their retirement, and were least likely to have other savings set aside for retirement. By contrast, only 53% of the youngest cohorts of respondents expected to receive some form of State Pension, compared to 81% of the oldest respondent group.[2]

Clearly the collapse of any PAYG system such as the State Pension would be justifiably lamented by anyone who has paid in but not seen any benefit, and would be a prime example of intergenerational *un*fairness. As such, anything that undermines the affordability and sustainability of the State Pension should be discouraged. In order for the State Pension to continue to fulfil the important function of providing a minimum standard of income we recommend that it should be set at a pre-agreed minimum income standard and regularly reviewed against this.

Cost levers

There are a number of cost levers that can be used to control the cost of the State Pension, each with different implications for IF.

- Contributions – State Pension is funded on a PAYG basis, with people under State Pension Age (SPA) paying NICs on earnings above a certain threshold. The rate of NICs, threshold limits and similar factors can be altered over time to affect how costs are borne. The Government could consider asking those over SPA to continue to pay NICs in an attempt to improve IF.

- Timing (e.g. SPA) – Increasing the SPA is another method being used by the Government to control the proportion of national spending on the State Pension and who contributes towards the costs. Since a policy change in 1995, the UK SPA has increased gradually from 65/60 and will reach 68 by the year 2039, with individuals knowing at least 12 years in advance exactly what their SPA will be. However, the sensitivity of life expectancy projections means that consideration should be given to the range of likely outcomes and the relevance of the important projection parameters. As such, when communicating SPA, we suggest that it may be appropriate to suggest a range of SPAs for younger generations, say those in their 20s and 30s, with a mechanism for providing increasing certainty as each generational cohort nears retirement.

[2] IFoA Policy Briefing: Retirement Readiness Survey Report from Australia, the United Kingdom & the United States, October 2017 - https://www.actuaries.org.uk/documents/policy-briefing-retirement-readiness-survey-report-australia-united-kingdom-united-states

Lower benefits for those below SPA may suggest individuals should work where possible, but higher benefits for those over SPA acknowledge society's expectation that people should not have to continue in paid work above a certain age. However, some individuals below SPA are less able to work than many who are over SPA. The benefit system should address this fairly to ensure those who are unable to work receive:

- the necessary benefits to meet their immediate needs; and
- the necessary National Insurance Credits to claim State Pension when they reach SPA.

- Amount – the full amount of new State Pension is currently £159.55 per week (around £8,300 a year). Providing the State Pension is increased in line with some inflation measure, it will continue to play an important role in helping to provide a minimum standard of income for those with a full National Insurance contribution record. For an average UK citizen, the State Pension provides just above the Minimum Income Standard as defined by the Joseph Rowntree Foundation. We have argued that having a State-funded pension which allows people to achieve a 'bronze' standard of income will not only provide a safety net for those retiring with little or no other pension wealth, but could act as an incentive for people to save towards a 'silver' or 'gold' standard, with the State Pension income making the savings gap between a modest and a comfortable retirement seem less daunting.[3]

- Escalation (e.g. Triple Lock) – The IFoA has consistently argued that the State Pension 'triple lock' is unnecessary if the amount of the new State Pension, (which is aimed at creating an affordable and sustainable system over the long term) has been properly set. As we know, the triple lock policy has been one factor which has helped pensioner incomes to increase at a quicker rate than incomes of the working age population. Whilst the policy was clearly well-intentioned, and its success in helping to reduce the rate of pensioner poverty should be celebrated, the increase in benefits of at least 2.5% pa far exceeds the pay increases recently seen by those in work. We suggest that 2.5% is an arbitrary figure and not in keeping with the rate of earnings increase amongst the rest of the population. It is important that pensioners are not left behind with a stagnant State Pension whilst the cost of living rises, but linking the uprating more closely to the actual experience of the rest of the population would be a more inter-generationally fair way to do this. Evidence from both John Cridland's review of State Pension age[4] and the Work and Pensions Select Committee's review of IF[5] suggest that the triple lock is increasing State Pension expenditure as a share of national income and is unsustainable over the long term.

Independent review

The Pensions Act 2014 introduced the requirement for a review of the rules around SPA by the Secretary of State, at least every 6 years. Each review is to have regard to projected life expectancy and any other factors that the Secretary of State considers relevant. Before preparing his own report, the Secretary of State is required to commission a report on projected life expectancy from the Government Actuary. In addition, the Secretary must appoint an independent person, or persons, to prepare a report on other factors (to be specified by the Secretary of State) relevant to the review.

Therefore the Secretary of State clearly has a significant influence over each review, and a consideration to improve IF could be to replace the role of the Secretary of State with an independent

[3] IFoA, Assessing Adequacy of Retirement Income: a bottom-up approach, July 2016, https://www.actuaries.org.uk/documents/assessing-adequacy-retirement-income-bottom-approach
[4] Department of Work and Pensions, State Pension age review: final report, July 2017
[5] Work and Pensions Committee, Intergenerational fairness inquiry Committee Report, November 2016

person, or cross-party body, that would make decisions on not just SPA, but on all of the cost levers discussed above. Planning on the State Pension system need to be long-term in nature, so shouldn't be influenced by short-term government spending decisions. Stability also encourages individuals to save for their own retirement, which reduces the burden on the State.

Occupational and private pensions

Occupational pensions

The IF problems posed by occupational pensions are perhaps most stark when considering DB provision. As with the State Pension, these schemes were set up in an era when life expectancy post-retirement was less than it is today, and in general they were based on an intention but not a commitment to provide inflation-linked revaluation before payment and increases in payment. Promises made in the past therefore underestimated the cost of providing the level of provision now mandatory and many providers and employers are now paying the price. Current market conditions are placing an increasing strain on the balance sheets of many employers, leading to a reduction in generosity of pay and pension promises. Not only are current workers being affected today, but the move away from DB towards less generous and riskier DC schemes means that this imbalance will only be exacerbated further down the line, with younger generations experiencing a reduction and more uncertainty in living standards whilst working and expecting this to continue into their retirement.

The majority of young people will have little or no DB pension benefits when they retire, and as such it will be extremely important that those contributing to DC schemes are building adequate pension pots to see them through their retirement. Automatic enrolment has been partially successful in addressing this problem by getting almost 7 million workers enrolled in a workplace pension scheme since its implementation.[6] However, current contribution levels are unlikely to be sufficient for many individuals and there is a risk that people are unknowingly heading towards inadequate retirement provision.

We suggest that adequacy could be improved by removing the age criteria in automatic enrolment (only those aged between 22 and SPA are eligible). Employers could also be encouraged to reward individuals who are saving over the minimum contribution rate in some way, perhaps by matching their contributions as the current ratio between employer and employee contributions for AE is lower than traditional pension schemes. We also suggest that introducing a method of auto-escalation, such as the 'Save More Tomorrow' scheme used in the USA could help to further harness the innate behavioural biases that have helped to make automatic enrolment a success, although consideration would need to be given as to how this could work when people change employer. This scheme encourages savers to commit to increasing their contribution rate when they reach some future event such as a pay rise, making the change to their take-home pay less noticeable.

Taxation of Retirement Saving

The design of the tax system underlying the UK's retirement savings framework provides opportunities to help or hinder IF. The current taxpayer now has two main tax-advantaged options for medium- and long-term saving: pensions or Individual Savings Accounts (ISAs), including the Lifetime ISA. The main difference in tax terms is that pension savings receive income tax relief at the point of saving but, broadly, income tax is paid when the money is spent. This compares to an ISA which is funded from post-tax income but with no tax when the money is drawn upon.

[6] Department of Work and Pensions, Automatic Enrolment evaluation report 2016, December 2016, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/576227/automatic-enrolment-evaluation-report-2016.pdf

The IFoA's Taxation of Retirement Savings Working Party has been exploring the current approach to taxation of all forms of retirement savings, whether they are labelled pensions or not. Two themes of relevance to the IF debate from this work are as follows:[7]

- Systems where tax is deferred from the point of earning to the point of spending (as with pensions) allow the opportunity to adjust the final tax rate for outcomes which have unexpectedly favoured one generation or the other, thus sharing risk more fairly between generations.
- Differentiation of income tax rates between current pensions and current earnings (these are currently the same) presents a possible way to offset the potential for bias towards the existing retired generation.

Under the pension model the final level of tax can be adjusted to achieve results which reflect the needs of the time and an assessment of what constitutes fair treatment of pensioners compared to workers. This contrasts with the ISA, where the tax is taken up front and it is difficult to make later adjustments without breaking the implied tax promise associated with ISAs.

We have argued that tweaking pension tax rates seems less likely to break the bond of trust between savers and the Government than introducing post-saving taxation on ISAs. Therefore savings models funded from post-tax income with the promise of tax free withdrawal – such as Lifetime ISAs which are aimed specifically at younger generations of savers – have the potential to reduce the ability of future Governments to adjust the tax system to react to IF issues. Consideration should be given to these issues as the retirement savings system evolves.

Pension savings do not currently attract NICs on withdrawal. Applying a limited level of NICs – potentially as part of a wider reform of income tax and NI – could help address any perceived unfairness in favour of the existing retired/retiring generation and assist the funding of public services used by the retired. Applying different rates of income tax to employment and pension income may achieve similar goals.

Such policy changes are likely to be difficult politically and determining an appropriate balance between generations, and within a heterogeneous pensioner population, would be challenging. However, the IFoA encourages a debate on the benefits of a flexible tax system and further work to examine how the taxation of retirement income could be adjusted to meet the IF challenge.

Sustainable investment

There is great potential for the investment of pension contributions to have a positive impact on IF and the sustainability of both pension schemes and the broader financial system. Where employed, Environmental, Social and Governance (ESG) investment practices look to ensure that institutional investors such as pension funds provide sustainable long-term investment returns and contribute towards the sustainability of the environment and financial system. The concepts of strong growth and impactful ESG investment are certainly not counterintuitive. We know that the global economy needs to move towards a serious reduction in CO_2 emissions in order to meet the targets set out in the Paris climate accords, but many also accept that climate change itself poses a systemic risk to the financial system.

The IF considerations of climate change itself are obvious, and we set these out in our response to the Commission's first call for evidence in 2016.[8] But climate change poses a threat not only in terms

[7] Updating the taxation of retirement savings, Tim Keogh, Chair, IFoA Taxation of Retirement Savings Working Party, in IFoA Intergenerational Fairness Bulletin, Issue 2, Retirement, May 2017 - https://www.actuaries.org.uk/documents/intergenerational-fairness-bulletin-issue-2-may-2017-retirement

[8] IFoA response to Resolution Foundation's Intergenerational Commission - Building a robust understanding of the problem of fairness between the generations, December 2016, https://www.actuaries.org.uk/documents/ifoa-response-intergenerational-committee-building-robust-understanding-problem-fairness-between

of environmental degradation, but to financial futures. The targets set out in the Paris agreement, and the need to move to a lower carbon economy mean that investment in fossil fuels and other damaging resources no longer represent a safe, long-term investment. As the Environment Agency Pension Fund set out in their submission to our IF bulletin on climate change,

> *"Considering the impacts of climate change is both our legal duty and is entirely consistent with securing the long-term returns of the Fund and is therefore acting in the best long-term interests of our members"*[9]

There is a range of policy responses which could help to make pensions investments more sustainable and intergenerationally fair. Firstly, last year we signed the Overseas Development Institute's statement urging G20 governments to honour their long-standing commitment to phase out fossil fuel subsidies. Fossil fuel subsidies act as a barrier to investment in renewables on the scale needed to deliver greenhouse gas reduction commitments made at Paris. We also support the work of the Financial Stability Board's (FSB) Taskforce on Climate Related Financial Disclosures (TCFD). Improved climate-related financial disclosure will allow a greater understanding of the financial and strategic implications associated with climate-related risks and opportunities, as well as enabling investors to make better informed decisions. Without effective disclosure there is a risk that investors in carbon intensive assets / companies will end up with stranded assets as if we are to meet the Paris agreement a significant proportion of known oil, gas and coal reserves can not be used for energy production.

Social Care

Funding models

Life expectancy has been steadily increasing over the last decade, but trends in healthy life expectancy have not kept pace. As such, the length of time a person can expect to live with health or social care needs is continuing to rise. To achieve long-term sustainability, and intergenerational fairness, it seems reasonable to find some way of ensuring that those benefitting from longer lives and access to health and care services contribute to this increasing cost. This is particularly important as the 'old age dependency ratio' (the number of people over the SPA for every 1,000 people of working age) is increasing. This is resulting in a growing proportion of State expenditure being focused on those over SPA, including health, social care and other age-related benefits.[10]

If the future of health and care funding is to be sustainable, there needs to be a balance between Government and individual funding. International experience and pensions policy in the UK demonstrate that governments can take a lead role in increasing the number of people contributing towards future costs. Success has been achieved through awareness-raising campaigns and implementation of national social insurance and saving programmes. We recommend that a widespread public engagement campaign is needed on the cost of social care today, so that the public has a better understanding of the potential impact of any future reform.

Saving towards potential care costs must also be incentivised not penalised. The 2014 Care Act proposed a care cap of £72,000 but the Government delayed the implementation date to 2020. The cap was introduced by the Government to prevent people from facing what they refer to as 'catastrophic care costs'. However, the cap only covers the amount that the local authority rate and excludes daily living costs and other top-up costs. IFoA research has found that just 10% of those

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[9] Climate change is a key issue for pension funds and they can take action, Faith Ward, Environment Agency Pension Fund, in IFoA Intergenerational Fairness Bulletin, Issue 1, Climate change, January 2017, https://www.actuaries.org.uk/documents/intergenerational-fairness-bulletin-issue-1-climate-change

[10] Cracknell, R. (2010) The ageing population. Key issues for the New Parliament 2010 House of Commons Library Research

who are aged 85 today would be likely to reach the cap at all, and they were likely to spend £140,000 on average before reaching it.

We are expecting the Government to consult on this policy in 2018 and hope that this consultation will look to propose solutions that help resolve the inadequacies in the social care system for current and future generations. One recommendation we have investigated is an all-inclusive cap of £100,000, which would cover all cumulative care costs, unlike the cap proposed in the Care Act. This would provide individuals who have the means to pay for their own care with clarity on their likely future care costs. It would also reduce complexity and make the balance between individual and State provision easier to understand and would protect those who live longer than average in residential care.[11]

The Government needs to strike a balance between Government and individual funding to meet health and care needs within a sustainable framework. Financial services can play a role in helping self-funders to meet their care costs and the IFoA has completed a series of research papers, which we have detailed in this response, on how this market might develop in a way that is complementary to Government funding.

Asset/income balance and equity release

The issue of how we can appropriately take someone's assets into account when assessing how much they should contribute towards their care is one that is currently being considered by policymakers. Unprecedented rises in property prices has meant that Baby Boomers in particular have benefitted from increases in wealth via property ownership and this phenomenon is not only unlikely to be repeated for future generations, but has also served to price many young people out of the housing market.

The issue of using one's housing wealth to pay for care was arguably one of the most contentious policies put into the spotlight in the 2017 General Election campaign. The emotiveness of the issue of housing, and the strength of the prevailing view that someone's housing wealth should be considered a home, rather than an asset, has meant that politicians have shied away from suggesting policies which might direct wealth from the home towards funding social care.

Equity release mortgages provide a potential solution to this problem, allowing people to release equity from their property to be used for other purposes, without individuals needing to sell or move out of their home. These products are, and could be, very useful in helping to solve the social care crisis whilst also tackling some core IF issues if individuals are able to fund their own social care costs without having to move out of their homes, and avoid falling back on the state.

The Government has already implemented the 'Universal Deferred Payment Scheme' whereby the Government lends against the value of an individual's house. But these have not had wide uptake, nor has the use of them been consistent across different regions in the UK. We recommend that the use of housing equity is a key question that needs to be addressed in the Government's anticipated Green paper.

[11] IFoA and Independent Age, Will the Cap Fit? What the government should consider before introducing a cap on social care costs, https://www.actuaries.org.uk/documents/will-cap-fit-what-government-should-consider-introducing-cap-social-care-costs