SQUIRE SANDERS

PENSIONS
in the Age of Austerity

PENSIONS IN THE AGE OF AUSTERITY

White Paper - October 2012

CONTENTS

FOREWORD

How long has the UK pensions crisis been going on? Some might blame Robert Maxwell, Gordon Brown's ACT raid, the failure of Equitable Life, the introduction of FRS17 or the collapse of Lehman Brothers as the origin of all our pension woes. This paper is not about raking over the coals of pensions history to look for culprits, but about examining some current themes and looking forward.

Pensions saving is at a crossroads: the brave new world of automatic enrolment, seemingly intractable problems of defined benefit funding, governance models and nervousness about savings adequacy are all live issues. Finding solutions to any one of these problems would be difficult in benign economic conditions, but unfortunately we are all painfully aware that this is an age of austerity, not luxury.

Against this backdrop of austerity we asked pension funds, their sponsors and our fellow advisers in the industry for their views and opinions about what worried them most, where they will be concentrating their efforts and their thoughts on the future. We surveyed the readers of the leading pensions journals Pensions Insight and Engaged Investor and then conducted in-depth interviews with key decision-makers in the industry.

We are very grateful to everyone who participated in the survey and interviews. The findings from our research, together with our thoughts on how to address the concerns raised are set out in this paper.

Squire Sanders (UK) LLP

PART ONE - THE RESEARCH

INTRODUCTION

Our research consisted of two phases. The first phase was a quantitative survey to capture data through a short, pre-coded question web survey conducted by Pensions Insight magazine. Respondents completed the survey between August and October 2012.

This information was then combined with a second stage in-depth qualitative phase of research. A number of employers, trustees, actuaries and people from the wider pensions industry were questioned via a topic guide that focused on opinions in three key areas:

- the wider issues that currently impact on the affordability of employers' current pension plans;
- the significance to employers of imminent or potential change to legislation; and
- the future of pensions and the balance of responsibility for securing retirement incomes.

TODAY – THE MAIN CHALLENGES

Respondents were asked to describe the main challenges regarding the affordability of pension plans in current market conditions. The employer respondents spoke about the challenges facing their own organisations whilst others gave a wider view of the problems with both defined benefit (DB) and defined contribution (DC) arrangements.

Three common and familiar themes emerged:

- increasing longevity undermining the affordability of the DB model and adequacy of likely DC savings;
- age discrimination legislation, leading to increased unemployment in the young and uncertainty about planning for retirement; and
- sustained low interest rates and correspondingly low gilt yields exacerbating pension liabilities, attributed by many to the Government's Quantitative Easing (QE) programme.

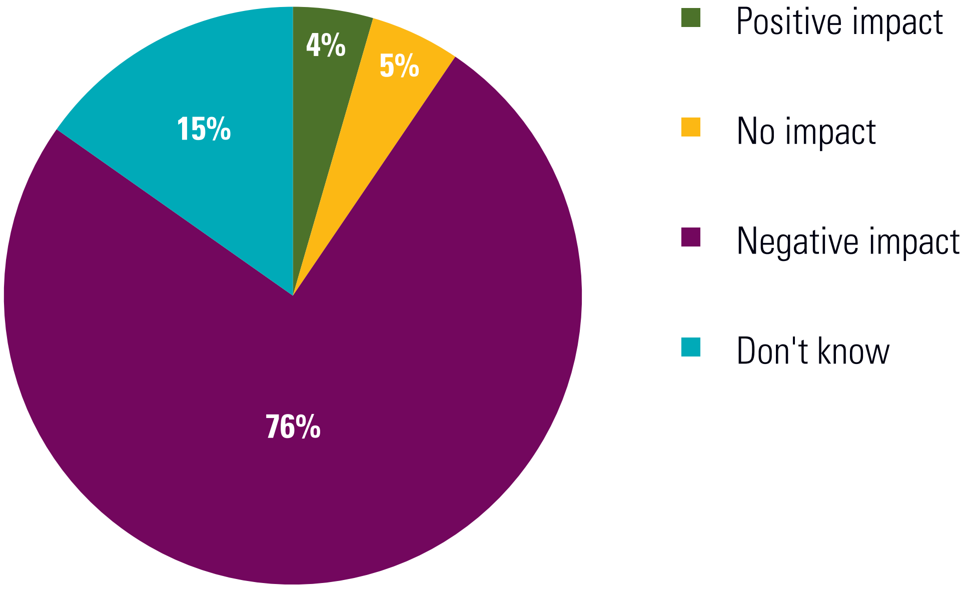
"In terms of DB, there are two key issues. Firstly, liabilities increasing because of increased longevity and how those liabilities are valued and put onto the company's balance sheet. Secondly, the very poor returns these days on assets. These two are working together to create 'the perfect storm'."

Kevin LeGrand, Buck Consultants

PART ONE - THE RESEARCH

Impact of quantitative easing

How has the Bank of England's quantitative easing programme affected your plan's funding position?



Three quarters of respondents felt that Quantitative Easing has negatively shaped their companies' pension funding ability.

15% could not say how QE has impacted their funding position.

Just 4% felt that the effect was positive.

PART ONE - THE RESEARCH

Increasing pension liabilities

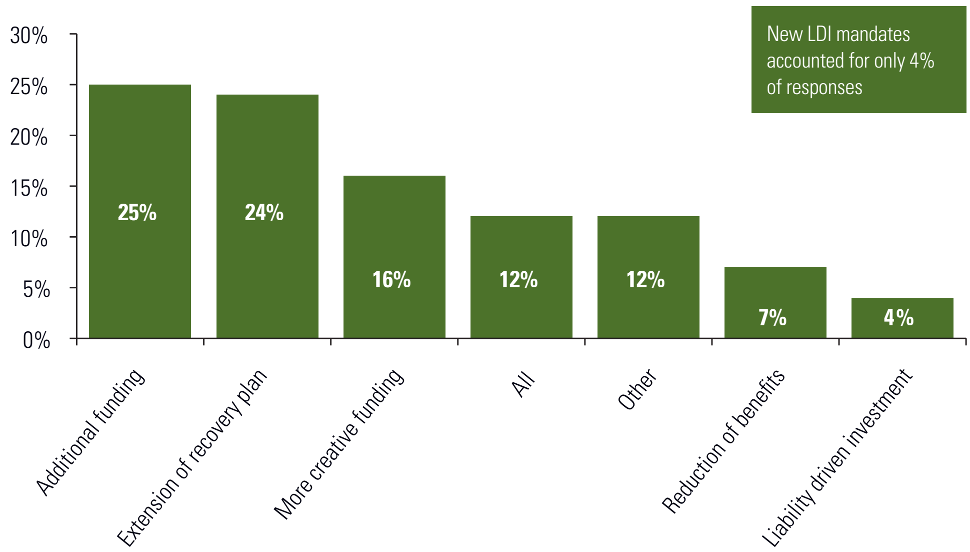
Affordability

Respondents commented extensively on the magnitude of DB liabilities and the lack of prospect of any relief. Some highlighted "zombie schemes" where the size of the liabilities dwarfs the value of the sponsoring company and the consequential increased probability of insolvency.

Many of the respondents highlighted the plight of ex-public sector businesses with generous legacy arrangements or industries whose overall turnover and capital base has shrunk considerably – such as manufacturing or motor – where again large liabilities dwarf the business and cash flows simply cannot service the debt.

Accounting issues were unsurprisingly also raised by several respondents as causes of strain to sponsors.

What is the likely response for your pension plan to increased liabilities?



"The activities of the Regulator are a major pressure and I'm concerned about some of the things I hear about that are coming out of Europe, but I'm still optimistic that some of the more damaging things will be constrained." *Anon*

PART ONE - THE RESEARCH

TOMORROW – FURTHER THREATS TO AFFORDABILITY

The introduction of automatic enrolment, the influence of the Pensions Regulator, the fairness of the PPF levy and the possibility of Solvency II being expanded to cover pension funds were raised by respondents as direct or indirect sources of additional pension costs. However, little mention was made of the Government's proposal to move to an increased universal state pension as a counterbalance to save costs. Presumably respondents thought this initiative is either still too far away to quantify or too complicated to implement.

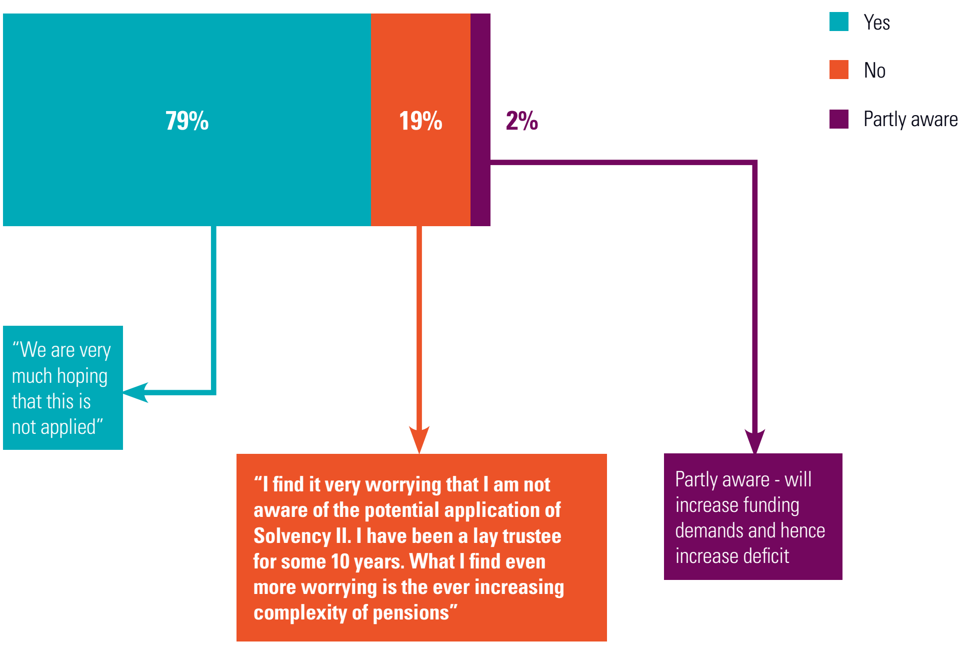
Solvency II

By comparison, there was no doubt amongst respondents that if the European Commission's proposal to expand Solvency II principles to pensions were to be implemented it would be disastrous for both those private sector companies offering defined benefit plans and for the UK economy as a whole.

There was a general perception that the momentum behind extending Solvency II had decreased and even some suggestion that within the European Commission itself there is some pressure for the whole idea to be dismissed.

Our survey revealed that although awareness levels of the potential implications of Solvency II have improved over recent months – "it was outside the pensions village" – there is still some complacency that the threat will simply disappear. No one mentioned the other reforms contemplated by the Commission to the IORP Directive, for example, in relation to potentially enhanced governance requirements for DC plans.

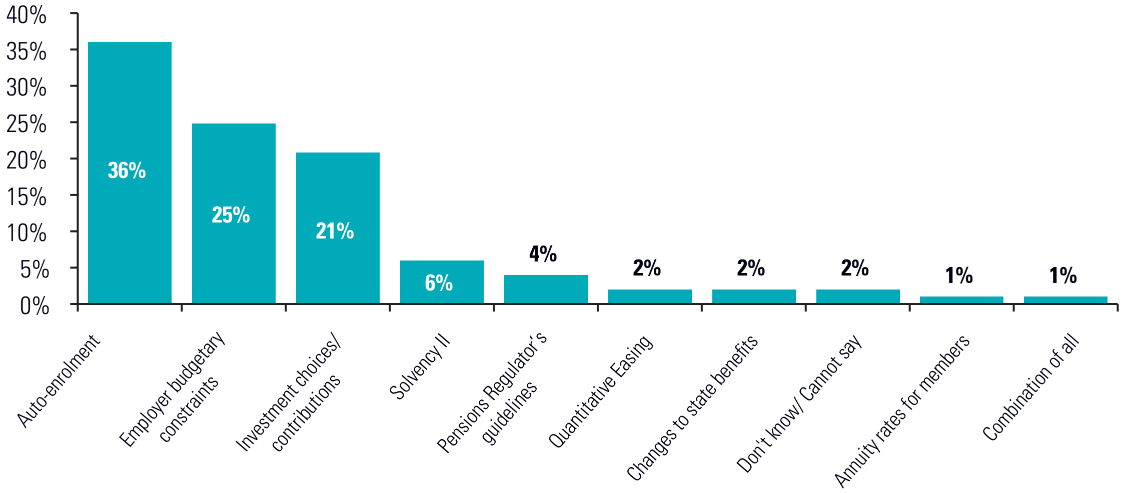
Are you aware of the potential application of Solvency II-style capital requirements rules to pension plans?



PART ONE - THE RESEARCH

Influences on DC plan design

What do you think will have the biggest impact on any defined contribution plan your organisation provides?



Respondents felt that auto-enrolment will have the greatest impact on any DC scheme their organisation provides.

Perhaps unsurprisingly, the three factors singled out as being most influential in future DC design were automatic enrolment requirements, the cost of employer contributions and difficulties over setting employee contribution levels and investment options. These accounted for 82% of the responses. Macro-economic issues which were so readily identified in relation to DB plans (e.g. QE and, by inference, the effect of lower gilt yields on annuity rates) were hardly registered, perhaps because attention in the DC debate is concentrated on the adequacy of contributions rather than outcomes in retirement.

The respondents in the qualitative study expressed wider concerns about automatic enrolment, particularly around its effectiveness due to expected opt-out rates and because they felt contribution rates will just not be high enough to support adequate retirement income.

Further concerns demonstrated scepticism about both member knowledge and employer engagement. A recurring theme was in relation to employers who have never taken a proactive approach to pensions for their employees: it was noted that these "pensions hands-off" employers are unlikely to change their behaviour but will continue to do the bare minimum required within automatic enrolment.

"There has to be some degree of compulsion – whether that is auto-enrolment we will have to wait and see. One thing which is a problem with auto-enrolment is that more people will opt-out with the deferral period than would otherwise. If you don't enrol someone in your pension scheme on the day they join the company but you do three months later, they see very graphically how much their pension is costing them."
Anon

PART ONE

THE FUTURE – WHOSE RESPONSIBILITY IS PENSION PROVISION?

Our research confirmed that, in an increasingly DC environment where investment risks are transferred to members, there are still reservations about the full effect of this on members. This reluctance to acknowledge the consequences of the transfer of the underlying risks is informed by three key factors.

1. **Cultural assumptions and historical expectations related to State-funded and employer-funded pension provisions remain among employees.**

   This was described by one respondent as a "social security mentality" that is ingrained across the UK employee population; employees simply put off thinking about retirement because it seems like a distant concern and/or they assume that they will ultimately be taken care of by the State.

"Unfortunately in the UK we have a social security mentality where everyone thinks it is the Government's job to bail them out if they don't have enough money and therefore they do nothing." *Anon*

2. **Pensions are difficult to understand.**

   For many, pension arrangements are too complicated for individuals to understand, resulting in either confusion or a "head in the sand" mentality.

3. **Lack of cash**

   Employees are unwilling or unable to spare part of their salary to set aside money for the future.

   To counter these factors, there was consensus that employees can only embrace the responsibility for their own retirement financing if there is a general improvement in financial literacy.

   More generally, risk sharing between employers and employees was an approach that gained strong support from some respondents as a fair alternative to a complete transfer of risk to pension savers.

"We're addressing debt management as a society at the moment, whereas saving is on the back burner" *Ray Martin, RBS*

PART ONE

CAN FINANCIAL EDUCATION HELP?

The question of financial education sparked discussion about both the role of education in the workplace and the need for financial education in schools. On the latter point, virtually every respondent we spoke to felt that financial education must start at an early age and should be taught in schools, although some acknowledged that this could be difficult for one or more of the following reasons:

- It is not easy to introduce new areas of learning into the established school curriculum – one respondent described this as a "highly political" issue.
- Though the basic concepts of money management could be taught, pensions (as only one form of saving) are complex and may not be suitable for school age students.
- There is an inevitable tendency to prioritise learning in subject areas that result in qualifications, therefore it could be difficult to generate interest in 'life skills' areas of learning that are not part of the exam system.

The prospect of educating employees in the workplace met with mixed reactions. Although in principle, most agreed that education is needed, if we are to change cultural perceptions around saving and planning for old age, a significant number of problems were identified in relation to workplace learning.

- It adds another pressure onto the employer (resource, cost and administration for teaching/training). A significant number of respondents feel that there is already too much responsibility for pensions placed on the employer.
- If employers provide pensions education, they are potentially exposed to a legal burden if employees complain that they have received poor or misleading advice.
- The current problems in pension provision mean that younger employees lack confidence in the system and do not want to risk investing in something that may not deliver value upon retirement, so education will not overcome the fundamental issue of mistrust.
- Some employees are simply too disengaged from the entire topic and will never absorb the information, no matter how much education is provided.
- Even if education were to be successful in raising financial awareness, it will not help if people still feel, fundamentally, that paying off debts and buying a house are their key priorities.

PART TWO - OPTIONS FOR CHANGE

INTRODUCTION

The central question of who is responsible for quality of life in retirement underlies many of the issues addressed in our research. In a world where DC has become and will, we believe, remain the predominant model for future pensions in the private sector, there is nonetheless nervousness at all levels about the impact of transferring all risk and responsibility for retirement to the individual member.

Risk can, of course, be pooled (whether by traditional insurance or using other investment techniques common in the DB world), but the responsibility for member outcomes does not lend itself to such a collective solution in the same way. There are, of course, only two other parties who can mitigate those risks or alleviate responsibility: the State and employers. We consider below some of the options for key stakeholders, bearing in mind the ability and willingness of those parties to pay for pension savings.

"I would like to see more hybrid-type arrangements where there is sharing of risk between the employer and the employee. At the moment we have gone too far giving all the investment risk and mortality risk to the employee."
Graham Wardle, BESTrustees

GOVERNMENT

Two factors will always determine how governments approach retirement policy: affordability and socio-political views on the rôle and responsibility of the State. In times of austerity the cost to the taxpayer will inevitably be more influential in driving policy than in more benign economic circumstances. Cultural issues clearly play a part here; we should not forget that the UK, despite its budget deficit, is still far less reliant on State support as a proportion of overall pension income levels than most of its European neighbours, where State pension provision is much more directly linked to austerity related measures[1]. However, any government only has a limited number of tools to use to influence demand and supply in a sector such as pensions, of which tax policy and the Government's attitude to regulatory intervention are the most important.

We address further possibilities for regulatory change later in this paper but would note the strong theme, as our survey respondents pointed out, that lessons should continue to be learned from past mistakes in over-engineering future pension design.

Turning to tax policy, which is of course how the State ultimately views affordability, we have to be realistic about the scope of available tax relief against the wider economic backdrop.

We have assumed in this paper that the UK Government will not countenance (with one possible minor exception) any proposals to reduce its overall tax income or increase the value of tax reliefs, which in pension terms cost the Treasury £18.9 billion in 2011/2012.[2] This would be consistent with the policy approach taken to reaching a settlement with trade unions and employers in the public sector where the affordability of new scheme design to tax payers was a central plank of Government policy[3]. Accordingly, we do not believe that tax holidays for stamp duty or VAT, which have been used to boost demand in other sectors, are a credible demand to make of Government. We should also assume that turning the clock back on the abolition of advanced corporation tax relief is a lost cause. The one exception we advocate relates to the need for financial education.

1 See the Appendix for comparable levels of pension savings as a percentage of GDP, calculated by the OECD.

2 £18.9 billion for individuals with pensions and a further £8.2 billion for employers.

3 Independent Public Service Pensions Commission **Final Report**, 10 March 2011.

PART TWO - OPTIONS FOR CHANGE

If the Government cannot be expected to increase tax incentives for the pensions industry, what can the industry reasonably ask of Government?

We have set out ten proposals to create a more certain framework for pensions.

1 There should be stability and transparency in the principles governing tax reliefs for pensions.

Continuous speculation in the run up to the Chancellor's Autumn Statement and the Budget about the possibility of further reducing reliefs (including the higher rate for individuals or the tax-free lump sum or the annual and lifetime allowances) undermines trust in the Government and acts as a disincentive to private savings. Previous reforms of the tax allowances should therefore be allowed to bed down and a clear commitment should be given not to interfere further.

2 There should be a coherent and transparent approach to how the tax system is used to drive the demand for competing savings vehicles.

It would be unrealistic to advocate complete freedom for delivery of pension savings to put them on a par with ISAs and other investment vehicles where there is no restriction on the form of income or capital taken after a protected period (such as for Venture Capital Trusts), given the moral hazard to the State of individuals dissipating tax advantaged savings and falling back on State benefits. To do so would also effectively call into question the validity of the "EET" model[4], which we believe is and should remain a core part of the pensions contract between the State and other stakeholders (pension savers and employers).

However, we do not believe that all pension savings must be narrowly targeted at producing an annuity or pension income in retirement especially where the DC model encourages, or rather requires, individuals to take full responsibility for their future.

3 The place of pensions in the savings market and, in particular, early access need to be reassessed to encourage current and future generations of savers.

Despite the fact that only two years have passed since the Treasury's consultation[5] on early access and the Government's conclusion – that the case for allowing a more flexible approach was not made – we believe that it is important to re-open that debate. The recent announcement that the Government is working on ways of allowing parents to use pension funds to guarantee their children's mortgages is perhaps a sign that greater flexibility will happen anyway (although to implement this particular change would require wholesale changes to current pensions legislation).

Flexibility has already been addressed in the context of wealthier pension savers, when the Government removed compulsory annuitisation for DC plans. By reconsidering early access to pension funds, especially where there is genuine hardship or there are other obligations which are deterring individuals from using pensions as a savings vehicle[6], the Government would not only be accelerating a pledge it made at the time it closed the last consultation on this subject, but it would also be encouraging a more holistic approach to financial planning.

Enabling student debt to be repaid via an offset from pension payments (in addition to the offset methods under the PAYE system) is an obvious potential purpose for such redirection of savings, but there may be other justifiable ways. One obvious issue, which all political parties have recognised but not dealt with, is the difficulty of how to fund for long term care costs for the elderly[7].

4. The relationship between pensions savings and funding long term care needs to be formally addressed.

We believe that if it is appropriate to consider using pension assets to stimulate property ownership, there must be scope to allow for a more integrated approach to pre-funding long term care needs within pensions savings too. Given the timing at which care needs occur most frequently is in the retirement phase, earmarking a proportion of savings for such a specific purpose would not compromise the Government's general approach to tax reliefs.

Greater savings flexibility could take various forms, but we believe that accessibility and possibly even transferability of reliefs between vehicles are options that need to be explored. Appropriate fiscal disincentives could be introduced to prevent abuse by reference to individuals' levels of pensions savings.

In flexing the system in this way, the UK Government would be highly likely to stimulate growth in other areas of the economy. It would also be in good company with the US, Canada and Ireland who have all introduced such flexibility into their savings models.[8]

4 I.e. Tax exemption on contributions and income/capital accumulation but where pensions in payment are taxed.

5 See **Treasury's call for evidence: Early access to pension savings** (December 2010) and **DWP's Attitudes to Pensions (2009) Survey**.

6 See, for instance, the **Ipsos MORI survey on the Future of Pension Provision in 2011** for the comparative attractions of ISAs.

7 See "**Fairer Care Funding**" July 2011

8 For example, the USA allows hardship relief from 401(K) defined contribution plans, Canada allows some access to RRSP pension savings, and there are proposals in Ireland to give early access to AVCs.

PART TWO - OPTIONS FOR CHANGE

EMPLOYERS

Defined Benefits, Quantitative Easing and the Pensions Regulator

Wider economic policy cannot be ignored in assessing the private sector's ability and willingness to fund pensions. The Bank of England is almost alone in denying that significant increases in DB liabilities have been fuelled by the Government's policy of Quantitative Easing. Our research confirmed the view that QE has exacerbated an existing problem.

"One thing the government could usefully do in the short term is recognise the impact of the action of QE on pensions schemes and not deny it." *Norman Braithwaite, Independent Trustee*

Some industry bodies have reacted to the reduction in gilt yields caused by QE by demanding the reintroduction of smoothing of the discount rate to value liabilities, which would place a lower value on liabilities, and so reduce current deficits.

Whilst we see benefits in this approach, we have more sympathy with the view that pension funds should be given incentives to invest in other asset classes such as infrastructure[9], where the Government has of course welcomed capital commitments.

Such ideas will, however, not alleviate the pressure on DB pension funds without an appropriate and clear regulatory response to the effect of low gilt yields on the liability side of the balance sheet.

A temporary change in the accounting treatment of pension deficits to include the use of smoothing to mitigate pension deficits exacerbated by QE would have short term benefits in an age of austerity but would continue to postpone a much needed recognition by society of the real cost (and value) of pension provision.

The temporary benefits of a short-term approach are at odds with the long-term solutions needed for stable pension provision.

Transparency in market information is also now expected by all institutional investors (including pension funds themselves). If smoothing is to be adopted, we would recommend a clear explanation of the approach and its effects. To do otherwise (and extend smoothing to asset values) could also compromise best standards of corporate governance in a way that may be unacceptable to both owners of assets and corporates alike.

More realistically, we believe that the regulatory expectations on employers to address pension deficits should be relaxed.

"There is quite a lot of pressure on the Pensions Regulator to relax the methodology it insists on using to calculate liabilities which is based on the Government's yields on gilts. If the covenant is strong enough, it will allow longer recovery periods whereas what companies were looking for is smoothing of the effect of the increase in liabilities." *Graham Wardle, BESTrustees*

5 The objectives of the Regulator should be expanded so that it can have regard to employers' interests and take a longer term macro-economic view.

The Pensions Regulator has statutory responsibilities under the Pensions Act 2004 to protect member benefits and reduce the risk of claims on the Pension Protection Fund (PPF). The problem with maintaining both of these objectives in the current climate is that there is no equivalent requirement on it to take into account the legitimate interests of employers.

We do not pretend that taking employer interests into account will be an easy job for the Regulator, especially given its extensive pronouncements about its views of the normal relationship between trustees and employers (i.e. that trustees should behave as if they were bankers to employers). However, if employers are to weather the current gilt yield storm and be able to honour the pension promises that have been made to their employees and former employees, we feel that greater statutory flexibility is essential.

9 See the SPC's **Vision 2020**, June 2012.

PART TWO - OPTIONS FOR CHANGE

Such macro-economic planning by the Regulator should take into account the possibility of further market volatility, especially if the Eurozone does disintegrate in a disorderly fashion.

It might be argued that the price for such relaxation is greater dialogue between the Pensions Regulator and employers, or that new anti-abuse safeguards are needed to ensure that employers have direct regard to the interests of former employees. Dialogue with employers is of course laudable; we would argue, however, that the employer debt régime under section 75 of the Pensions Act 1995 already ensures appropriate protection for accrued benefits and that any temptation to introduce further legislation should be resisted.

6. The PPF rules surrounding contingent assets need to be reassessed.

In a similar vein, there are a number of technical anomalies about the rigidity of the PPF's rules concerning contingent assets which need reassessment. There has been a marked decline, for instance, in the number of parental company guarantees because of changes to the funding test which trustees need to satisfy in relation to third parties but which set unreasonable demands. In an age of austerity, any such support must be better than nothing and more flexibility is needed in the application and scope of the régime.

THE DC DIMENSION

The combination of austerity and automatic enrolment is not one that the architects of the latter régime envisaged when it was first discussed by the Pensions Commission (the Turner report).

In this connection, our research reiterated two simple truths about the viability of pensions as a savings vehicle:

- no tax incentive can create demand for saving from those who cannot afford to save; and
- despite significant tax advantages, pensions compete poorly in the public mind, where other options are more immediate and either more liquid (in the case of ISAs) or more tangible (in the case of residential property).

Despite understandable calls to increase the level of contributions, we would suggest that the automatic enrolment régime should be allowed time to bed in without further political interference. It should be remembered that automatic enrolment only sets a minimum default level of contributions and there is nothing to stop willing employers from paying more into their nominated qualifying schemes.

"As far as auto-enrolment is concerned, we are not going to know for another five years whether or not it has been successful...the danger is people will think their pensions are better than they are." *Anon*

Employers need budgetary certainty. The employers who want both to control costs and engage their workforce towards better long-term saving will not use automatic enrolment to "dumb down", but rather use it as a base for building sustainable savings levels. In that connection, building on automatic enrolment contribution levels could enable employers to redress the perceived effects of the removal of the default retirement age, if such increased contributions help to allow employees to retire.

If it is in the self-interest of employers to use DC arrangements to control the shape of their workforces by maintaining decent levels of contributions, they can and should support this by encouraging equivalent behaviours in their employees.

Basic finance behavioural benefit models, such as building matching and automatically increasing contributions into employment contracts, are commonly used in more developed DC markets such as the US.

But these models and improved financial education in the workplace will only become widespread if employers are confident that they will not run any regulatory risk for talking openly to their employees about financial planning and helping them to make appropriate decisions.

PART TWO - OPTIONS FOR CHANGE

Employers should also take more responsibility in two other areas: charges and governance.

The next three of our ten proposals are three inter-related recommendations to improve the quality of the DC environment.

7. **Statutory exonerations should be given to employers when engaging employees in pensions**

8. **Increase benefit in kind tax relief for provision of financial advice to employees**

9. **Financial education basics should be introduced into the school curriculum**

As our survey revealed, breaking down barriers to financial illiteracy would be made significantly easier if financial education were introduced at a much earlier level into the school curriculum so that employers were not "on the back foot" when educating their workforce on the importance of managing their financial affairs efficiently.

Some initiatives have been singled out in this connection, in particular the announcement by BT that it was introducing mandatory pensions training as part of its HR programme.

From an employer's perspective, the risk of litigation for giving inappropriate investment advice or making financial promotions about, in particular, contract based pension arrangements[10] exists because they are not generally authorised to give investment advice or carry on any form of authorised financial services activity. So the normal (and appropriate) regulatory response is to say as little as possible about pensions when in dialogue with their employees. This is not helpful. The position of employers is reinforced in one limited area on a statutory level by an often over-looked exoneration for employers from responsibility for the choice of a provider of stakeholder pensions[11].

"Knowledge is a huge issue - and the complexity of pensions means that employees don't want to confront it. Financial education from a young age is very important and making sure people are supported to understand why that is and what it means to them (right the way through the school system and upwards)." *Jim Bligh, CBI*

10 This issue also applies to trustees in the trust based DC world.

11 See section 3(8) of the Welfare Reform and Pensions Act 1999.

PART TWO - OPTIONS FOR CHANGE

We do not believe, following the introduction of the statutory employer duty of automatic enrolment, that it is any longer tenable for employers to be put into a position of having to provide a significant employee benefit but to be nervous of explaining exactly what that benefit is or providing information on how it could be best managed by the individual employee.

Accordingly, we advocate extending the statutory protection for employers in the Welfare Reform and Pensions Act 1999 (which only refers to the selection of a stakeholder pension arrangement) to other forms of pension savings products to enable a more meaningful dialogue about the investment risks associated with pension products. This need not disturb those employers who want to pay for professional investment advice and of course appropriate boundaries must be set by reference to specific investment products, as under current FSA rules.

As a corollary, employers need to be free to spend more on providing professional investment advice without suffering the complications of landing their employees with tax charges for benefits in kind. The current tax treatment therefore needs to be reconsidered and the threshold for tax-exempt benefits in kind needs to be raised.[12] The cost of this extension of relief would need evaluation by Government, but is a justifiable exception to our first proposal not to tamper further with tax reliefs.

Charges

The Government's challenge to the pensions industry to reduce and to make more transparent the level of DC charges is a real one. While we believe that this issue is a lot more complicated than is often portrayed in the media, it is clear that the direction of political travel is that if the industry does not respond to the Government's challenge, there is a high risk of regulatory intervention to impose charge caps on DC pension products. To some extent, automatic enrolment may be a catalyst to solving this problem by encouraging new entrants to the market with competitive charging structures designed to attract new business (as happened with stakeholder pensions when they were introduced). However, such charging structures will only be supportable by reference to both scale and scheme memberships which have no or very limited requirements for advice and where default life-styling solutions are expected to operate as the base model having a pre-determined investment pattern. We believe that it is ultimately unsupportable to have a wide polarity between the charges paid by automatically enrolled new savers and those who are already in qualifying schemes with higher contribution levels.

If employers want to engage in a constructive way to improve outcomes from DC, we believe they may find that the advisory costs that are not currently paid on any scale will have to be built into the pension budget. In this connection, see above our recommendation about raising the threshold for benefits in kind when investment advice is funded by the employer.

Whether capped or otherwise, we believe that all charges should be made transparent and should be fully disclosed to pension savers, not in isolation, but in the context of understandable information about risk and reward for pension saving.

UK employers operate in a very different legal environment to US employers where the sponsor is a fiduciary recognised in law. However, we also note the potential risk of claims matching those growing in the US, where a company has recently been fined for breaching its fiduciary duties to participants in relation to costs in its 401(k) pensions plan.

The Pensions Regulator's attention to employers' duties in DC plans may lead in future to similar claims in the UK.

12 Pensions advice costing below £150 a year is exempt from tax, but if the cost of the advice exceeds £150 the whole amount is taxable as a benefit in kind.

PART TWO - OPTIONS FOR CHANGE

DC Governance

10. Re-examine the responsibility of employers for DC arrangements

Finally, our research revealed continued concern about the quality and consistency of DC governance. Pension providers, for understandable business and regulatory reasons, will not want to engage with members who are only contractually bound to them as a result of automatic enrolment and for whom they have conducted no fact-finding investigations as to the suitability of their investment decisions. They will have to deal on an execution only, default fund base model. Equally, however, because of the current risks of straying into giving unauthorised financial advice, employees and trustees are constrained in supporting members' personal financial education, despite there being more obvious interfaces with employees which could facilitate more informed decision-making. All of this combines to the detriment of employees who are members of DC plans and who cannot or will not choose to take independent financial advice at their own cost.

"The first question is 'do members understand their pensions?' and the answer is most haven't a clue. That is painfully obvious in DC - just look at the number of people who invest in the standard default fund and … note that, where there isn't a default fund, research shows if you give people a choice of four funds then they will put a quarter in each and if you give them a choice of thirty they will take the first on the list." *Norman Braithwaite, Independent Trustee*

Moving to a new regulatory model such as that which applies in the US – where employers are recognised at law as being fiduciaries who are responsible for the pension arrangements of their employees – would be seen by many as being a step too far. Equally, it would be unrealistic to expect employers to be able to discharge a duty to take into account the financial circumstances of their employees.

However, we believe that some action needs to be taken to bridge this governance gap and to support member education. If, as we suggested earlier in this paper, statutory exonerations can be extended which would protect employers from frivolous claims by employees, it may be time to encourage employers to monitor the quality of the pension arrangement provided to their staff.

CONCLUSION AND SUMMARY OF RECOMMENDATIONS

This paper has covered a number of complex interconnected pensions issues which beset all stakeholders who are involved in pensions. There are other discussion areas, such as defined ambition and other forms of benefit design, removal of "red tape" regulation, and changing investment and funding structures which our survey did not address but which are part of the mix. We will be conducting follow-on research during 2013.

What did emerge from our research to date was the number of variations on the themes of affordability and where responsibility for delivering pensions lies. Ultimately, no single party – whether Government, employer or individual - has that responsibility alone but we believe the following key proposals may help to restore faith in pensions and bring a more prosperous and better informed pensions system for the future.

1. There should be stability and transparency in the principles governing tax reliefs for pensions.
2. There should be a coherent and transparent approach to how the tax system is used to drive the demand for competing savings vehicles.
3. The place of pensions in the savings market and, in particular, early access need to be reassessed to encourage current and future generations of savers.
4. The relationships between pensions savings and funding of long term care needs to be formally addressed.
5. The objectives of the Regulator should be expanded so that it can have regard to employers' interests and take a longer term macro-economic view.
6. The PPF's rules for assessing contingent assets need to be reassessed.
7. Statutory exonerations should be given to employers when engaging employees in pensions.
8. Benefit in kind tax relief should be increased for provision of financial advice to employees.
9. Financial education basics should be introduced into the school curriculum.
10. The responsibility of employers for DC arrangements should be re-examined.

What are your views? If you would like to participate in our next survey, or have any comments, please let us know.

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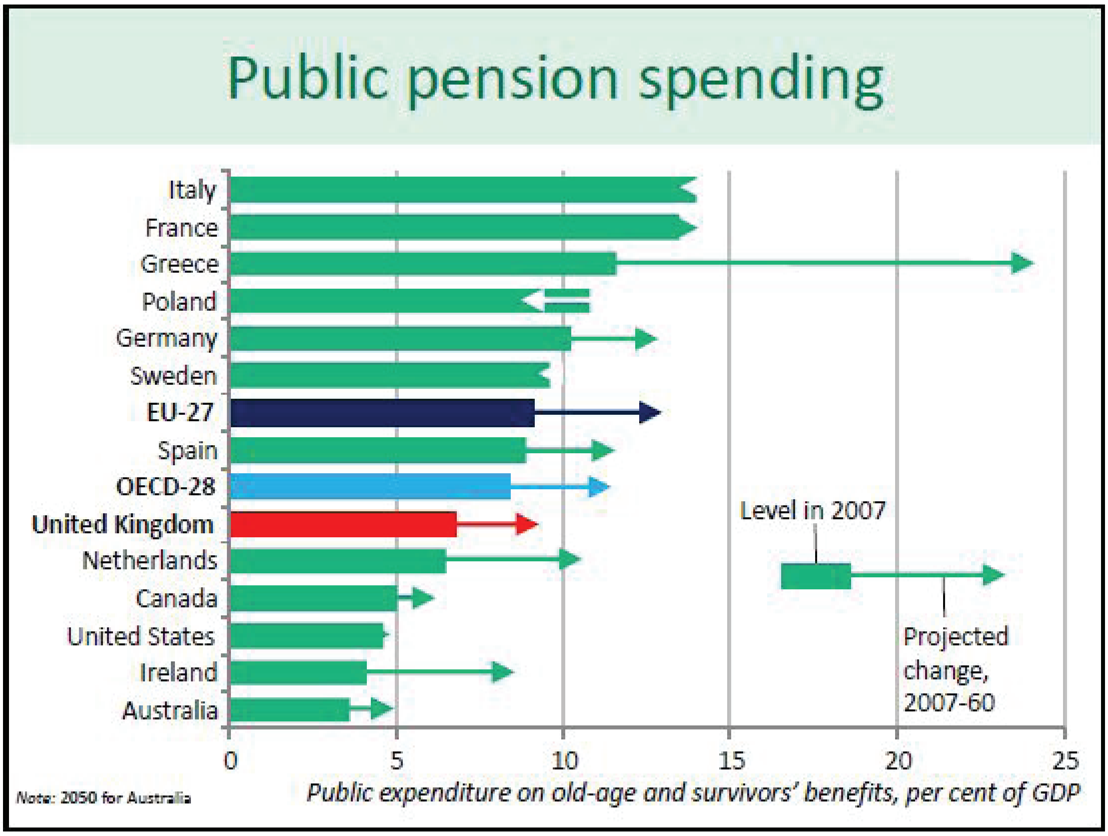
October 2012

APPENDIX



Source: **Pensions at a Glance 2011**, OECD