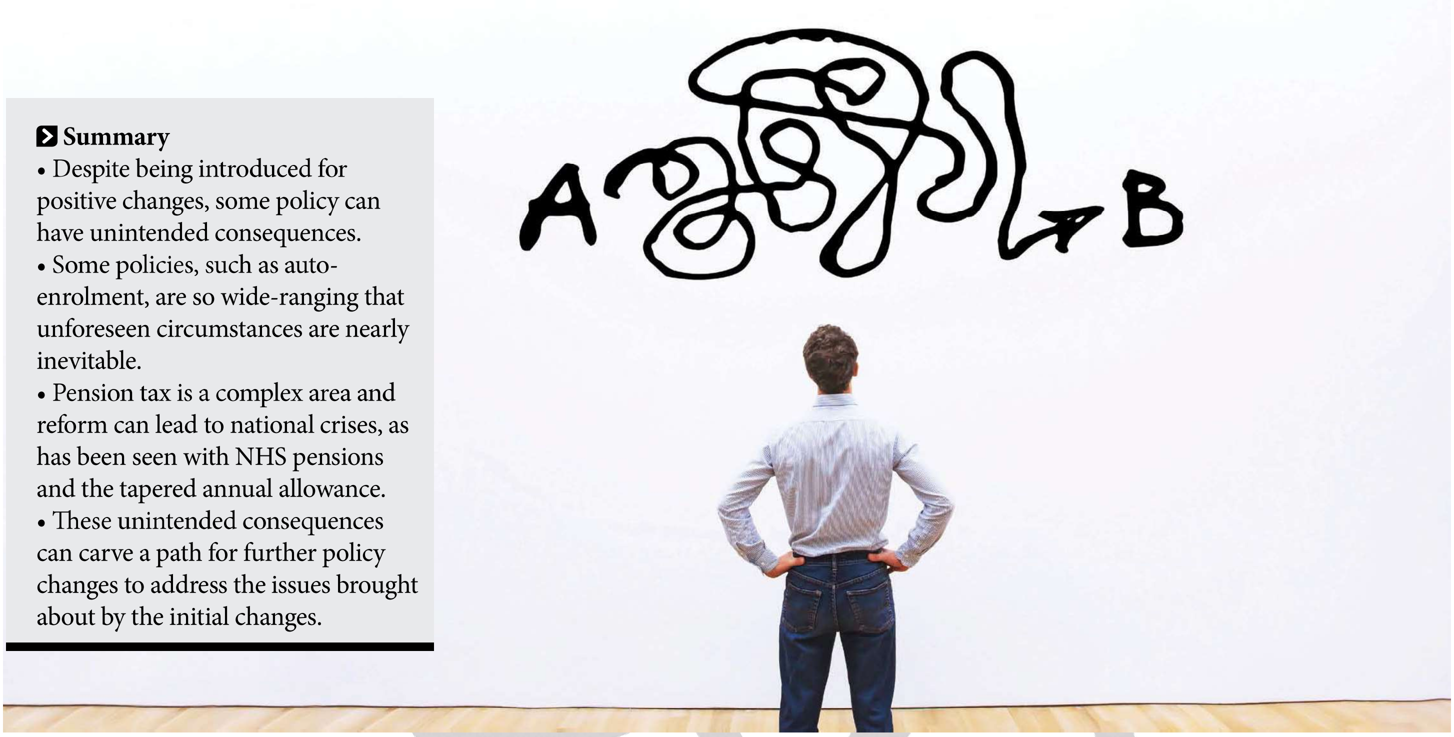
Summary

- Despite being introduced for positive changes, some policy can have unintended consequences.
- Some policies, such as auto-enrolment, are so wide-ranging that unforeseen circumstances are nearly inevitable.
- Pension tax is a complex area and reform can lead to national crises, as has been seen with NHS pensions and the tapered annual allowance.
- These unintended consequences can carve a path for further policy changes to address the issues brought about by the initial changes.



Unintended consequences

Whatever guise they take, most changes in the pensions sector are designed to bring about positive outcomes. However, they can have unforeseen negative impacts. Jack Gray investigates some of the changes that have had unintended consequences

Despite the stereotype that the pensions industry is slow moving, policy in the sector appears to be ever-changing. It has seen huge reforms over the past decade and there are constant discussions on how to improve pension outcomes. Although changes are nearly always well-intentioned, they can bring about unforeseen circumstances that are not always beneficial.

Getting involved

One of the biggest pension shake-ups was the introduction of auto-enrolment (AE) in 2012. However, the journey to requiring people to join a workplace pension scheme began many years prior.

"The legislation that introduced personal pensions in the late 1980s also permitted employees to opt out of their employers' pension schemes if they wished," begins LCP senior partner, Bob Scott. "The result was a huge mis-selling scandal, driven by commission-hungry insurance salespeople who advised individuals to give up their generous employer-funded schemes. It took another 25 years before AE required individuals to join their employers' schemes once again."

AE has helped more people than ever in saving for their retirement. LGIM head of DC, Emma Douglas, notes that although the success of AE has been "tremendous", its introduction means that "engagement has not increased".

"We have created a nation of 'triple defaulters' who remain on the 'factory settings' of the default contribution rate, default retirement age and default investment fund," she adds.

Squire Patton Boggs partner, Matthew Giles, agrees that the policy has been a success. However, he warns that it may have set false expectations about what level of pension contributions are needed to have a comfortable retirement and has allowed some employers to justify reducing their contributions to the AE minimum.

AE may have also led to an increase in dormant pension pots. PensionBee research suggests that the number of dormant pots will increase to 21.5 million in 2020 due to Covid-19, with the majority being AE pensions. "Due to AE we are likely to see a significant increase in abandoned pension pots," explains PensionBee CEO, Romi Savova. "DC pensions, which are received by employees under AE, are the fastest growing type of dormant pension, with an expected increase of 48 per cent, from 10.2 million dormant pots in 2019 to 15.1 million in 2020."

Tax reform

The ongoing debate surrounding pension tax continues in 2020. The controversial and complex topic has had many instances of well-intentioned changes leading to unsavoury circumstances. The most high-profile case was in the NHS Pension Scheme, which saw widespread opt-outs and workers cutting their hours to avoid tax bills resulting from the tapered annual allowance.

"Tax reform often has unintended consequences," says Giles. "The introduction of annual and lifetime allowances to pension saving means that pension saving is no longer tax-efficient for some high earners or long-term members of defined benefit (DB) schemes."

Gowling WLG pensions partner, Chris Stiles, adds that, although the allowances aim to ensure that retirement savings were only given tax privileges up to a certain point, they have become a "complicated minefield". He states that the issues have been exacerbated by a "reduction in the allowances relative to their starting point" and as features, such as the money purchase annual allowance (MPAA), have been "bolted on".

"Even a small mistake by taxpayers can lead to devastating tax consequences," he notes.

The Covid-19 pandemic has created further unintended consequences of pension tax policy. LGIM head of product policy strategy, Colin Clarke, points to the MPAA as an example. He states that many people have accessed their pensions earlier than they may have expected due to the crisis and, because they are now subject to the reduced allowance, "they are restricted in how much they can pay in to build up their pots for when they do actually retire and need the income".

Scheme funding

Policy around scheme funding throws up some examples of changes that were later rectified after unintended consequences were identified. The minimum funding requirement, introduced in the Pensions Act 1995, was designed to ensure that schemes had an achievable funding target, which was set relatively low with the aim of making it accessible for all. However, as Giles explains, it became the default funding basis, rather than acting as a minimum, and had a "levelling down effect".

"It was ultimately discredited as too weak and replaced in 2005 by the scheme-specific funding requirement," he continues. "As part of the new funding regime that followed, The Pensions Regulator (TPR) at one point adopted an approach of challenging valuations where the recovery period was over 10 years. The reaction to this was for some schemes to treat the 10-year timeframe as the new standard – the trigger point was later dropped.

"Now the regulatory pendulum is due to swing back to a more standardised funding approach, which will inevitably have further unintended consequences."

Potential unintended consequences can be identified in the proposal stage of future changes. Scott says that TPR's DB funding code consultation, which gives trustees the option of 'fast track' or 'bespoke' approaches for completing scheme valuations, could result in an increase in contributions for certain employers. It may also result in lower contributions for others whose funding assumptions are more prudent than fast track.

"TPR also encourages de-risking so that pension schemes rely less on investment returns from investment in growth assets," he adds. "However, if the resultant contribution demands lead to earlier failure of the sponsoring employer, members may end up receiving a lower proportion of their benefits than if the de-risking had not taken place."

The price of freedom

Arguably the biggest change in pension policy in recent times was the introduction of pension freedoms in 2015, which gave people more personal responsibility with their savings and altered the way they planned for retirement.

Although it is an attractive policy, according to PLSA head of DC, master trusts and lifetime savings, Lizzy Holliday, it does have a "costly" side-effect. "The new options for savers shift the effects of uncertainties like life expectancy and the performance of markets onto the individual in retirement," she says.

"Evidence suggests savers are not engaging in complex decision making required to manage these risks, and potentially losing out as a consequence."

Foresight

Foresight on the possible consequences of policy changes can solve problems before they arise. The government recently published its first draft of its Corporate Insolvency and Governance Bill, designed to provide emergency protective measures to help companies survive disruptions caused by Covid-19.

"In its original drafting, the bill had the potential to create a situation where bank lenders were higher up the pecking order for recovering cash than employees' pensions in the event of a company insolvency," explains PLSA head of DB, LGPS and standards, Joe Dabrowski.

"The government has since committed to amending the bill to make changes that are more favourable to pension schemes." These amendments include ensuring that TPR and the PPF have a 'key role' following an insolvency and that the interests of pension schemes are represented in any company recovery plans.

The industry has an important role in shaping pensions policy and proactive engagement on changes can stop problems before they arise. However, unintended consequences are almost inevitable in such a complex and wide-ranging sector, and proactive support on their mitigation can be equally as important.

Written by Jack Gray