

## AAT RESPONSE TO THE PENSIONS SCHEMES BILL 2014-15

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### 1 OVERVIEW AND EXECUTIVE SUMMARY

- 1.1 The Association of Accounting Technicians (AAT) is pleased to respond to the House of Commons Public Bill Committee invitation to submit views in respect of the Government's "Pension Schemes Bill 2014-15".
- 1.2 AAT is supportive of the aims outlined in the Pensions Schemes Bill (the Bill) in establishing a new legislative framework for private pensions, defining them on the basis of the promise they offer for members about their retirement benefits during the accumulation phase, with a view to facilitating the development of schemes that offer members some level of security of benefits while not burdening employers with a large amount of risk.
- 1.3 While the government has decided not to proceed with more flexibility for defined benefit (DB) schemes, the Bill will enable the development of schemes that provide greater certainty than traditional defined contribution (DC). This will be provided, for example, by buying deferred annuities each year payable from scheme pension age, or by facilitating collective benefits, with a fixed employer contribution rate and a target pension income for employees that could be adjusted if the scheme is underfunded.
- 1.4 AAT believes there is merit in attempting to plot a third way between DB and conventional defined contribution (conventional DC).
- 1.5 The government's policy, under the broad heading of defined ambition (DA), attempts to do this both by creating a framework for more secure pension promises than conventional DC, and by risk-sharing, also known as collective DC (CDC).
- 1.6 Fostering the conditions for the development of schemes that offer a level of certainty of member outcomes that goes beyond that offered by conventional DC, without requiring employers to take on the full risks associated with DB is a worthwhile aim. Furthermore, as set out below, there are positive aspects to CDC that make it an attractive proposition.
- 1.7 However, we do foresee benefits in the establishment of such schemes in the next few years. Much of the detail on how DA schemes will operate still remains to be finalised. With contracting out ending in April 2016<sup>1</sup>, the timetable for employers wanting to consider replacements for DB is tight. While DA could be a solution for this sector of employers, they will need to see the options available to them very soon. In acknowledgement of this last observation AAT urges that thought must be given to ensuring that clear proposals and guidelines are made available for the consideration of interested parties as soon as possible.
- 1.8 Furthermore, AAT does not detect widespread demand for CDC arrangements from employers at present. The reasons, as far as it has been possible to ascertain, are cultural antipathy towards collective solutions coupled with the complete upheaval in the pensions system created by the budget announcements around freedom and choice. Both of these reduce the likelihood of employers embracing these new arrangements, as CDC schemes will be perceived by their employees as restrictive when compared to conventional DC arrangements. The recent announcement with regard to the taxation of death benefits in drawdown, which are only available to those in conventional DC arrangements, make DA options appear even less attractive, even if the majority of people will in reality need to use their entire pot to fund their retirement.

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<sup>1</sup> Pension Act 2014 part 1 (24)

- 1.9 However, that is not to say that AAT opposes the Bill. AAT wants employers to have as many options open to them as possible, and if DA arrangements do become established it will be because the public has come to understand their positive attributes.

## 2 PUBLIC ATTITUDES TO DA

- 2.1 DA and CDC in particular do have undoubted advantages. The question is, whether these would, in the minds of the public, outweigh their disadvantages. Trust in pensions has, for decades, been fragile and the public will be suspicious of new types of risk put before them.
- 2.2 CDC schemes can lead to greater returns than conventional DC arrangements by both reducing costs and their ability to adopt more efficient asset allocation strategies and access a wider range of asset classes. Returns can be smoothed offering greater certainty of outcomes for members, who will not see their eventual retirement payouts determined on the state of the market in the year they retired.
- 2.3 AAT notes that the price cap on DC schemes is not anticipated to extend to CDC arrangements. Certain solutions for ensuring more stable outcomes cannot be achieved within the 0.75 per cent price cap, so some employers may see this as a particular advantage. Certainty of liability for employers is also a positive aspect of CDC.
- 2.4 On the face of it, these positives make CDC a 'no-brainer'. The government's response to its 'Reshaping Workplace Pensions' consultation alongside the Bill pointed to a report from the Institute for Public Policy Research that found a collective scheme was the most popular model in the market.
- 2.5 While higher returns, less risk and no annuity purchase is an appealing proposition, AAT would caution against thinking that public perceptions of CDC could not sour if and when markets perform badly or longevity assumptions change in a way that negatively affects returns. As the entrant to the market, CDC will be under greater scrutiny compared to the existing pension types, even if conventional DC valuations have fallen further than those in CDC, collective schemes will still face criticism. They may also face criticism in rising markets when conventional DC arrangements, which are not having their returns smoothed, are 'performing better'.
- 2.6 The UK's main experience of pooled investments has been with-profits funds, which, in recent years, have attracted a large amount of negative press<sup>2</sup> as customers' returns fell well short of their providers original projections. It is AAT's view that CDC arrangements will face challenges winning the argument over full DC arrangements, which are reliant on individuals not having to depend on anyone else, which do not involve the reattributing of assets from one group of individuals to another, for example from younger savers to older savers. CDC schemes will be under extreme media scrutiny and as a consequence will be vulnerable to reputational damage from providers offering alternative pension structures.
- 2.7 UK pensioners have become used to fixed returns, with the vast majority of retirees receiving guaranteed payments from either defined benefit schemes or annuities. Cutting pensions in payment, as can happen with CDC schemes, would be culturally new to the UK market, which is only just beginning to move away from the principal options being either full DB or annuities, both of which are guaranteed.
- 2.8 Furthermore, CDC arrangements are complex and opaque, and AAT believes that as a consequence they will struggle to engage with employees when the rest of the market is gravitating towards simplicity and freedom, even if the traditional DC route is becoming more complex because of the range of at-retirement options that will be open to investors.

<sup>2</sup> ['With-profits returns are on a downward spiral' - Telegraph](#) 2 March 2013

### 3 INTERGENERATIONAL UNFAIRNESS

- 3.1 There is already a growing understanding amongst younger people that they will not enjoy the retirement security their parents did. The shift from DB to DC and the steady increases in state pension age have contributed to this view.
- 3.2 Cross-generational collective pensions can involve a reduction in pensions in payment, and it is uncertain whether the UK public will accept these.
- 3.3 CDC schemes in the Netherlands, where there is a far stronger collective tradition than in the UK, have come in for criticism from younger members of the population, who are mistrustful as to whether their contributions are going towards paying the benefits of older members.
- 3.4 AAT believes CDC schemes in the UK will be left exposed to accusations in the future that younger members are supporting the retirement incomes of older members, thus undermining confidence in the system.

### 4 PENSION FREEDOM AND CHOICE

- 4.1 The Bill will also give force to the measure announced in the 2014 Budget to give people aged 55 and over more flexibility over how they will be able to access their DC pension savings from April 2015, including the ability to withdraw the entire sum, at any time from age 55. This individualistic fund-based approach appears to be at odds with the general thrust of the government's DA policy, which is more collective in its nature and which prioritises security of income.
- 4.2 AAT considers that, even before the budget's "freedom and choice in pensions" policy had been unveiled, CDC faced headwinds in gaining traction amongst employers. These concerns are compounded by the sweeping changes to the UK pensions system that make conventional DC more attractive.
- 4.3 Submissions to the government's consultation on CDC were received before the Budget. Therefore, responses given by the industry had not taken into account the massive changes that were subsequently announced. It is inevitable that the Budget pension changes, in particular the shift in emphasis from income to fund value that the new system brings from April 2014, means attitudes to CDC will have changed.
- 4.4 Employers will, AAT believes, be reluctant to put in place pension schemes that exclude their employees from the ability to make use of the budget freedoms. Where CDC arrangements are smoothed, anyone wanting to exit the scheme to transfer to a conventional DC arrangement would be subject to an exit penalty, making the scheme unattractive with members.
- 4.5 It also seems to us that the goal of certainty of income, while still a priority for the majority of savers, seems to be at odds with the Budget freedom and choice changes contained within this Bill.
- 4.6 AAT has already registered concerns as expressed in the response to the initial consultation on "Freedom and Choice in Pensions"<sup>3</sup>, that the new rules as originally drawn created a serious risk of significant tax leakage as people opt to be paid through pension rather than salary. While the Bill's measures – notably the reduced £10,000 annual allowance for

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<sup>3</sup> Paragraph 2.4 [AAT response to the Treasury consultation on "Freedom and choice in pensions"](#)

individuals who enter flexible drawdown – go some way to reducing the potential for unforeseen tax leakage, they by no means stop it altogether. AAT sees no change in the potential for significant tax leakage on this account.

- 4.7 AAT also predicts significant changes in behaviour with regard to estate planning on account of the removal of the 55 per cent tax on pension fund assets on death. AAT anticipates that some individuals will in future hold significantly more money in pensions as they will be able to pass on up to £1.25m through their pension to nominated beneficiaries, subject to their marginal tax rate, with a further £325,000 passing without inheritance tax. The new rules mean couples will be able to pass £3.15m to heirs at potentially lower rates than they do today.

## **5 PROHIBITIONS ON TRANSFERS OUT OF UNFUNDED PUBLIC SERVICE PENSION SCHEMES**

- 5.1 The Bill also contains measures to enable a prohibition on transfers out of unfunded public service pension schemes, which we think are sensible.

## **6 RELAXING RESTRICTIONS ON DB SCHEMES**

- 6.1 AAT notes that the government has abandoned plans to relax restrictions on DB scheme design and consider that this is sensible, given that it is pressing ahead with DA solutions that offer an alternative. It is AAT's view also that it avoids potential further undermining of trust in pensions, just as pensions are beginning to be viewed more favourably by the public.

## **7 TIMESCALE AND AREAS OF UNCERTAINTY**

- 7.1 There are still some areas of the operation of CDC schemes that are yet to be defined, in particular the way probabilities of targets being achieved are expressed.
- 7.2 AAT awaits detail on investment principles and guidance on how surpluses and deficits will be dealt with.
- 7.3 AAT does not yet know how CDC schemes will be treated for tax purposes. Without clarity in this area it is hard to see how employers can make an informed view as to whether they are interested in setting up or becoming part of a CDC arrangement.
- 7.4 As mentioned above, employers looking to use CDC or other DA structures as a replacement for DB by the time contracting out is removed in 2016 will need answers to these questions soon.

## **8 ALTERNATIVE STRUCTURES**

- 8.1 The Budget 2014 changes have fuelled a wave of innovation in retirement income solutions. AAT anticipates that existing master trust providers may be able to offer some of the positive aspects of CDC in the post-retirement phase, such as lower cost and better asset allocation, without the need for the new legislation. Mass-market drawdown models, with boards of trustees, will go some way to addressing some of the challenges CDC is being designed to meet.

## 9 CONCLUSION

- 9.1 In conclusion, AAT believes that legislating to create a third type of pension scheme that sits between conventional DC and DB is worthwhile. More choice has to be better than less, and allowing employers the opportunity to establish pension schemes that offer more security than conventional DC is a positive move.
- 9.2 AAT does however question the extent to which there is appetite amongst employers for taking the big step into the unknown that establishing a defined ambition pension scheme would be.

## 10 ABOUT AAT

- 10.1 AAT has over 49,800 full and fellow members and 80,000 student and affiliate members worldwide. Of the full and fellow members, there are 4,100 Members in Practice (MIPs) who provide accountancy and taxation services to individuals, not-for-profit organisations and the full range of business types (Figures correct as at 30 Sept 2014).
- 10.2 AAT is a registered charity whose objects are to advance public education and promote the study of the practice, theory and techniques of accountancy and the prevention of crime and promotion of the sound administration of the law.
- 10.3 In pursuance of those objects AAT provides a membership body. We have drafted this response on behalf of our membership.

## 11 FURTHER ENGAGEMENT

- 11.1 If you have any questions or would like to consult further on this issue then please contact AAT at:

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