HEALTH WEALTH CAREER

UNDERSTANDING THE NEW STATE PENSION

MERCER'S RESPONSE TO THE WORK AND PENSIONS COMMITTEE INQUIRY

MAKE TOMORROW, TODAY

MERCER

The new State Pension is being introduced in April 2016. Concerns have been raised that many of those affected by the changes do not know enough about the changes or exactly what the changes will mean for their pensions. This is especially true of people who are close to retirement now and who may have done most or all of their retirement planning and saving under the "old" system.

EXECUTIVE SUMMARY

In our view:

- The current government campaign to raise awareness will not adequately prepare individuals for the upcoming changes.
- The State Pension system remains complex and difficult to understand.
- Generic explanations will not give a sufficiently reliable and accurate understanding of their own personal position; personalised information will be necessary.
- The majority of people do not readily engage with pensions, and generic publicity campaigns will not change that. The Department for Work and Pensions (DWP) should provide personalised State Pension forecasts to adults below State Pension age, without relying on individuals to contact it first.
- People need to be told:
  - How much they can expect from the State Pension.
  - When they can expect it.
  - What they need to do to obtain their full entitlement.
- Advisers need to be given comprehensive information in plain English about the new State Pension system to be able to properly advise people.
- DWP staffing and training should be improved to ensure that it can quickly and accurately answer queries from members of the public.

Does the current campaign to raise awareness adequately prepare individuals for the upcoming changes?

The communications we are aware of (for example, the webpages and booklet available on www.gov.uk, and the DWP videos published on YouTube) are not specific to people's individual circumstances. The Select Committee, during its review of pensions freedoms guidance and advice, has already heard from other sources that personalised information has more impact than generic information. This corresponds with our experience, which is that only the minority of already interested individuals will engage with generic information — to engage the interests of the majority, who are less interested, communications have to be more personal. This is particularly the case for information on pensions, which people view as largely uninteresting, irrelevant to them, and complex — all of which serves to make people's eyes glaze over when the topic is mentioned.

Consequently, although the DWP campaign might raise awareness that a change is about to happen, it is unlikely to help individuals understand what those changes are, comprehend how the changes will affect them, or help them prepare for the changes — indeed, it might confuse them further. For example, the DWP's pensions YouTube site has a video explaining how people's pre-2016 position will affect them post-2016; however, the video mainly describes how an individual's pre-2016 position can differ. If the objective is to help people understand their position post-April 2016, then it might have been more effective to use people's pre-April 2016 status to direct them to different videos, which could then concentrate on explaining how they will be affected post-April 2016 and what they might be able to do about it.

The latest publicity campaign seems unlikely to help people understand how much they can expect from the new State Pension and when. Areas of concern include:

- Lack of awareness that many people will get less than the full rate of the new State Pension.
- Lack of understanding about how high an individual's State Pension age is.
- Lack of understanding of available National Insurance credits for caring responsibilities, etc.
- Loss of the Guaranteed Minimum Pensions' inflation protection, when this protection was due to be provided through the State Pension, and a lack of clarity around which public-sector occupational schemes (if any) will be required to pick up this lost indexation.
- Lack of awareness that the new State Pension (like the old State Pension) will not be increased in payment if people retire to certain countries.
- Low understanding of what State Pension entitlements may (or not) arise on the death of a spouse.

After detailed modelling, we have developed case studies, which are provided in the Appendix to this paper, to show how even very small differences between people can have quite significant consequences for the transitional rate of their State Pension. In our experience, the majority of financial and DWP advisers are not fully aware of these differences.

Currently, people can only receive individual information about their State Pension by applying to the DWP. We understand this information will shortly be available online, which is likely to make a material difference to people's willingness to engage. However, people are likely to be easily discouraged, so the online system must be simple to use and only require limited information. To help people prepare for the changes, the output will also have to be simple.

These might be the key features to illustrate, with any other supporting information kept to the background:

- What your State Pension age is.
- State Pension entitlement you would have if you reached State Pension age on the date you make the information request.
- What your entitlement could be if you continue to build up further qualifying years.
- What you have to do (for example, the number of additional years of National Insurance contributions you have to pay or be credited with) to receive your full entitlement.

Regardless of how clearly it is presented, information on State Pension changes will not be sufficient for people to understand what actions they need to take — for this, the State Pension changes need to be put in the context of their other savings. This will introduce further complications, because the potential variety of sources and types of saving will be difficult to present in an informative way.

We understand that the DWP has decided to end the facility to produce Combined Pension Statements. Although we accept that the new online service might require amendments to the facility, in our view it is important for individuals to have a single source for accessing information about their likely retirement income to be able to prepare properly for their retirement.

For individuals close to and at State Pension age, we think it is important for their spouses or civil partners to understand what earnings-related State Pension, if any, would be paid to them. The rules are exceptionally complex and depend on the dates of birth of both spouses and the age at the death of the first spouse to die.

Is targeting the over 55s for additional information about the State Pension reforms sufficient or should this be expanded to include a wider age range and/or other groups?

We recommend that the DWP sends regular (the regularity and priority might be age-dependent) communications to the entire working-age population. Early knowledge of these figures should enable people to:

- Plan ahead.
- Understand the importance of private saving.
- Correct any errors in their details (including National Insurance histories) that come to light.
- Apply for any unrecorded National Insurance credits to which they might be entitled (for example, grandparents caring for grandchildren).

Although it is important not to criticise past practice solely based on current criteria, we expect the example of communicating the ongoing rise in women's State Pension age is something the government would wish not to repeat. Paul Lewis has pointed out some of the consequences of relying on indirect communications in his blog: http://paullewismoney.blogspot.co.uk/2015/11/women-given-just-2-years-notice-of.html.

DWP research in 2004 confirmed that a large number of people were unaware of their State Pension age.[1] The groups most unaware of the changes tended to be those groups one might expect to be most reliant on the State Pension. Since 2004, legislation has been passed that increases State Pension ages further for younger groups. Because of the associated complexity, it seems likely that a smaller proportion of the public than before accurately knows their State Pension age.

Similarly, calculating an individual's projected State Pension is complex, so relatively few people are likely to understand their expected position. For example:

- Some groups may be aware of the headline "full rate" of new State Pension, but will not qualify for it. Consequently, they may be overestimating their State Pension entitlement and underestimating their need to save.
- Conversely, some groups may be entitled to a protected pension based on their already-accrued earnings-related State Pension. Unless they have received an individual statement, very few of these people will be aware of their entitlements. In our experience, State Pension entitlements in excess of the basic rate come as a surprise to many people. These groups might be overly concerned due to underestimating their State Pension.

Separate DWP research in 2007 into another DWP communication exercise confirmed that the majority of people who "read or at least glanced at" the DWP letter found automatic pension forecasts to be useful.[2] Many had been motivated to take action in response.

However, the numbers who engaged with the forecast were low, particularly at younger ages. This suggests that communications need to be repeated — the DWP cannot rely on people reading a single letter.

[1] DWP. *Research Report No 221: Public awareness of State Pension age equalisation*, 2004.
[2] DWP. *Research Report No 447: Evaluation of Automatic State Pension Forecasts*, 2007.

In our view, direct individual communications, using a variety of media, are needed at all ages to ensure younger people can make appropriate decisions early enough in their working lives to make a difference, and to help older people understand the choices they will face on leaving work and in retirement.

To what extent are Department communications addressing the needs of specific groups who are affected differently, such as women born between 6 April 1951 and 5 April 1953?

It is not simple to find information directed at specific groups. In particular, people would need to know that they had to look for these communications, and it is clear that not all of them do. This is why we favour individually tailored communications.

How could workplace pensions be used to signpost people to information about their State Pension?

Employees already receive a considerable amount of information during the auto-enrolment process. We expect that providing information on the State Pension at the same time, although relevant, could distract from the immediate decisions people are expected to consider. At the same time, a feature of the auto-enrolment process is that there is no need for individuals to engage at all. As a result, we do not feel that it should be mandatory for employers to provide information on the State Pension to those with workplace pensions.

In addition, many small and medium-sized employers are already overwhelmed by the administrative burdens imposed by auto-enrolment. Adding extra requirements is likely to undermine employers' engagement with the process. This, in turn, would likely undermine the effectiveness of auto-enrolment.

If signposting were to be required (that is, as a disclosure requirement), this should be limited to pointing members to the appropriate website or telephone number for confirmation of their State Pension forecast amount and age.

However, encouraging and enabling best practice is a different matter. As mentioned above, statements that combine information on State and private pension entitlements would be useful. Most members of money purchase arrangements must be provided with "statutory money purchase illustrations" (SMPIs) at least annually. These are cumbersome communications because of the amount of detail required to explain the derivation of the outcomes. Although many providers are finding ways to improve their delivery, the introduction of "freedom and choice" has made them even more complex and, in some cases, even less relevant. There would be a lot of value in considering how to bring SMPIs into the 21st century to provide better directed and more effective information to individuals. For example, illustrating the benefits that could be provided by members' existing rights if they chose to retire on the illustration date might be more meaningful than a projection that assumes they continue to contribute at the same rate to age 65, and their funds continue to grow at some assumed rate.

However, it would not be sufficient to rely on even improved SMPIs to communicate the State Pension changes since the latter need to be communicated to everyone, including those who are not members of a workplace pension.

Should employers of those in contracted-out pension schemes be providing their employees written information about the State Pension reforms when contracting out ends in April 2016?

Employers that have continued to provide contracted-out pension schemes, and the schemes' trustees, are very conscious of their obligations to their members. Most are likely to inform their scheme members about the effect of the April 2016 changes on their pension entitlements. Employers that have chosen to reduce future accrual or increase member contributions to compensate for their increased National Insurance bill will also need to consult with members about the changes. In many cases, these communications are already being planned, although some have been delayed awaiting the DWP's confirmation of the exact disclosure requirements it intends to apply.

These communications would be made simpler and more effective if the DWP meets its intention to publish an online calculator by December 2015, particularly if this (and the calculation specification) is made available to trustees and providers. However, apart from this we do not think there needs to be further government interference in the communications that this select employer group will make.

APPENDIX

ABOUT THE AUTHORS

Deborah Cooper is a partner, and the Risk & Professionalism leader and head of Policy for Mercer's Retirement business in the UK.

Glyn Bradley leads on contracting-out and State Pension matters for Mercer's Retirement business in the UK. He is a senior associate in the business's Innovation, Policy and Research team.

NOTES

These examples are illustrative only, based on our understanding of the relevant legislation, and making a number of modelling assumptions. The examples are not intended to show any real individual's entitlement, nor should they in any way be relied upon as financial advice.

JOHN, 35
A FRESH START

John will be 35 when the new State Pension system begins on 6 April 2016. After leaving full-time education, he spent some time travelling overseas but has never worked in the UK or claimed any benefits from the UK social security system. When the new system starts, he will have no qualifying years in the "old" State Pension system. His foundation amount will be nil.

Under current legislation, John's State Pension date would be his 68th birthday, leaving him 33 potential qualifying years. If he were to begin working in the UK soon, under the old system, he would still have time to earn 30 qualifying years and accrue a full basic State Pension: £119.30 per week from 6 April 2016. If he worked every year up until his State Pension age, he could also have accrued another £55–£70 per week, depending on his earnings level, giving a total State Pension of approximately £175–£190 per week. This is quite a narrow range, because the State Second Pension was on course to become progressively less earnings-dependent over time.

However, under the new system, he would only have time to earn 33 out of the 35 qualifying years needed for the full single-tier rate of £155.65 per week. Proportioning the full rate down, we would expect him to receive about £146.76 per week in today's terms. In reality, his final State Pension age may well be higher than 68, increasing the number of potential qualifying years available. Additionally, he may be able to make voluntary National Insurance contributions to make up for his lost years.

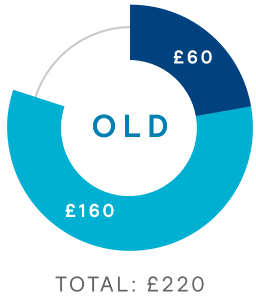
SARAH, 30
YOUNG, HIGH EARNINGS, CONTRACTED IN

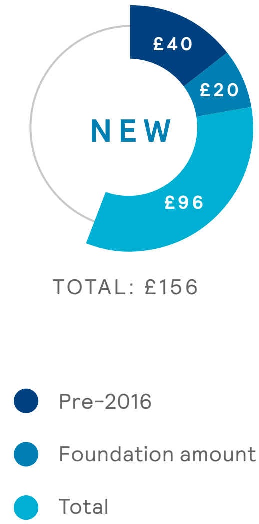
Sarah will be 30 when the new State Pension system begins on 6 April 2016, and currently has a high-flying job in investment banking, where she earns a substantial salary. Currently contracted in to the old State Pension system, she qualifies for both the basic State Pension and the full earnings-related State Second Pension.

Sarah started work when she was 21, so when the new system starts, she will have nine qualifying years in the old State Pension system. Under the old system, and including her State Second Pension, she will have built up about £60 per week, which is higher than the £40 she would have built up under the new system. Her foundation amount will therefore be about £60 per week. Under current legislation, Sarah's State Pension date would be her 68th birthday, giving her 38 potential future qualifying years.

Under the old system, she would have enough time to accrue a full basic State Pension, £119.30 per week from 6 April 2016, as well as an earnings-related State Pension of around £100 per week. She would have had a total pension of about £220 per week in today's terms.

However, under the new system, although she would qualify for the full single-tier rate of £155.65 per week, it is significantly less than she would have received under the old system.





AMY, 25
YOUNG, LOW EARNINGS, INTENDS TO START A FAMILY

Amy will be 25 when the new State Pension system begins on 6 April 2016, and is planning on starting a family soon. She is currently working at a below-average salary and will take time off work to look after her children until they are at secondary school, when she plans to return to work.

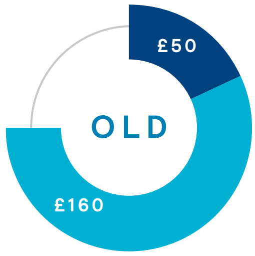
Amy started work at 16, so, like Sarah, when the new system starts, she will have nine qualifying years in the old State Pension system. Her foundation amount will be about £50. As with Sarah, her foundation amount is what she will have built up under the existing system, which is higher than what she would have built up under the new system. This is because, even for low earners, the current rates of accrual for State Second Pension and basic State Pension exceed the rates at which the new single-tier pension will build up.

Under current legislation, Amy's State Pension date would be her 68th birthday, giving her a further 43 potential future qualifying years. She is entitled to earnings credits while receiving Child Benefit for a child under 12 (even if her Child Benefit award is zero due to a high-earning spouse).

In the future, Amy has several children. She returns to low-income work part-time after 22 years, when her youngest child is 12. Under the old system, it would be possible for her to accrue the full basic State Pension of £119.30 per week if she returned to work by the time she reached age 47, as she would have time to earn the full 30 qualifying years. She would also have earned the flat-rate element of the earnings-related State Pension for both the 30 years she worked and the 22 years for which she receives State Second Pension credits, giving her a total pension of £210 per week.

Amy's foundation amount of around £50 is just over 11/35ths of the full single-tier rate. Therefore, she needs another 24 qualifying years to obtain the full rate. Under the new system, Amy will also accrue qualifying years for the 22 years during which she is entitled to receive Child Benefit for a child under 12. She only needs to work a further two years to obtain the full £155.56 per week.

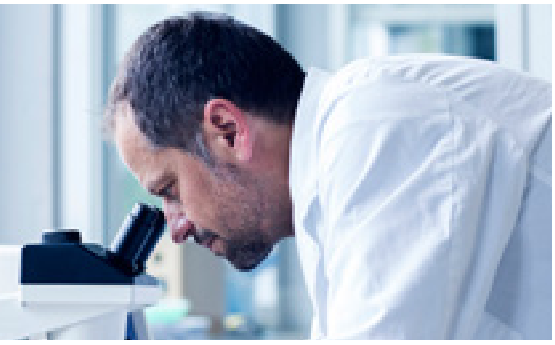
Thus, Amy's total State Pension under the new system is likely to be lower than under the old system. This is because the current crediting arrangements for parents caring for young children are already more generous than they were historically, and would count towards the State Second Pension the same as if the parent were in low-paid employment.



TOTAL: £210

TOTAL: £156

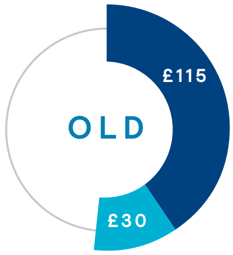
- Pre-2016
- Foundation amount
- Total

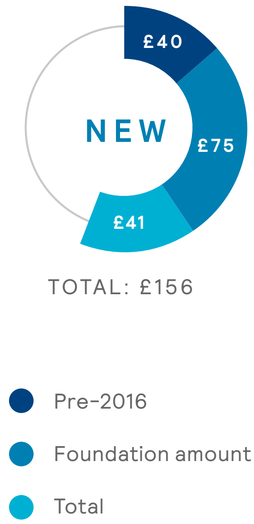


COLIN, 45
MIDDLE-AGED, MIDDLE EARNINGS, CONTRACTED OUT

Colin will be 45 when the new State Pension system begins on 6 April 2016. He earns an average salary and has been paying into a contracted-out pension scheme since he started working after leaving school at the age of 18, in return for lower National Insurance contributions. Colin has built up almost no earnings-related element of the State Pension. Had the old system continued, he might have expected a full State Pension of £119.30 per week plus a small State Second Pension in the region of £25 per week, giving him a total State Pension of about £145 per week.

When the new system starts, he will have 27 qualifying years in the old State Pension system. Unlike Amy and Sarah, he has built up relatively little State Second Pension, so his "old" amount will not be much more than the basic State Pension he has earned. However, with his contracting-out history, this is likely to be far more than what he would have received under the new rules once the substantial contracting-out deduction is applied. His foundation amount will be about £115 per week. Under current legislation, his State Pension date would be his 67th birthday, giving him 22 potential future qualifying years. This will allow him to top up his State Pension to the single-tier amount of £155.65. This is expected to be slightly higher than he would have received had the old system continued.





PETER, 45
MIDDLE-AGED, MIDDLE EARNINGS, CONTRACTED IN

Peter is Colin's twin brother. He also earns an average salary and started work when he left school at the age of 18. However, unlike his brother, he is currently contracted in to the old State Pension system, so he qualifies for both the basic State Pension and the full earnings-related State Second Pension, but has had to pay higher National Insurance contributions throughout his career.

Peter's foundation amount will be around £160 per week. This is what he will have already built up under the old rules, and is higher than what he could have built up under the new rules. As this is more than the full rate of the new single-tier pension, it is protected under the new system, but Peter cannot increase it any further. The first £155.65 will be revalued in line with national average earnings (and possibly "triple locked" so that it increases by at least 2.5% per year or in line with price inflation), and the balancing £4.35 per week will increase in line with prices.

ARTHUR, 65
REACHES STATE PENSION AGE ON 5 APRIL 2016, HIGH EARNINGS

Arthur will reach his State Pension age on 5 April 2016, when he turns 65. He has been a member of a contracted-out pension scheme throughout his career and earns a high salary. When he reaches his State Pension age, he will receive the full basic State Pension (£119.30 per week on 6 April 2016). He will not receive any earnings-related State benefits, as these are expected (though not precisely or guaranteed) to be provided for by the scheme in which he was a contracted-out member.

Had Arthur been a member of a contracted-in scheme, in addition to the basic State Pension, he would have received an earnings-related amount of around £155 per week, giving him a total State Pension of around £275 per week.

As part of contracting out, his company scheme benefits include Guaranteed Minimum Pensions (GMPs) built up between 1978 and 1997. Those built up before 1988 do not increase once in payment, and those built up after 1988 increase by a maximum of 3% each year, depending on inflation. Roughly speaking, when his company GMP does not keep up with inflation, Arthur's State Pension will be increased to compensate for the earnings-related State Pension increases he would have received had he not been contracted out.

CONTRACTED OUT

HAD HE BEEN CONTRACTED IN

- Pre-2016
- Foundation amount
- Total

HARRY, 65
REACHES STATE PENSION AGE ON 6 APRIL 2016, HIGH EARNINGS

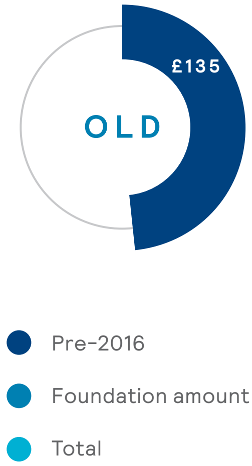
Harry started work with Arthur and had a very similar career at the same company. However, his birthday is the day after Arthur's, so he will reach his State Pension age on 6 April 2016, when he turns 65. Harry has already finished work. Like Arthur, he has built up a full basic State Pension but has no earnings-related State Pension. His foundation amount will therefore be about £119 per week. As he reaches State Pension age on 6 April 2016, he will not be able to accrue any further qualifying years to top up his pension to the new single-tier amount, even if he returns to work.

Like many retirees in the first few years of the system, Harry has been contracted out for a significant part of his career and will not get the full rate of the single-tier pension.

Unlike for Arthur, there will be no additional increases to his State Pension if his company GMP does not keep up with inflation.

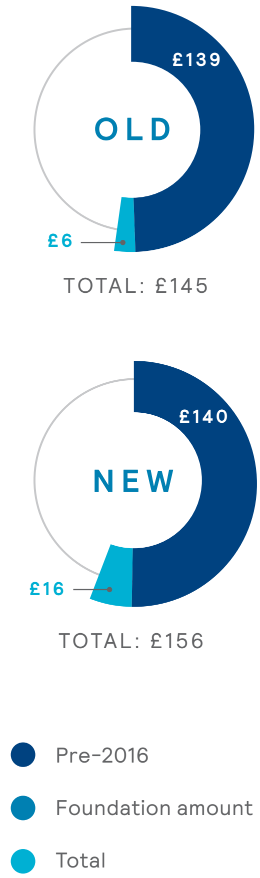
MARY, 65
HARRY'S WIFE

Mary is married to Harry, and they are the same age. Mary reached her State Pension age in March 2012, not long before her 61st birthday. Mary earned a much lower wage than Harry in her working life and worked in the public sector, where she was contracted out of the earnings-related State Pension. Mary didn't work when their children were young — she was credited with Home Responsibilities Protection from 1978, which went towards her basic State Pension but did not earn her any earnings-related State Benefit. She only needed 30 qualifying years for a full basic State Pension, and with the Home Responsibilities Protection, she is currently receiving a full basic State Pension: £119.30 per week when the new system comes into effect. She also built up a small amount of the State Second Pension of £15 per week, giving her a total pension of around £135 per week. Since Mary has some employment history, her State Pension in her own right is still more than the "married women's pension" of just over £70 she would be entitled to based on her husband's National Insurance history.



CHRISTINE, 60
MARY'S YOUNGER SISTER

Christine is Mary's younger sister by five years. She will have to wait until age 66 before she gets her State Pension. Christine and Mary currently work in similar roles at the same pay scale. However, as Christine will be 60 on 6 April 2016, she has six years to top up the State Pension she receives to the full single-tier amount of £155.65 per week.



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