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QUEEN'S SPEECH PENSION ATTENTION

June 2014

Pensions took centre stage in the Queen's Speech, as the Queen announced Government plans to give individuals "*discretion over the use of their retirement funds*", firstly through greater flexibility at retirement and secondly by allowing workers to contribute to Dutch style, "collective" pension funds. Both changes have the potential to radically reform the way individuals and employers approach saving for retirement in the UK, but can the reforms have a future together?

The proposed changes to allow individuals more flexibility with their pension savings were announced in the Budget earlier this year, and will effectively remove the current requirement for individuals with "money purchase" benefits to buy an annuity on retirement. The changes are likely to also include the ability for individuals to take their entire pension savings on retirement if they so wish, firmly putting individuals in control of their pension saving, from the first day of saving until retirement (see our Budget Commentary).

The second pension reform announced, to allow Dutch style collective pension funds, is a move away from individual control. Workers would contribute to pooled pensions funds along with potentially thousands of others and in return would be offered a target pension paid directly from the fund (instead of through annuities).

Collective pension funds have been widely used throughout Europe as they generally reduce overall costs by achieving economies of scale, mitigate the risk that employers will have to fund any shortfall if investments perform badly and cushion the fund's members, in general, against poorly performing investments and the additional cost of pensioners living longer.

Whilst the Government has been keen to highlight the potential positives of collective pension funds, and the sharing of the risk between employer and worker of poor investment and longer lives appears to be a fair compromise, these types of funds are not without problems, particularly where the target pension offered is affected by poor investment performance. In practice it has proved difficult in some collective funds to adjust target pensions and "claw back" benefits notionally accrued.

In order to be sustainable, this collective pension fund model relies on a continuing stream of new workers joining the fund who are willing to share the risk of poor investment performance over successive generations (in times of poor investment performance, the young will effectively pay for the old). A number of years of poor investment performance and diminishing will for sharing risk between generations has meant that collective pension funds have come under criticism in the Netherlands with some commentators calling for a move towards UK style individual pension pots.

We applaud the Government's willingness to challenge the current status quo on benefit provision. The numbers could work if sufficient larger employers chose collective pension funds as the pension scheme of choice for their employees, but given that many employers have already moved away from final salary pension schemes and are becoming increasingly risk averse, we question the appetite of many employers to move away from the defined contribution ("money purchase") model which is currently favoured and to generate the uptake required to make a collective pension fund in the UK viable.

Collective pensions require a communal attitude to pension savings which is now increasingly out of line with the individual attitude to pensions prevalent in the UK. To introduce them, comprehensive changes are needed to the UK's current pension architecture and overall approach which are challenged by politics, employer appetite and parliamentary time to implement. In the brave new world of pensions freedom and choice, collective pension funds will be of interest to some, though probably a minority.

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