



## Scottish independence: the implications for pensions

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## Executive Summary

The Scottish independence referendum will take place on 18 September 2014. The NAPF is strictly apolitical but as a membership organisation representing occupational pension schemes throughout the UK, it is essential that our members, and the millions of people who save into occupational pensions, are fully informed of the potential implications of the referendum for pension schemes and for people's incomes in retirement.

The NAPF welcomed the recent document published by the Scottish Government, "Pensions in an Independent Scotland", which sets out in greater detail the implications for pensions in Scotland if there is a majority 'yes' in the referendum.

This NAPF document outlines the potential impact of policy intentions set out in that Pensions Paper and identifies four areas where the Scottish and UK Governments will need to provide greater clarity so that pension funds, and their members, can make informed decisions prior to the referendum.

- Under EU law, pension schemes with members in Scotland and in the UK could become 'cross-border' schemes and would, therefore, need to be fully funded at all times. A more demanding funding regime is likely to lead to the closure of defined benefit (DB) schemes. At the very least, there should be a grace period (and an exemption) to help schemes manage any transition.
- There remains a lack of clarity about how the regulatory structure for pension schemes in an independent Scotland would work, and how any transition would be managed. Unpicking the current compensation regime would be extremely difficult and require careful management (over a long period of time). It is also likely to lead to substantial costs.
- The Scottish Government's commitment to the introduction of the single-tier pension provides welcome clarity. However, there remain unanswered questions about how they will manage the abolition of contracting-out. It is important that employers are assisted in managing this process; otherwise there is an increased likelihood of more DB schemes closing.
- While the Pensions Paper sets out no immediate plans to alter pensions tax relief arrangements, a later Scottish Government may wish to make changes to the policy. Such changes would have implications for pension schemes administering pensions for Scottish, as well as English and Welsh, taxpayers. Any complexity in tax regimes is likely to add significant costs for employers and schemes, which are in turn likely to be passed onto pension scheme members.

In order to address these points and to act in the interests of its members, the NAPF will seek to engage with all political parties, and both Governments, to ensure pensions remain at the top of their agendas.

## About the NAPF

The National Association of Pension Funds is the leading voice of workplace pension provision in the UK. We represent 1,300 pension schemes from all parts of the economy and 400 businesses providing essential services to the pensions industry. We represent both public and private sector schemes, including over 70% of the local authority pension funds. Our members provide pensions for 16m people and collectively hold assets of around £900bn, making them major institutional investors. Our main objective is to ensure there is a secure and sustainable pensions system in the UK.

### **NAPF membership in Scotland**

Our members in Scotland include some of the largest local authority pension funds in the UK, including Strathclyde, Lothian and Falkirk Councils, as well as some of Scotland's largest employers, including Heineken, House of Fraser and Scottish Power. In total, our Scottish members have combined assets in excess of £70bn. More than a quarter of a million employees are actively saving into these schemes, which also provide retirement income to 330,000 pensioners in Scotland.

## **Introduction**

1. The Scottish independence referendum will take place on 18 September 2014 and the impact of a 'yes' vote on workplace pension provision in the UK is likely to be profound and far-reaching.
2. The NAPF's overarching aim is to secure the future of workplace pensions and to influence the direction of retirement policy. The NAPF is a strictly apolitical membership organisation representing occupational pension schemes throughout the UK. As such, the NAPF has a duty to act in the interests of its members by contributing to the debate on the potential implications for workplace pension schemes of an independent Scotland. It is essential that our members, and the millions of people who save into occupational pensions, are fully informed of the implications of a vote for, or against, independence on their pension schemes and, ultimately, their income in retirement.

## **The key issues for pensions**

3. The period running up to the referendum will afford the opportunity for debate and discussion around the implications of Scottish independence. Already, politicians have focused on the future of Scottish pensions as a lens through which to view the independence debate.
4. It is important that plans for any constitutional change are given due consideration by both the UK and Scottish Governments, not least because further reform may take place, regardless of the outcome of the referendum. The implications for pensions arrangements in the event of a 'yes' vote are substantial. We welcome the opportunity to raise the issues, and have identified a number of key questions that need to be addressed.

### **State and public sector pension provision in an independent Scotland**

5. State Pension payments are made from general taxation and are therefore unfunded, but people build entitlement to their state pension through National Insurance (NI) contributions or credits made over their working life. Government spend on State Pensions is significant: in 2010/11 it was £82bn, 40% of all social benefit payments. State Pension entitlement for those who leave the UK depends upon whether they move to another EEA state or a country with which the UK has a reciprocal arrangement regarding State Pension provision.

6. The State Pension provides an important foundation for private pensions saving. The NAPF supports the UK Government's proposal for a single-tier state pension at an amount set above the level of means-tested benefits. The proposed system (currently being legislated for through the Pensions Bill 2013) provides greater clarity and certainty on what future pensioners can expect from the state in retirement. It also complements automatic enrolment reforms, whereby employers in the UK must provide workers with a workplace pension.
7. The Scottish Government has stated its commitment to honouring existing State Pension entitlements. It has also committed to the introduction of the single-tier pension in an independent Scotland. This commitment - reiterated in the recent publication by the Scottish Government - provides welcome clarity. However, the Scottish Government's commitment to continuing indefinitely with the Savings Credit element of Pension Credit risks undermining one of the key principles of the reform: that people know what State Pension they will receive in retirement and are confident that they are not at risk of losing out on means-tested benefits as a result of saving privately for their retirement.
8. The UK Government has currently committed to up-rating the single-tier pension by at least the average growth in earnings. In an independent Scotland, the single-tier pension would be up-rated by the greater of either prices, earnings or 2.5% - the Coalition's triple-lock guarantee. The State Second Pension would continue to be up-rated in line with average earnings up to an individual's State Pension Age and then in line with CPI inflation once their pension is in payment.
9. The transition from the current system to the single-tier pension will be difficult, particularly for employers affected by the abolition of contracting-out of the State Second Pension. The abolition of contracting-out will lead to increased costs for employers with contracted-out DB schemes, from the loss of the current National Insurance (NI) rebate and the costs of making changes to schemes to make up for this loss. It is important that employers are assisted in managing this process, otherwise even more DB schemes are likely to close. This is why the NAPF has argued for a statutory override, so that adjustments can be made to schemes to make up for the loss of the NI rebate.
10. Given that the single-tier pension is due to be implemented from 2016, it will be important that there is clarity on how the contracting-out elements of the legislation, such as the statutory override and treatment of protected persons, will apply to pension schemes in an independent Scotland. It will also be important to understand how public sector employers in Scotland will meet the increased NI costs from 2016. The Scottish Government's pensions paper made no mention of whether the statutory override would also be implemented in line with UK Government policy.

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11. The UK Government is responsible for the public service pension liabilities of unfunded public service schemes, including the Principal Civil Service scheme and the NHS Scheme. At 31 March 2011, unfunded public service pension liabilities were £893bn<sup>1</sup>. This represents 93% of public sector pension liabilities and 37% of all UK pensions liabilities. The Scottish Government currently has responsibility for a small number of public service schemes, which represent less than 1% of devolved activities. There are clear questions for the Scottish and UK Governments about how these liabilities will be divided.
12. In addition to the unfunded schemes, there are also a few funded schemes, including the Local Government Pension Scheme (LGPS) and the MPs' pension scheme. The LGPS in Scotland is administered separately and funds are managed by Scottish administering authorities. However, these schemes would be affected by how the Scottish Government chose to implement the single-tier pension, in particular whether there would be any assistance provided by the Scottish Government to Scottish administering authorities to make up for the loss of the NI rebate from 2016.

## The strategy for occupational pension provision in an independent Scotland, including automatic enrolment

13. There are a number of key pieces of pensions reform currently being implemented, of which the most important is the introduction of automatic enrolment. The NAPF strongly supports automatic enrolment, which we believe is a fundamental part of the solution to the pensions savings crisis in the UK. The system is being phased in gradually by size of employer, with the smallest employers not having to comply with the new duties until 2017. The minimum contributions are also being phased between now and 2018. Complying with the automatic enrolment duties is not an easy task for employers and the Pensions Regulator (TPR), which is overseeing the compliance regime, recommends that employers start planning for automatic enrolment 12-18 months before their staging date.
14. We therefore welcome the Scottish Government's commitment to continue with automatic enrolment as planned. This will provide reassurance for the large companies in Scotland which will have already started automatic enrolling their staff and the medium-sized employers who will be well advanced in their preparations.
15. There is also the question of who would police automatic enrolment in an independent Scotland. Whether TPR continues to police compliance with the new duties in an independent Scotland is

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<sup>1</sup> 2010-11 Whole of Government Accounts, HM Treasury.

likely to depend on the wider pensions regulatory architecture that is put in place. This is discussed in further detail later in this document.

16. As part of its automatic enrolment policy, the UK Government set up the National Employment Savings Trust (NEST). NEST is a trust-based pension scheme with low charges and a public service obligation to accept any employer that wants to use it in order to fulfil their automatic enrolment duties. Given that this is a UK Government-backed arrangement, the Scottish Government has committed to creating a Scottish equivalent, called SEST, in an independent Scotland. This will be welcome news for smaller employers in Scotland, who might otherwise struggle to find a pensions scheme provider. However, the setting up of NEST was not a simple task and required significant capital from the UK Government. The Scottish Government's paper does not provide any assessment of the costs of setting up SEST, how this would be funded and what this funding might mean for the charges SEST would levy on savers. Should NEST not wish to operate as a cross-border scheme, there may also need to be some unpicking of the pots of Scottish members who are already saving in NEST.

### **Regulation of workplace pensions and identifying the relevant regulator to manage the regulatory regime for Scottish pensions**

17. At present workplace pensions in the UK are regulated by a number of national regulators, including TPR, the Financial Conduct Authority (FCA) and the Prudential Regulatory Authority (PRA). There is also a compensation mechanism in place for members of defined benefit schemes whose sponsoring employer(s) become insolvent. This is administered by the Pension Protection Fund (PPF)<sup>2</sup>.
18. It is important to ensure consistent regulatory oversight of workplace pensions and that there is a comprehensive compensation mechanism in place. The FCA, TPR and PPF are UK institutions and whether, or how, their functions would work in an independent Scotland is likely to depend on the more general approach to UK institutions following independence. This in turn will depend on what currency is used in an independent Scotland. The Pensions Paper's proposals were based on formal monetary union and an integrated financial services market, based on continued use of Sterling in Scotland. However, given the confirmed uncertainty about which currency might be used, the sustainability of these proposals could be open to question.

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<sup>2</sup> 172,018 people were receiving PPF compensation, or will do in the future. In 2012/13 the PPF paid out £332m in compensation, [PPF Annual Report 2013](#).

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19. The key regulatory proposals in the Pensions Paper are:

- Scotland adopts existing UK private pensions law in the first instance, although the Scottish Government retains the right to amend it in the future;
- The Bank of England and the PRA would be tasked with their regulatory duties in Scotland, or a Scottish body would take this role;
- There would be a Scottish TPR to oversee all private pensions regulation in Scotland. It would work closely with the UK's TPR and FCA; and
- There would be transitional arrangements to ensure PPF and FAS continue to operate across the UK, or there may be a Scottish equivalent.

20. These proposals provide a modicum of clarity regarding the Scottish Government's intentions, but a wealth of unanswered questions remain. In particular, how any transition would be managed and how new Scottish bodies would be set up and funded. With regards to the PPF arrangements, there is uncertainty in the short term about which schemes would be overseen by which body; what would happen to Scottish schemes that have already entered the UK PPF in the short term; and how any schemes in the PPF, that may be identified as cross-border following independence, will be separated. In the long term, the separation of Scottish assets and liabilities for transfer to the Scottish PPF is likely to be a complex and costly undertaking.

21. Regardless of how the regulatory transition is managed, the biggest challenge is likely to be how to identify schemes that become Scottish or cross-border as a result of an independent Scotland. One of the biggest potential issues for UK pensions schemes would be the impact on their funding arrangements should they become cross-border schemes. This is discussed in more detail below.

22. Whatever the approach, unpicking the current regulatory structure, and the compensation structure in particular, would be extremely difficult and would require careful management over a long period of time. This is likely to lead to substantial costs for UK and Scottish institutions, as well as for sponsoring employers and schemes. Ultimately, these costs may have to be passed on to pension scheme members eroding the value of their pension savings.

## The European dimension – European membership, currency, cross border solvency issues for occupational schemes – in the context of an independent Scotland

23. At present, the Institutions for Occupational Retirement Provision (IORP) Directive applies to all occupational pension schemes in the EU. Among a number of provisions governing how IORPs

can operate, the Directive sets out solvency requirements with which IORPs must comply. In particular, any cross-border schemes operating in the EU must be fully funded “at all times”.

24. Currently, the number of cross-border schemes is very low. In EIOPA’s annual report on cross-border IORPs the number was down by two in 2013 to 82<sup>3</sup>. Half of these are between the UK and Ireland (25 Irish schemes operating in the UK and 14 vice versa). There are three UK-based schemes operating in Germany, five in France and five in the Netherlands. The NAPF’s interpretation of this data is that it proves there is little demand for cross-border pension schemes.

**A NAPF [Scotland Group] Member told us:**

“If a DB scheme has members in different EU member states, the scheme needs to be fully funded very quickly. This could result in schemes having to be split up at huge expense (or members being forced to leave the scheme). The argument that the number of DB schemes is declining to the point of future extinction fails to acknowledge UK DB schemes with members in England and Scotland (such as retailers, banks, insurance companies) that could reasonably be expected to continue for many years to come.”

25. A cross-border scheme is a scheme located in one EU country accepting contributions from an employer in another EU country. Should an independent Scotland become a member of the EU, a significant number of UK pension schemes would become cross-border schemes, and as such would be required to fill any funding gap<sup>4</sup>. They would also be required to undertake annual, rather than triennial, valuations: a significant additional regulatory and cost burden. One possible way of avoiding such an outcome would be if an arrangement were reached, as part of EU accession negotiations, to exempt such schemes from this requirement or give them a grace period to achieve full funding.

26. Obviously, the implications of any cross-border regulations would depend on the status within Europe of an independent Scotland. It is difficult to quantify the potential impact on funding requirements in the absence of any clarity on this issue. However, we remain concerned about the potential impact of increased pension funding on economic growth and the potential increase in scheme closures. We welcome the Scottish Government’s recognition of schemes’ concerns

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<sup>3</sup> [2013 Report on market developments in cross-border IORPs, EIOPA, July 2013](#).

<sup>4</sup> The [PPF 7800 Index](#), published 12 November 2013 notes that the average funding ratio (against section 179 liabilities) is 93.8%. A section 179 funding basis is less onerous than the section 222 (technical provision) basis so a greater number of funds would be underfunded against their technical provisions.

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about this issue and we are keen to be involved in the discussions proposed in the Pensions Paper to explore the impact of this and potential transition arrangements.

### Pensions taxation

27. There is already a power to implement a different tax treatment of Scottish taxpayers, should the Scottish Parliament wish to do so. Use of this power will affect pensions savers, as tax thresholds act as a trigger for automatic enrolment into a pension scheme and the amount of pensions tax relief a person is entitled to.
28. The Scotland Act 2012 gives the Scottish Parliament the power to set a Scottish rate of Income Tax to be administered by HM Revenue & Customs (HMRC) for Scottish taxpayers. It is expected to apply from April 2016. The Act also provides powers for new taxes to be created in Scotland and for additional taxes to be devolved.
29. For employees and pensioners, the Income Tax change will be applied through PAYE (Pay As You Earn). HMRC will issue tax codes to employers in the months before April 2016 which will identify those employees who are Scottish taxpayers, and employers will deduct tax at the appropriate rates, which may be higher or lower than or the same as those which apply in the rest of the UK. The definition of a Scottish taxpayer is based on the location of an individual's main place of residence.
30. If the Scottish Parliament set different tax thresholds, it is not yet clear what the implications for automatic enrolment and pensions tax relief would be. Any complexity in tax regimes is likely to increase significantly administration and operational costs for employers and schemes, and these are likely to be passed onto pension scheme members.
31. While the Pensions Paper sets out no immediate plans to alter pensions tax relief arrangements, a later Scottish Government may wish to make changes to pensions tax relief policy (automatic enrolment thresholds), which would have implications for pension schemes administering pensions for Scottish as well as English and Welsh taxpayers. In the longer term, employers with employees in Scotland as well as England and Wales, are likely to be managing separate PAYE and corporate tax assessment and collection systems. The costs of making these changes to both the private and public sector need to be taken into consideration. We would urge an independent Scotland to maintain as harmonious a tax regime as possible.

## The impact of pension schemes as institutional investors

32. In addition to the direct impact on UK pensions schemes, there will also be knock-on effects as a result of their role as key institutional investors. It is difficult to extrapolate how much UK investment by pension funds sits within Scotland. However, as important long-term institutional investors, both in the UK and globally, pension funds hold around £1tn of assets under management. It will be important to the Scottish economy that Scotland continues to be an attractive place to invest following independence.
33. One of the issues that is likely to dictate investment in Scotland by pension funds is what form fiscal and monetary policy takes in an independent Scotland. There is ongoing debate about what currency an independent Scotland would use and, as a result, the level of control it would have over its own monetary policy. The outcome of this debate will affect the level of currency risk for schemes invested in Scottish companies.
34. There is likely to be a denominating of a proportion of UK gilts as Scottish sovereign bonds. These are likely to trade at higher yields than their UK equivalents, at least initially, reflecting less liquid markets, the smaller economy underpinning them and the lack of any fiscal policy track record. This will affect the attractiveness of Scottish bonds and could have a knock-on effect on the assets and liabilities of Scottish pension funds, which may feel bound to use the Scottish bond as the marker for scheme discount rates.
35. Clarity on these key planks of fiscal policy in an independent Scotland could help prevent mass disinvestment by strong long-term investors, such as pension funds, in the Scottish economy.

## Conclusion

36. The NAPF is a strictly apolitical organisation and has no brief for either pro- or anti-independence lobbies. However, the potential impact of the referendum on workplace pensions could be significant and the NAPF has a duty to act in the interests of its members by contributing to the debate on the potential implications. It is essential that our members, and the millions of people who save into occupational pensions, are fully informed of the implications for their schemes of a vote for or against independence and, ultimately, their income in retirement.
37. This paper has set out what we believe are the key areas that the Scottish and UK Governments need to address so that pension funds and their members can make an informed decision prior to

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the referendum. We welcome the recent Pensions Paper but believe that there remains a large number of areas where greater clarity is still required.

38. In order to address the points raised and to act in the interests of members, the NAPF will be engaging with all political parties and both governments over the coming months to seek answers and clarification and to ensure that pensions issues remain front of mind for all parties. We look forward to taking an active and on-going part in this critical debate.

### **Further information**

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