SCOTLAND’S PENSIONS FUTURE: HAVE OUR QUESTIONS BEEN ANSWERED?

3 February 2014
The ICAS perspective

The Institute of Chartered Accountants of Scotland (ICAS) is a professional body of 20,000 members who work across the UK and in more than 100 countries around the world. Our members represent different sizes of accountancy practice, local and global businesses including financial services and industry, the investment community and the public sector.

The ICAS Charter requires it to act primarily in the public interest, and our responses to consultations and contributions to public debate are therefore intended to place the public interest first. Our Charter also requires us to represent our members’ views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

ICAS members have a contribution to make to the debate on Scotland’s future, its meaning and the implications for those in Scotland, the rest of the UK (“rUK”) and beyond. ICAS has a duty to act in the public interest, which means we should contribute information and insights, and ask pertinent questions, based on the considerable interest and experience of our members in technical areas such as pensions, taxation, governance and regulatory matters.
Scotland’s pensions future: have our questions been answered?

Contents

Introduction .................................................. 4
1. The State pension ........................................ 4
2. Public sector pensions .................................... 6
3. Private sector pensions ....................................
   • Regulation of work-based pensions ............... 7
   • Cross-border issues for occupational pension schemes in an independent Scotland .... 9
4. The wider context ......................................... 10
Conclusion .................................................... 11
Introduction

Scotland’s pensions future: what pensions arrangements would Scotland need? was published in April 2013. It set out a series of questions on pension-related matters that in our view needed to be considered over the months leading up to the referendum on Scottish independence on 18 September 2014.

The Scottish Government subsequently published Pensions in an Independent Scotland in September 2013 (the “Pensions paper”), and Scotland’s Future: Your Guide to an Independent Scotland in November 2013 (the “Guide”). This briefing paper assesses the extent to which our earlier key questions have been answered. What follows in each section below are the key questions and a contextual paragraph taken from the ICAS April 2013 paper, together with a short commentary and conclusion on the extent to which consideration has been given to our questions. The contextual paragraphs have been updated to include more recent financial information where this is available.

1. The State pension

Our questions
- Who would make State pension payments in an independent Scotland and take responsibility for any entitlements built up prior to independence?
- What State pension arrangements would the Scottish Government need to introduce?
- What transitional arrangements would be needed?
- What would the Scottish Government receive, if anything, from the UK Government by way of providing for those of working age with “accrued” entitlement to a State pension?

State pension payments are made from general taxation, and are therefore unfunded, but entitlement is built up over many years. Responsibility for the “accrued” entitlement of those of working age living in Scotland to a State pension and the practicalities of making payments to those who are currently retired would be a major feature of any formal negotiations between the Scottish Government and the UK Government. From a public expenditure perspective the State pension is significant. In 2011-12, State pension payments of £87 billion (2011-10: £82 billion) were made by the UK Government, representing 41% (2010-11: 40%) of all social benefit payments and 12% (2010-11:13%) of UK expenditure.

Our reaction
The Scottish Government’s Guide confirms the intention that, in an independent Scotland:
- Current pensioners would continue to receive their pensions as now, on time and in full – and that accrued rights would be protected; and
- Planned reforms would be rolled out from 2016, including the introduction of the single tier pension.

The Pensions paper and the Guide clarify how State pensions would be accrued and paid in an independent Scotland and the transitional arrangements to be adopted. The “triple lock” to be adopted for the first parliamentary term of an independent Scotland would protect the value of the State pension (and single-tier pension and guarantee credit) over time against prices or earnings, with a minimum annual increase of 2.5%. The Conservatives have made a similar commitment to the “triple lock” should a Conservative UK Government be elected in 2015.

The new single-tier pension would be introduced in an independent Scotland, as currently planned by the UK Government, in April 2016, and could be slightly higher than that proposed for the UK. The UK single-tier pension is estimated to be worth a minimum of £158.90 per week in 2016-17, assuming it is uprated by at least 2.5 per cent. The Scottish Government is committed to setting an initial rate of £160 per week or will match the UK rate if it is higher.

The single-tier pension is to be paid in full to those with 35 qualifying years of NI contributions or credits. A minimum qualifying period of 7 to 10 years is proposed by the UK Government and would be adopted in an independent Scotland. In our view, the minimum qualifying period might impose unwelcome constraints on employee mobility and thereby impact on Scotland–rUK migration and vice versa. For example, someone who worked in England for 6 years during their working life and in Scotland for the remainder would need to work an additional 6 years to achieve 35 qualifying years of NI or credits. This would be no different from the situation experienced by workers from other EU states currently working in the UK nevertheless it would be an additional constraint compared to the status quo.

Accepting that the State Pension Age (SPA) should rise to 66 by 2020 as proposed by the existing UK timetable, the Guide commits to a review of the SPA and notes the possibility of postponing further changes in Scotland to 67 and beyond. An Independent Commission would consider this matter in the first two years of independence. Our understanding is that there is some uncertainty as to how to interpret the lower average life expectancy in Scotland, as compared to the rUK, and it is therefore unclear whether this would justify any reduction in the SPA. Consequently, more detailed consideration of Scotland’s demographics would seem appropriate before any policy decisions are made.

Questions of affordability underlie any proposed government generosity in relation to pensions, including any delay in increasing the SPA in line with the timetable announced by the UK Government. Affordability is a challenge for many developed countries including the UK, but the demographics of Scotland with a higher projected ratio of pensioners to those of working age population mean that this is likely to be more of a challenge here. The Guide accepts this and discusses some possible ways to boost the working age population, mainly through economic growth and inward migration – although it needs to be factored in that these extra people will retire and require a State pension in due course. Clearly, it is uncertain at this stage as to whether these ideas for boosting the working age population would be sufficient as a means of improving affordability.

Furthering the debate
In conclusion, the Guide has addressed a number of questions at a high level – although this has generated further questions and possible concerns in a number of detailed areas. In our view, the following key questions about transitional arrangements remain outstanding and some may not be answerable prior to the referendum:

- What transitional arrangements would be needed to successfully migrate responsibility for the payment of the State pension to pensioners living in Scotland at the date of independence, including communication with individuals?
- What transitional arrangements would need to be made to ensure that the “accrued” entitlement to the State pension of those of working age living in Scotland at the date of independence are successfully transferred, including communication with individuals?
- How does the Scottish Government propose to define “living in Scotland at the date of independence” or “country of residence at the date of independence” for the purpose of determining entitlement to a Scottish State pension? How would this definition dovetail with arrangements for determining citizenship and any flexibility for individuals to choose, including any potential to choose dual citizenship?
- Would there be any scope for mitigating the possible effects of a minimum qualifying period for both the Scottish and UK State pensions, given that EU law may not permit special arrangements between Member States?
- What amount or reimbursement would the Scottish Government seek to negotiate from the UK Government by way of providing for those with “accrued” entitlement to a UK State pension i.e., both individuals in receipt of a State pension and those of working age? How might this be calculated?
- Are there any legal barriers which would prevent the rUK, as a member of the EU, transferring responsibility for the “accrued” State pension entitlements of those living in Scotland at the date of independence?
2. Public sector pensions

Our questions
- Who would be responsible for unfunded public sector pension liabilities built up prior to independence?
- What legislative and regulatory framework would Scotland need to support the on-going administration of public sector pension schemes?
- How would unfunded pension liabilities be shared, for example, unfunded liabilities arising from the Armed Forces Pension Scheme, the NHS in Scotland Pension Scheme and the Principal Civil Service Pension Scheme?

At 31 March 2012\(^2\), unfunded public sector pension liabilities of £919 billion (March 2011 restated: £894 billion) were reported by the UK Government, representing 91% (March 2011: 93%) of all UK public sector pension liabilities and 35% (March 2011 revised: 36%) of all UK liabilities. What would Scotland’s share be in the opening balance sheet of an independent Scotland? For schemes which are Scottish based, the Scottish Public Pensions Agency has recently identified unfunded liabilities of £60 billion\(^3\) representing 70% of Scottish public sector pension liabilities identified so far. However, detailed work would be required to identify additional liabilities relating to Scottish-based members of UK-wide public sector pension schemes.

Our reaction
The Guide confirms that all public service pension rights and entitlements which have been accrued will be fully protected and accessible, and that the Scottish Public Pensions Agency will deliver public sector pensions in an independent Scotland.

The Pensions paper provides some assurances that the Scottish Government would take on the responsibility for the pensions of active, deferred and pensioner members of unfunded schemes, including members of UK-wide unfunded pension schemes living in Scotland. It also sets down a marker that the responsibility to take on these unfunded liabilities would be a feature of future negotiations with the UK.

In addition to considering the SPA in an independent Scotland, the Scottish Government would consider the impact of this policy on the working and retirement patterns of public servants. It would also review the pension terms of all uniformed services.

The Scottish Government commits in the Guide to providing a fair, affordable and sustainable pension and reward package for public sector employees. However, the affordability (and therefore the sustainability) of public sector pensions remains a long-term matter, which will need to be managed in the light of changing demographics and other demands on public funds.

Furthering the debate
In summary, the Guide has set out the Government’s intentions on how public sector pensions will be administered, together with some indication of how they might be reviewed and amended over time. However, there is little detail on how the existing unfunded pensions might be split between Scotland and the rUK, or how public sector pensions can continue to be afforded.

Any liabilities arising from Scotland’s share of unfunded public sector pension liabilities acquired following independence, would need to be based on those individuals whose pensions the Scottish Government acquired responsibility for paying. Therefore, it is not a case of negotiating an amount with the UK Government but rather agreeing on a range of criteria to be applied to individual scheme members to determine which Government should be responsible for payment of a pension and the related liability.

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3 Written evidence submitted by the Scottish Public Pensions Agency to the Scottish Affairs Commons Select Committee, in response to the Committee’s call for evidence issue on 6 February 2013: [www.publications.parliament.uk/pa/cm201213/cmselect/cmscotaf/writev/ref/m06.htm](http://www.publications.parliament.uk/pa/cm201213/cmselect/cmscotaf/writev/ref/m06.htm)
The remaining questions therefore include the following:

- What should the criteria be for determining which government would be responsible for the pensions of individual members of unfunded public sector pension schemes - for example, members of the Armed Forces Pension Scheme; the NHS in Scotland Pension Scheme and the Principal Civil Service Pension Scheme?
- What other transitional arrangements would be needed to successfully migrate responsibility for scheme members living in Scotland at the date of independence, including member communications?
- How does the Scottish Government propose to define “living in Scotland at the date of independence” or “country of residence at the date of independence” for the purpose of determining responsibility for paying the pension of members of an unfunded UK scheme? Issues of citizenship may be relevant here as they would be in relation to the State pension.
- What amount or reimbursement would the Scottish Government seek to negotiate from the UK Government by way of providing a pension from an unfunded UK scheme?

3. Private sector pensions

Regulation of work-based pensions

Our questions

- What pension regulation and protection arrangements would an independent Scotland need for private sector pensions?
- What would happen to existing pension law?
- Would new industry bodies be set up: for example, to perform the functions of The Pensions Regulator and the Pension Protection Fund?
- Would current UK arrangements be replicated or replaced: for example, what would happen to auto-enrolment arrangements?

We believe it would be advantageous for the Scottish Government to continue, at least in the early years of an independent Scotland, to adopt existing UK arrangements for pension regulation and protection and develop these over time. However, this approach would bring its own challenges, with the protection of defined benefit arrangements and the future of the UK Pension Protection Fund likely to be in the forefront of these.

Our reaction

The Guide sets out a number of proposals, including:

- A rolling over of UK law for an interim period;
- Close alignment of the structure and activities of the regulatory framework with the rUK;
- A continuation of the roll-out of automatic enrolment; and
- The creation of a Scottish equivalent of NEST (the National Employment Savings Trust).

The establishment of a Scottish Pensions Regulator is proposed: it would work with the rUK Pensions Regulator and the (UK) Financial Conduct Authority. However, the current pension protection arrangements would continue, with the existing (UK) Pension Protection Fund continuing to cover Scottish schemes, and with Scottish schemes continuing to pay PPF levies. It may be helpful to look at similar arrangements across Europe: we are aware that Luxembourg has a similar arrangement with Germany, although Luxembourg is proportionately smaller compared to Germany than Scotland would be compared to the rUK.
In our view, it is questionable how having two regulators, two countries and only one protection fund would work in practice, especially when policy intentions or the interests of the different governments diverge, and it begs the question as to why the UK Government and the UK PPF might agree to such a degree of risk sharing. Concerns have previously been raised that a pension protection fund solely for Scotland may not have the critical mass and the scheme profile to act as an effective safeguard for all Scottish schemes. Therefore, if it can be made to work, retaining a combined PPF with the rUK could be an effective resolution, from the Scottish perspective. However, this could tie the government of an independent Scotland to the overall approach taken by the rUK to pension law and regulation for the foreseeable future.

It is helpful to have clarified that a SEST (Scottish Employment Savings Trust) would replace NEST in Scotland, although further clarification would be helpful on the likely set up costs of establishing SEST and as to how the accumulated contributions of Scottish members of NEST might be transferred into SEST, given that NEST is unable to operate cross border. We would also question the cost effectiveness of SEST – and even its viability – given the lower numbers of members than in NEST and a similar element of fixed costs relating to the initial set up and continuing operation.

Arrangements for future transfers between SEST and NEST would also need to be considered to accommodate the needs of those who move between Scotland and the rUK during their working life and who are employed by businesses using government established arrangements to provide pensions to their staff.

Establishing a system of law and regulation in an independent Scotland similar to the current UK system would not be as straightforward as simply rebranding all aspects of UK law impacting on occupational pensions as Scots law. Scottish pension law would need to be tailored to enable the infrastructure of the regulatory system to be established in a Scottish context.

_Furthering the debate_

In conclusion, the Guide sets out the broad terms of the intended regulatory and protection arrangements in an independent Scotland. These do, however, give rise to concerns as to whether the proposed arrangements can be agreed with the UK Government and on how the arrangements are likely to work in practice. They also generate further questions such as those that follow:

- How would Scottish pension law put into effect the regulatory and protection arrangements proposed in the Paper?
- What would be the likely costs of establishing a regulatory structure for pensions in an independent Scotland from the date of independence and for new regulatory bodies to develop toolkits and codes of practice to support the governance of Scottish occupational pension arrangements?
- What would be the likely cost to Scottish occupational pension schemes and employers of transitioning from one regulatory regime to another?
- How would the Scottish Government approach negotiations with UK Government, so as to secure agreement on the continuation of the (UK) PPF for both the rUK and an independent Scotland?
- What would be the options for establishing pension protection arrangements in Scotland if these negotiations were unsuccessful? How would this impact on the (UK) PPF?
- If the negotiations were successful, how would the (UK) PPF respond in a future scenario to any divergence between pension regulation in Scotland and in the rUK?
- Could a private sector provider, such as an existing master trust, be offered the opportunity to provide SEST?
- How would arrangements established by employers and pension administrators, which will be necessary to accommodate the Scottish rate of income tax under the Scotland Act 2012, be adapted to meet the requirements of an independent Scotland’s tax system?
Cross-border issues for occupational pension schemes in an independent Scotland

Our questions

- How would EU solvency requirements for defined benefit and hybrid pension schemes be met across the UK if Scotland became an independent country?
- What solvency requirements would need to operate cross-border between Scotland and the remainder of the UK, if Scotland remains within the EU?
- What solvency requirements for pension funds should operate, if Scotland does not remain within the EU?

If Scotland became an independent country there would be significant cross-border issues for schemes which currently operate UK-wide. Under EU law (as interpreted by UK legislation), schemes which operate in more than one Member State must fund their liabilities in full and any underfunding must be rectified immediately rather than through a staged recovery plan. Dealing with underfunding would have major cost and cash flow implications for employers with underfunded cross-border schemes.

Our reaction

The Guide accepts that this is an issue and believes that discussions should start immediately to agree appropriate transitional arrangements. It is confidently asserted that arrangements would be agreed which provide the necessary flexibility for employers, while ensuring that members and beneficiaries are protected, and the Guide correctly states that this is an issue for the UK Government as much as for the Scottish Government. However, in our view, the three year transitional grace period mentioned a number of times is likely to be wholly insufficient for many schemes which are currently funding their deficits over much longer periods. A recent survey by PWC of 150 UK defined benefit pension schemes reveals that it will take companies which obtained an actuarial valuation in 2013, on average, 11 years to repay their pension deficits.

In our view, it is unclear how discussions would be initiated to secure these transitional arrangements and whether the key parties to such discussions – the European Commission and the UK Government – would be willing to engage at this point in time. Subsequent to a vote for independence in September 2014, it is likely that these discussions would become embroiled within the more fundamental issue of Scotland’s membership of the EU generally.

However, the European Commission’s plans to reform the Pensions (IORP) Directive could provide an opportunity for the rules around cross-border schemes to be altered in a manner which eases the ‘cross-border funding problem’. The cross-border rules as they currently stand have not facilitated the establishment of a significant number of cross-border pension schemes as they were intended to do. Timing may be an issue as changes to EU Directives take time to deliberate and then bring into domestic law. The European Commission is not due to receive a final report and regulatory impact assessment from EIOPA (The European Insurance and Occupational Pensions Authority) on any proposed reforms until 2015 at the earliest and consequently any changes to cross-border rules are unlikely to be in place prior to the Scottish Government’s proposed independence day of 24 March 2016.

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Furthering the debate
While this issue has been recognised, it remains very unclear how the funding issue is likely to be satisfactorily resolved. Clearly the extent to which this issue impacts on an independent Scotland depends on the status of Scotland within the EU, and this more fundamental uncertainty provides a further overlay of complexity. The outstanding questions include the following:

- Can the Scottish Government encourage the necessary “immediate” negotiations with the UK Government and the European Commission, so as to secure some form of transitional relief from the requirements of EU law on cross border schemes?
- What concessions would the Scottish Government be likely to have to make to secure an agreement on transitional relief?
- What would be the options for Scotland if these negotiations were unsuccessful? How could the Scottish and the rUK Governments help Scottish and rUK businesses to comply with the law while facing possibly significant funding demands from their pension schemes?
- Could there be scope for the EU to amend the cross-border rules in the Pensions (IORP) Directive in a manner which facilitates the operation of cross-border schemes more widely across Europe and which would ease the impact on schemes operating in Scotland and in the rUK in the event of Scottish independence?

4. The wider context

The Scottish Government’s papers, published in September and November 2013, provide the public and commentators with more information on policies being developed around pensions and a whole range of other topics including the currency which would be used in an independent Scotland and arrangements for joining the EU. However, the ability of the Scottish Government, following a ‘Yes’ vote, to deliver these policies is to a large extent dependent on future negotiations with the UK Government, the European Union and other bodies. Our insights on pensions in an independent Scotland are therefore given in the context that there are no mechanisms to resolve with certainty some fundamental issues which would impact on pension arrangements, such as the currency an independent Scotland would use and EU membership, prior to the referendum.

We have referred to the State pension reforms which are due to be implemented across the UK in April 2016. These are not the only changes to pension arrangements which we may see over the coming years: the UK Government is currently considering which reforms to undertake to improve the extent of private pension saving and the quality of private pension products provided by the pensions industry. This means that the pensions system an independent Scotland may inherit may be different in a number of respects than the one we have at the moment. The Scottish Government would therefore be wise to keep a watching brief on this complex and changing topic.

Currency
While the Guide sets out the intention to negotiate a sterling currency union with the rUK, it does not set out what alternatives there might be if such negotiations were unsuccessful. Indeed the UK Government continues to assert that it will not enter into a currency union with an independent Scotland. There therefore remains a high degree of uncertainty as to what the currency of an independent Scotland will be. The choice of currency will have a very significant impact across the pensions sector, the economy and the country generally, and this will inevitably remain as a major uncertainty for the time being.
**EU membership**
The Guide asserts that an independent Scotland would continue as a member of the EU, not through negotiating as a new member state, but through treaty change requiring the unanimous support of all existing 28 Member States. Doubts have been expressed as to whether such unanimous support would be forthcoming or whether this could be achieved by March 2016. There remains uncertainty therefore as to whether Scotland would continue to remain a member of the EU on independence, whether it could negotiate readmission as a new Member State or through Treaty change, or whether there would be a gap period in membership. EU membership and the legislative underpinning which this provides, as well as the cross border arrangements on matters such as trade and taxation, underlie many of the issues relating to independence, including pension policy. This is also going to remain a critical uncertainty for the foreseeable future.

**Infrastructure costs**
The Guide does not set out in full the likely cost of setting up new government infrastructure or developing existing infrastructure for Scotland as an independent country. As highlighted in the Guide, and as evidenced above in relation to pensions, there are intentions to use some of the existing bodies in Scotland for new and extended purposes, to set up some new bodies, and to continue to share some joint bodies with the rest of the UK. It would be helpful for some estimation of the additional costs of the new and extended infrastructure to be given and the likely cost of acquiring through recruitment or training any additional specialist staff resources required.

**Negotiation and policy uncertainty**
In many subject areas following a vote for an independent Scotland, the eventual outcome would reflect the result of the negotiations between the Scottish and UK Governments between September 2014 and March 2016. The Scottish Government has set out its proposals in the Guide, including in many areas a preference for joint arrangements or areas of co-operation with the rUK. Clearly a successful outcome, from Scotland’s perspective, depends on successful negotiations between the Scottish and UK Governments, but clearly this cannot be assured at the present time.

In addition to setting out a blueprint for independence and the Scottish Government’s preferred outcome of negotiations (with the UK and the EU), the Guide sets out a number of policies which would be followed by the SNP if they were elected to government in the first elections of an independent Scotland. Clearly, if another party was elected to government, different policies would be likely to be followed. Such “policy uncertainties” will inevitably continue to exist.

**Conclusion**
The two Scottish Government papers - *Pensions in an Independent Scotland* and *Scotland’s Future: Your Guide to an Independent Scotland* – provide the public with an overview of its policy agenda for pensions. The papers respond to many of the questions ICAS raised in *Scotland’s Pensions Future: what pensions arrangements would Scotland need?*

However, demonstrating that an independent Scotland can deliver a pensions system which meets the needs of Scottish citizens is an on-going challenge for the Scottish Government. Its proposals show that it plans to meet this challenge through replicating the status quo and adopting reforms which are currently planned such as the implementation of the single-tier state pension. Any proposed differentiation is at the margins such as the proposal to establish an independent commission to examine the timetable for increasing the state pension age to 67.

Replicating existing arrangements in an independent Scotland would not be without its challenges. ICAS has already highlighted that without changes to EU rules on the funding of defined benefit pension schemes, employers would need to make good any deficits held by new cross-border schemes.
We have also highlighted that the Scottish Government’s scope to implement its policy agenda for pensions post-independence would depend on the outcome of any post-referendum negotiation. With that in mind, there are limitations on the degree of assurance the Scottish Government can provide on what could eventually be delivered. Having said that, the papers move the debate on pensions and independence forward and provide an opportunity to tease out some more detailed but nevertheless important aspects of delivering a separate pensions system.