The future of UK occupational pensions

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Abstract The UK pensions environment, having been constructed in a piecemeal fashion over a period of nearly 50 years, is far more complex than it needs to be. Further reforms about to be put in place in April 2001 are intended to involve employers more in pension provision for their employees, but will also serve to add yet more complexities. At the same time, a 40-year experiment with the provision by government of second-tier pensions appears to be drawing to a close. This paper proposes a radical approach to future compulsory pension provision.

Keywords: *UK pensions; complexity; new reforms; stakeholder; second-tier provision; compulsion*

Introduction

The spread of employer-sponsored occupational pension schemes from the late 1950s to the early 1970s was the most significant development in UK pensions of the last century; half the working population has been covered by occupational pension schemes since the mid 1960s. The favourable pension position the UK now enjoys at the start of this new century, compared to that of its European partners, is largely due to the willingness of UK employers and their employees to put aside substantial voluntary pension savings. Personal pensions have also played a large part in attracting further voluntary savings from employees and the self-employed, but there is no doubt that the best pensions produced in the UK over the last 40 years or so have arisen because of employer involvement.

There have been many attempts by government to encourage the spread of employer-sponsored schemes, notably in 1973, 1974 and 1986, but these have been largely unsuccessful; the percentage of the working population covered by occupational pension schemes has remained constant for the last 35 years. This has been the case even though the working population has increased in size to quite a significant extent. While around half the current workforce have membership of occupational pension schemes, it is only a minority of employers who provide them. Typically, the larger employers are likely to provide pensions for their employees, whereas the smaller employers are not.

Structural change

The UK pensions market is about to

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change substantially, indeed the author believes we are about to witness a genuine structural change in both the focus of the market and the nature of product. This is being driven by four Acts of Parliament that will affect the pensions environment from April 2001. There has never been a period of change quite like this before and, in the author's opinion, this legislation will lead to the most fundamental change ever seen in the UK. First, however, it is worth examining the situation now and what led to it.

People have made predictions of structural change before, most notably in the mid- to late-1980s with the coming of the (then) new personal pensions. At the time of the 1985 green paper, and the period of consultation following it, many commentators and industry bodies came out strongly in favour of more weight being given to employer-based pensions than to individual pensions. The thought was that historically the best pensions that had been produced in the UK had arisen where employers had been actively involved; in particular, where they had been contributing towards their employees' pension savings. By 1985 there had been almost 30 years of experience to back up such claims. The modern era of pensions had effectively started with the 1956 Act that spawned the enormously important occupational scheme sector and simultaneously established a separate environment to support individual pensions, which were then known as Retirement Annuity Contracts.

This dual system survives almost intact today, although it has had numerous (some would say countless) embellishments since, so as to make it virtually recognisable as such. But the underlying structure is there.

In the 1985 to 1988 period the author was in the camp that favoured a general push towards employer-sponsored schemes and away from individual pension arrangements — the two 'big' topics of the day. The main arguments used in those days in favour of this approach were the economies of scale provided by the method of group distribution and the severely restricted market that could sensibly bear the costs of individual distribution. Indeed, it seemed highly unlikely that individual pensions would ever break out of their erstwhile natural marketplace and spread to less affluent people than Retirement Annuity Contracts had done. In addition, the state second tier pension scheme (Serps) that had been established in 1978 was itself structured in such a way as to mimic the benefit structure of traditional occupational pension schemes. Many people regarded it, in effect, as an occupational pension scheme for those employees who were denied access to such arrangements through their employment.

A strengthening of the Serps scheme together with a re-affirmation of government backing for good occupational schemes, and leaving individual pensions to their natural markets of the self-employed and payers of additional voluntary contributions would, we argued, have consolidated all that was strong in the UK pensions experience. It would also have established a solid foundation for future pension growth. Had it happened that way we would, by now at the dawn of this new century, already be reaping the substantial benefits such an approach would have produced; but it did not, and we are not.

In the event, the opportunities that existed in those days were foregone in the pursuit of a policy that was almost the complete opposite. Serps was reduced

both in value and in scope; occupational pensions were weakened, not strengthened — in particular by legislation which went along with the crazy notion that individual choice was paramount and allowed employees to leave, or not bother to join, company pension schemes to which employers were contracted to contribute. The focus instead was put into the individual distribution of the (then) proposed 'portable' pensions. Now, as it turned out, the 'portable' pension idea gradually mutated into the 'personal' pension which was itself nothing more than a re-hash of the old Retirement Annuity Contract, already by then 30 years old and showing its age. Personal pensions were no more portable than Retirement Annuity Contracts had been, and Retirement Annuity Contracts were hardly portable at all.

Current reforms

This is all well known; it is ancient history in pensions terms, but it has some remarkable similarities to the pension 'reforms' that are currently being enacted. The radical stakeholder pension that was proposed in the 1998 green paper turns out after all to be nothing more than a re-hash of the existing personal pension. Indeed, it is a personal pension, nothing more, still based on the outmoded and antique Retirement Annuity Contract nearly 50 years on. It has limitations imposed on it which are intended to enable it to defy the laws of financial gravity and stop the true costs of individual distribution falling on consumers and, at this stage, it is far from clear what the long-term effect of this aspect of price control will have on the markets of the future. Some people clearly think this might work, others do not, but the fact is it is simply not known at this stage. If the approach does

fail though, the consequences could be unhelpful, not to mention unpleasant; it is possible that the individual pensions markets could simply come crashing down.

At the same time, the Serps scheme is being further degraded, this time mutating into something called S2P which is nothing more than a flat-rate top-up to the existing (and itself degraded) state basic pension. What this all amounts to is a continuing and accelerating trend away from state provision of pensions and towards private pension provision. The model for private provision, as has been demonstrated, is largely based on the premise behind the 1956 legislation — the dual system of occupational and individual pensions driven by taxation incentives for both employers and employees. But there is one change being introduced that might just provide the UK with genuine reform if it is followed by further enlightened initiatives by a future government. Some suggestions for such initiatives are proposed here.

Genuine reform

The important change being introduced soon is that for the first time ever in the UK employers will be required by law to make pension schemes available to their employees. This has never been the case before. Since 1956 employer involvement in pension provision has been voluntary. Not all employers are affected by this legislation, some of the smaller employers are exempted from the stakeholder access requirements, but the vast majority will need to take positive action by 8th October, 2001 — a very short timescale indeed. The laws are suitably draconian, with employers who fail to meet their obligations by the set date being liable to be fined by the regulator (Opra) by an amount of up to

£50,000; this is significant. Although employers are not obliged to contribute to their employees' stakeholder pension schemes at this stage, it seems likely that some form of compulsion could be imminent.

Compulsion, in some form or another, has been here since 1961 and has been used to fund the various unfunded state second-tier pensions. By and large, this 40-year experiment in providing second-tier pensions in the UK has failed and we are left with a state pension system comprising the state basic pension and the new S2P that will provide, in total, benefits of around the level the state basic pension itself produced in the mid-1960s. We have not travelled very far in the last four decades. For this reason the author would not be in favour of further compulsion aimed at employees that would simply re-kindle the dying embers of the state second-tier pension experiment. The author is in favour of a more radical approach to compulsion; one that would involve employers directly and would seek to build the occupational pension sector.

The pensions revolution that has taken place in recent years in the United States since the introduction of 401(k) plans is noteworthy. The author suggest that an adaptation of one feature of such schemes should be considered as a way of encouraging employers to maximise the coverage of stakeholder pensions.

While most employers do not provide pension schemes for their employees, the majority of them will have provided for their own pensions; this would be through Executive Pension Plans (EPPs), Small Self-Administered Schemes (SSASs), Retirement Annuity Contracts (RACs), Personal Pensions (PPs) or Self-Invested Personal Pensions (SIPPs). Serious consideration should be given to the idea that the amount of tax relief an employer is granted for his or her own

pension (and for the pensions of their senior staff) is directly related to the pension coverage enjoyed by their workforce. In other words, unless a set percentage of employees are covered by suitably funded pension arrangements, the employers would not be eligible to receive tax relief on their own pensions.

A transitional period of perhaps five years could be introduced, during which time employers could phase in contributions for their relevant employees, but the intention should be to move as quickly as possible to a situation where the vast majority of UK employees enjoy occupational pension scheme membership with active assistance from their employers. By incentivising employers in this way, the likely coverage of stakeholder pensions would be increased, but employees would be protected from the costs of distribution.

There is a sound base on which this can be built; intermediaries have been very successful over the last 25 years at helping employers provide pensions for themselves. The EPP and SSAS markets were quickly established after the enabling legislation in the mid-1970s. Intermediaries would be equally successful in encouraging and helping their employer clients establish occupational stakeholder pension schemes for their employees. It is easier and cheaper to inform pension-aware employers about group stakeholder pensions than to attempt to educate the entire workforce in such matters, as has been seriously suggested in some quarters recently.

The idea is not a new one; it is based on and derived from what has happened in the USA, but the author is convinced that its importation into the UK pensions environment would be the catalyst for change that the introduction of stakeholder pensions requires.

Implementation

The detailed implementation would clearly be complex, there would be an obvious need for the occupational stakeholder scheme to receive sufficient employer contributions to ensure worthwhile benefits are produced and that additional pension contributions made by employees would be both suitable and advisable. It would also be useful if all occupational pension scheme members were allowed to hold concurrent membership of occupational and individual pensions to avoid the problem of invalidating existing savings plans. Indeed, as it is now normal for people to accumulate many fragments of very different, and probably incompatible, bits and pieces of pension during their working lives, the effect of further choices and complexities being regularly introduced by government needs to be thought through very carefully.

In this context, the law passed in 1986 giving employees the right to leave, or not to join, their employers' pension schemes is clearly unhelpful. The exercise of choice in these circumstances is both foolish and dangerous; people electing to leave or not join their employers'

schemes place themselves outside of the current pension system altogether. It is virtually impossible for pension providers to sell other forms of pensions to such employees. According to recent statistics more than 20 per cent of employees who become eligible to join occupational schemes now choose not to do so. This has been the case for over a decade and this growing band of 'unpensionable' employees will need to be brought back into the pensions fold at some point. It is worrying that the new stakeholder access requirements have also been designed to exclude these employees; in the new legislation they are not regarded as being 'relevant' for access purposes.

Conclusion

The important role employers can play should not be overlooked as the stakeholder debate develops. A return to the pre-1988 position where occupational scheme membership was a condition of service, together with new incentives for employers to make pensions available to all employees, could provide a viable alternative to employee-compulsion.