Original Article

Tomorrow's investor

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ABSTRACT This article summarises the implications for private pension policy of a 3-year study by Britain's oldest 'think tank', the Royal Society for Arts (RSA). It finds that the proper design of a private, funded pension system can add 50 per cent or more to pension outcomes. Few countries have designed and implemented an ideal system, and in consequence there is a significant loss in the productivity of savings and the adequacy of pensions. The article focuses mainly on the situation in the United Kingdom, but incorporates research and examples from around the world. It will be of interest to those involved in the reform and regulation of pension systems in developed markets, and to those involved in the establishment of such systems in the developing world. The RSA's work began by asking pension savers what benefits they sought from the saving system. Through discussion in 'citizen juries', it became apparent that most savers did not want a high degree of individual choice. Rather, they wanted a system that could be trusted to make choices on their behalf. Subsequent research suggests that, if properly managed, such trustworthy systems are capable of a high degree of productivity. In economic terms, where there is asymmetric information and principle agent contracting for delivery of long-term benefits, institutional design can make very large differences to outcomes. The work sets private pension policy within the broader context that pension policy makers face. It then goes on to describe an 'ideal' pension system, which would have the following characteristics: (i) pensions savings would be collected through some form of auto-enrolment; (ii) pensions institutions would be of a size to benefit from economies of scale; (iii) they would be trustee governed; (iv) their funds would be responsibly and collectively invested; and (v) that the pension 'promise' is flexible enough to allow for unanticipated changes in the liability and investment in an appropriate portfolio of investments. Although few countries meet this ideal, in Europe, both Holland and Denmark approximate to it. We note that these countries are generally judged to have some of the best pension provision in the world, and have a significantly different institutional design to that found in other developed markets, particularly the USA. The article notes that, in the United Kingdom there has been a drift away from the ideal design of a private pension system. As a result of a desire to avoid unaffordable pension promises, low-cost, collective and trust-based systems have been wound down. Recent government policy initiatives have sought to reverse this trend, but their success is dangerously threatened by a lack of focus on the details of institutional design and pension regulation.

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This article aims to address two simple questions: 'What would a good pension system look like, and how might it be created?'

Its genesis was a series of 'citizen juries' conducted by the Royal Society for Arts (RSA)¹ in 2008. These involved allowing ordinary members of pension plans to give their opinion on the pension system, after having quizzed pensions experts.

They were not happy with the system of private pensions as it has developed in Britain today. Their dissatisfaction reflects that of many inside the industry.²

Therefore, over the past 3 years, the RSA has been working on a project to design a better system for private pension savings and investment in the United Kingdom. As part of that work, it has not only become involved in the pensions debate in the United Kingdom, but also studied the pension systems in other countries.

The result has included making specific policy recommendations: to the government, to stakeholders and to the pension industry. We hope these will be of interest to anyone aiming to design an effective private pension system, and learn from the experience of the United Kingdom.

We would note that, although most of its conclusions are surprisingly uncontroversial, few systems in the world have successfully achieved anything resembling best practice.

BACKGROUND

Those writing about pension provision describe it as having three 'pillars'. The first pillar is provision made by the state and is usually funded on a 'pay-as-you-go' basis. The second is provision made through an employer. The third is provision made privately. There is, of course, some overlap between these pillars. For example, the government provides pensions as an employer to public sector workers.

Nevertheless, the three pillars are a helpful way of thinking about the scale and nature of pension provision.

The scale and cost of pension provision is huge. Take the United Kingdom as an example. As regards state provision, approximately

£60 billion from national insurance contributions, or 5 per cent of the GNP, was set aside in 2007 to pay pensions.³ But even at this level, state pension provides only 38 per cent of the previous earnings. (Britain therefore provides one of the lowest 'income replacement rate' of any OECD country.) In any other country with similar demographics, a larger proportion of GDP will be required to fund pensions.

The second pillar of pension provision is occupational pensions. Save for some public sector employees, whose pensions are paid from taxation, typically occupational pensions are funded by making payments into a fund during an employee's working life, usually with contributions made both by employer and employee. Historically, for the state or for larger employers, these pensions were the ones where the level of pension was targeted at the level of the employee's salary, with a proportion of salary awarded for every year of service. They offered a 'Defined Benefit' (DB). Over the past 20 years, even large employers have become concerned that with the uncertainty of life expectancy, and of investment returns, they can no longer keep the DB pension promise. This concern is acute in the United Kingdom, but it is also current in the other countries around the world. As a result, DB pensions have been, or are being replaced with, Defined Contribution (DC) pensions, where the level of pensions is simply dependent on the contributions made and the returns made on those contributions.

In the United Kingdom, some £80 billion a year, or 6.5 per cent of the GNP, is spent on private and occupational pensions. Of this, approximately £40 billion is placed in traditional DB pension funds. A further £20 billion goes to pay unfunded government pensions and £20 billion is spent on private and occupational DC pensions. It is this last area which is growing.

We would note that many employer DC pensions look much like private pensions, which are the third pillar of pension provision. These are essentially individual savings accounts, but with the tax and other advantages, and the restrictions that accrue to pensions.

In the United Kingdom, occupational and private pensions are extensive, but far from comprehensive. In 2008, just over 50 per cent of employees are covered by some sort of an employer-sponsored pension, down from 55 per cent a decade earlier. Approximately, 34 per cent are covered by a DB pension, down from 45 per cent a decade earlier.⁴ More than three quarters of people with income below £5000 do not contribute to a private pension, 60 per cent of those with income between £5000 and £15000 have no such provision.⁵

KEY PENSION CHOICES

In all pensions systems, policy makers face certain choices that are fundamental to the design of the system. On some of these issues there is considerable debate. On others there is consensus. There are four fundamental themes that are worth touching upon.

The dependency ratio

One critical issue where there is agreement among experts is that the pensions 'dependency ratio' needs to be managed. This means that, if pensions costs are not to get out of hand, there must be consistency between the number of working years during which pension savings are made, and the number of years in pensionable retirement. The mathematics that underpin this conclusion are compelling. Imagine a world where the average person works for 40 years, until they are 65 years of age, and then dies at the age of 70 years. Therefore, the retired population is one-eighth of the working population. In a pay-as-you-go system, the funders will be eight times the size of the beneficiaries. In a funded system, the average pensioner will have 8 years of saving for every year of retirement. Now, imagine the same situation in which the average age a person lives be 105 years. Now, the retired population is the same size as the working population. The maths suggest that whatever system may have been supportable when the dependency ration was one-in-eight is unlikely to be sustainable when it is one to one.

This of course is exactly what has been happening in many countries as longevity has

increased. In 1911, when old-age pensions were first introduced in the United Kingdom, some 5.2 per cent of the population were over 65 years of age. Today, the figure is 16 per cent and will increase to 23 per cent by 2034.⁶ In the United Kingdom, the government has taken action on this front with a decision over time to raise the retirement age to 68 years. But in other countries, such as France, these changes have met with considerable opposition.

Policy makers therefore have to be honest with the citizenry. If life expectancy continues to rise, that is good news. But it would seem sensible that a principle be established that the dependency ratio should not be allowed to rise to a point where pensions become an unaffordable burden on the working population.

This is not an easy policy to implement. For example, those involved in arduous physical employment may not be able to continue to work if the nature of their job is one which it is simply not possible for someone in their late 60s to undertake. Special provision may well be required for such cases.

In the United Kingdom, the state pension is to be adjusted in response to greater longevity;⁷ however, the same cannot be said of private pensions. Arguably, the failure to create flexibility on this issue has led to the closure of so many DB pensions as the uncertainty of life expectancy becomes too great for employers to bear.⁸

The fairness of collective benefits

A second, related issue is that pension benefits typically advantage wealthier people. The value of a pension depends on how long you live. In the United Kingdom, and in other countries, there is a considerable gap between the life expectancy of wealthier and poorer people. Therefore, for example, according to the Office for National Statistics, 'males in the professional class had a life expectancy at birth of 80 compared with 72.7 years for those in the manual unskilled class'.⁹ If they both save the same amount for a pension, and both retire at the age of 65 years, the professional will receive twice the pension of his working-class neighbour.

Thus, all else equal, the poor will have subsidised the pensions of those better off.

This effect is exaggerated in those DB plans that give a pension that is proportionate to final salary, as typically the better off find that their salary is progressively larger throughout their career, and thus the ratio of their contribution to their pension is lower than those with a more stable salary. And finally, those who would be entitled to welfare benefits to supplement their state pensions get less marginal benefit from their pension savings than those who are better off.

There are elements of pension design that can help mitigate some of these inequities. For example, a DB pension that targeted a (higher) pension based on average salary would be more equitable than the one based on final salary. Others of these inequities need to be addressed outside the pension system, with policies on health, housing and welfare.

Yet, despite the apparently regressive nature of pensions, trade unions and other representatives of less wealthy citizens have been strong supporters of comprehensive, collective pension provision. Therefore, while these considerations suggest lessons for pension fund design, the fact that trade unions are so supportive of collective systems gives some indication of how important pension provision is to those who might otherwise be in need in their old age.

Balancing state pension and private saving

More contentious is the question of the balance between state and private provision. In the United Kingdom, state provision of pensions is limited and often needs to be supplemented by welfare benefits. One response, which seems to be the intention of the current government, is to raise and simplify the state pension, to avoid a 'welfare trap', and hence encourage everyone to save.

As regards the funding of such a change, part would be paid for by the elimination of many welfare benefits. Part might be paid for by raising the retirement age.

However, there is another potential way in which a higher state pension might be funded. There are often very significant tax advantages

and other subsidies given to private pension savings. One powerful school of thought suggests that it would be better to eliminate these subsidies, but provide more substantial state provision. This is an important debate. We would note, however, that any fundamental change in the pension regime will have profound effects that go well beyond pensions themselves, and would be likely to change the level of saving in the economy and the way in which industry and commerce is financed.¹⁰ It would also be likely to have profound transitional effects.

The architecture of non-state pension provision

Although there is a heated debate about some of these issues, we have been struck by the fact that there seems to be a broad consensus that all citizens should be able to access occupational and private pensions. Any such pension should, at the lowest possible costs, allow savers to access a portfolio of investments that is designed to defray the liability they are seeking to protect against; in the case of pensions this means income in their old age.

Further, there is also a consensus that, in the United Kingdom, the current architecture of pension provision is deeply flawed and very expensive. Estimates vary, but it is our belief that for no additional cost, pension outcomes could be improved by 50 per cent or more, compared to a typical DC pension that might be offered today. We have discussed this figure and debated it at length with experts, stakeholders and fund managers. Although some have queried individual assumptions, no one has challenged the view that a massive improvement is possible in the pensions that are typical in the United Kingdom.

The payoff from such a reform would be huge. As we noted above, £20 billion a year is already saved through individual DC or private pensions, and this is growing. Some 5 per cent of the GNP is spent in funded pensions. Therefore, a 50 per cent increase in the productivity of pensions would be a huge prize, both for pensioners individually and for the efficiency of the economy as a whole.

However, in the United Kingdom, such a prize will require changes to be made. The regulatory framework to create that structure is not presently in place. There will need to be a broad consensus about the sort of pensions architecture that we are trying to create, and commitment to it from policy makers and stakeholders. Such consensus must not be dependent on party politics – it will need to last for a generation. There need to be providers willing to offer these new pensions.

We believe that all this is possible. The necessary changes to the regulatory structure are comparatively modest. From talking to stakeholders, we believe that, despite the understandable concerns of employees to defend their pensions, and of employers to limit their liability, there is a broad consensus on the need for change, and for the characteristics that any new pension system might have. Finally, we believe that private sector providers would be able and willing to respond to this demand, offering considerably improved pensions, at no additional cost to beneficiary or sponsor.

In the remainder of this article, we will look at why we have such high cost and inadequate provision of occupational and private pensions in Britain, and lay out the actions that need to be taken in order to resolve the problem.

WHAT WENT WRONG?

A generation ago, occupational pensions were the mainstay of non-state pension provision. These were typically designed with the aim of providing a known pension to the recipient, often based on their final salary. An actuary was employed to ensure that the expectations that were being given were matched by the funds available to meet them. Both employer and employee made contributions to fund the pension, and those contributions and the returns on them were allowed free of tax. Tax was only paid on the pension benefit.

As we discussed in the section above, these schemes were not perfect. But they did command support both from the sponsoring employer and the employee beneficiary. However, over the years, these schemes became the subject of

regulatory tinkering. In particular, regulators limited the amount that could be paid to the pension funds, to avoid their being used as tax shelters. Then, in the 1990s, as stock markets rose, it appeared that these schemes had set aside more than enough to meet the expectations they had given the beneficiaries. Therefore, sponsoring employers asked pension trustees if they could stop making contributions for a time: to take what was known as a ‘contributions holiday’. In response, the pension trustees demanded that the employer would have to fully underwrite the promises that had been made, so that, if circumstances changed, there would be no risk that the pension fund would be unable to meet its commitment.

Thus the typical pension changed from one where there was the expectation of a given pension to one where that pension was guaranteed. However, we would note that the guaranteed pension contained two, potentially serious flaws: one for the beneficiary and one for the sponsor.

For the beneficiary, the guarantee was not a complete one. In particular, it did not protect against high inflation. This, in turn, means that many pension trustees will be inclined to invest in a way that ensures they can pay the nominal value of a pension, but its purchasing power could be deeply eroded. For those who remember the plight of those who had all their savings in bonds in the 1970s this should be a sobering observation. Particularly so when it is clear that many DB schemes are, indeed, trying to make a specific match of their investments to their contracted liabilities, without consideration of how their beneficiaries might be affected by high inflation. In extreme conditions, this could be a time bomb at the heart of our DB system; the pension will be paid as contracted, but it may have little real value.¹¹

However, the more immediate problem with DB pensions was the promise that had been made by the employer. When it was established, a typical pension plan would have set expectations of a pension, but not made a hard promise; this was because it was not possible to predict the future with any certainty, particularly

over the 80 or more years that a pension fund would need to stay open in order to pay the pensions due to all its members. In particular, life expectancy and investment returns were uncertain over this period of time.

In the early years of the millennium, it became apparent that life expectancy was increasing much faster than had been expected. This is of course a very good news for the population. But it created a problem for the pension industry. As we discussed above, for pensions to be affordable, it is necessary to manage the 'dependency ratio'; in this case, the number of working years during which contributions are made, relative to the number in which pension payments are withdrawn. Longer life expectancy had knocked this out of kilter. Further, as the millennium progressed, it became clear that the high investment returns that had characterised the 1980s and 1990s were unlikely to be realisable in the future. Therefore, the DB schemes that had been in surplus now discovered that they had significant deficits. Not only did this mean that existing promises would need to be funded, it also highlighted the danger of making future promises. Employers became reluctant to underwrite pension benefits.

Their nervousness in doing so was exacerbated by changes to the way in which pension deficits were accounted for. In the past, in order to calculate the solvency of the pension fund, actuaries would estimate the payments that would be due each year. They then examined the fund's investments, which had a market value, and estimated whether the income they would generate would be adequate to meet these liabilities. Both these calculations require judgement, and therefore, in an effort to objectify the calculation, the rules were changed. Actuaries were asked to calculate the liabilities in the same way, and then to discount the future payments to a single figure representing the liabilities. This would then be subtracted from the market value of the investments to calculate the surplus or deficit in the scheme. Although such a calculation may seem to have a degree of academic rigour, it means that the annual calculation of surplus and deficit can be very

volatile, depending on assumptions about the discount rate used on the liabilities and the short-term movements in stock and bond markets.

All these factors taken together had a dramatic effect on employers' willingness to support DB pensions. One by one, private sector organisations have closed or modified them. Very few private sector employees taking a new job will now be offered a DB pension.

[In the public sector, the future of DB pensions is still to be addressed. The recent government commission, led by Lord Hutton, has made recommendations that aim to preserve DB pensions, but to reduce liabilities by moving to career average pensions and allowing the adjustment of retirement age to defray the effect of increases in life expectancy.]

These developments also affected the nature of the debate about pensions. Employers, quite naturally, wished to avoid making any promises whose circumstances might later mean they lived to regret. Equally naturally, the trade unions and other worker representatives were robust in wishing to preserve the DB promise. Therefore, discussion of pensions in the United Kingdom has narrowed to the one where employers wish to escape from future promises, whereas the trade unions seek to defend the *status quo*. This has meant that there has been too little discussion about the best alternative system of pensions management.

Further, the law in Britain makes the exploration of this topic difficult. Because of perceived pension scandals, lawmakers have been keen to ensure that any promise is well defined. As a result, those designing pensions have been encouraged to believe either that they must promise a DB, or that they must create an individual savings account, on which the saver has full claim, but no other entitlement or expectation.

With this backdrop the United Kingdom has, we believe, ended up going down the wrong route in the development of its pensions architecture. On the one hand, there are the old DB schemes. But, outside the public sector, most are closed to new entrants. Thus DB

pensions will remain, for many years, a huge store of investment value, but over the years they will begin to decline. In their place, many employers have introduced individual DC schemes, where there is no employer guarantee. DC pension is becoming the dominant form of pension provision.

But occupational DC pensions are not receiving the same level of contributions as DB pensions. Further, only 50 per cent of employees are covered by an occupational scheme. Others need to buy a private pension, which are often, as we shall see, extremely expensive.

Indeed, the cost of pension provision through private and DC plans is extremely high. This is often overlooked by consumers and regulators alike, who perhaps believe that market forces will create the necessary pressure to reduce costs. We believe that market forces must play an important part in the provision of pensions. But they must be organised in a way that gives the consumer the best chance of choosing the right product. In addition, the architecture of the pensions industry must be designed to advantage those who can offer the lowest cost/highest return products to their customers.

Therefore, to design a better pension system we must first have regard to what drives costs and returns in pension management. This is the subject of the next section of this report.

THE REQUIREMENTS OF A SUCCESSFUL PENSION SYSTEM

Anyone visiting a business bookshop will discover that many volumes have been written about the best way to invest. In the City of London, many thousands of people earn many billions of pounds by investing or advising on investment. This report does not seek to duplicate their debates. Rather, it seeks to answer a different question: 'However you invest, what are the key features of the architecture of pensions that will deliver the best value to savers?'

We would suggest that there are five features that need to be addressed in any effective pension system. We discuss them under five headings: cost, returns, product design, pension governance and responsible investment.

Costs

The cost that we pay for pensions matters a lot. This is often overlooked because pension costs are expressed as an annual charge on the balance saved. However, the 'average time' during which money is held in a pension might be around 25 years. On that basis, a 1.5 per cent charge per annum translates into 37.5 per cent over the lifetime of the pension. When the RSA explained this arithmetic to pension savers,¹² they were aghast. They had not understood the mathematics of charges. And felt strongly that this should have been explained to them. This, more than anything, made them feel that the system was not trustworthy. Therefore, it is perhaps worth taking an example of how charges affect returns.

Imagine a wise young person who decides, at the age of 25, that they will save for a pension, so that they can retire at 65 and enjoy a pension for the next 20 years. They set aside £1000 each year, and raise that sum to cover inflation, which is 3%. They receive a 6% return on their money. That means that, by the age of 65 if they have no fees to pay, they will have a pension pot of £248 170. This in turn will create an inflation protected pension of £16 080 for the next 20 years. Now imagine that this person has to pay a fee of 1.5% per annum on their savings. How much will that reduce the pension that will be earned? The answer is that it will be reduced to £9900. In other words, someone who pays no fees gets a 60% higher pension than someone who pays 1.5%, because £16 080 is about 60% more than £9900.¹³ Of course some fees will need to be paid to administer the pension. However, in the past, a large DB pension plan would have charged less than 0.5% for this service.

This is a very large difference in pension payment from what seems a modest charge of 1.5 per cent. As we noted, it happens because costs compound over time. The 'average life' of a pension, that is, the average time over which a pound stays in the pension pot, is about 25 years. Therefore, a 1 per cent per year charge will take about 25 per cent off the value of your pension.

Industry bodies have criticised the RSA for using the example of 1.5 per cent charges. They

claim that their charges are less than 1 per cent, sometimes half a per cent or less. If this is so, it is a good thing, and we would encourage the industry to be clearer about what their charges are, and about their ultimate effect on pensions outcomes. However, we would also note that the price lists of pension providers suggest that much higher charges are being made.¹⁴ Further, what little is known about DC pension charging suggests that even those responsible for the schemes are unclear about charges. In a government survey, 13 per cent simply did not know the charge; 5 per cent thought it was above 5 per cent per annum and 4 per cent thought there was no charge. Many seemed to believe that the charge related to the annual contribution, and was not charged annually on the outstanding balance.¹⁵

Any reader who wishes to delve more fully into this topic might wish to visit the Financial Services Authority website.¹⁶ In particular, the page that illustrates various private pensions, allowing the user to decide the sort of pension they will buy and illustrating the fees that they will pay. They might take a really simple example of an individual who invests £10 000 at the age of 25 years and cashes it in to buy a pension at the age of 65 years. Therefore, this covers the fees only during the accumulation period of the pension. He will find that the fees range from £41 468 to £98 987. In government-sponsored stakeholder plans they vary from £51 200 to £68 144. The point of this illustration is not to criticise any particular pension provider. It is simply to point out that, based on the official numbers presented by firms to their own regulatory authority, the fees charged on pensions are very large and of huge significance in determining the size of the pension.

But the existence of overpriced pensions is a symptom of the problem. In any market that works well, these high prices should not exist; they would be competed away. But they have not been. Therefore in designing a pension system, it is necessary to consider first how the architecture of the system can be designed to ensure that market and other forces result in good pensions being offered.

Returns

What is true for costs is also true for investment returns. A 1 per cent lower return will give a 25 per cent lower pension. Therefore, someone who expected £100 a week as a pension will get £75 if the return is 1 per cent lower. Putting it the other way around, someone who expected a £75 pension will get £100 if returns are 1 per cent higher – a 33 per cent uplift in their pension.

Any future design for pensions must allow that the money is well and appropriately invested. By this, we do not wish to enter into the debate about the advantages or disadvantages of active and passive investment, or opine on appropriate asset allocation. Rather, we would observe that the assets and liabilities of a pension fund should be well matched. Funds should be invested in a way that seeks a long-term real return over the life of the fund. The promise that the pension fund makes should be designed to allow this to happen, remembering that a pension promise may last for 80 years.

Any future pension fund must be sensible in the promise that it makes and appropriately flexible in the investments with which it defrays this promise.

Product design

A well-designed, low-cost pension should be just that: a pension. A pension is an income that will be provided in retirement, or to your dependants should you die leaving them in need. It is different from an individual savings account. It is worth reflecting on the problems that are caused by someone who uses an individual savings account to provide for their retirement. As they do not know how long they are going to live, even if they know how much you will need each year, they do not know how many years they will need it for. To be on the safe side, they either need to save too much, or else buy an insurance policy that will work like a life insurance in reverse; that is, that it will pay out if you live for longer than might be expected. This is essentially the principle of buying an annuity, but annuities are often expensive.¹⁷

The alternative is to save for your pension collectively. If all save together then, provided we know *on average* how long people will live, in the event one individual lives longer, their pension will be supported from the savings of those who did not. Further, such a system allows a more flexible investment philosophy, and it costs less to administer. However, it requires that those who subscribe to the pension trust those who are managing it to do so competently and selflessly.

If we take all these features (costs, returns and product design), they make a huge difference to the likely value of the pension paid. One study, by Beth Almeida and William Forna,¹⁸ reckons that for the same expected pension, an individual DC pension cost 83 per cent more than the one which was collectively provided! The UK Government actuary comes up with a figure of 39 per cent.¹⁹

Governance

The need for trust lies at the heart of an effective pension system, because outcomes are uncertain and it may be many years before someone who subscribes to a pension enjoys the final benefit. Savers need to trust that, even when there are unforeseen circumstances, the pension fund will still be run in their interests. This is particularly true in the case of collective pensions, where the beneficiary may not be able to specify their precise claim on the fund.

The British legal system has a solution for these sorts of circumstances. Rather than writing a contract, where it is difficult to specify all the permutations of events, the money is invested 'in trust' and a trustee is charged with only looking after the interests of the beneficiary and cannot themselves benefit from their role.

In talking to legal experts, some have suggested that it may be possible to write a pension contract that would have a similar outcome to a trustee-based pension. However, an equal number have told us that, given an uncertain future, pensions are better governed through trustees.

Therefore, an effective, low-cost/high-return pension system is likely to be one that is governed by trustee law, rather than by contract law.²⁰

Responsible investment

The final element that is required of a successful pensions system is that it is responsibly invested. That is, that the way in which the future pensioner's money is invested is appropriate for the liability they are trying to defray, and that the investments are chosen and managed in a way that does not damage the beneficiary's broader interests. Therefore, for example, an investment portfolio should be properly diversified. It should be invested in assets that offer long-term value, that is, they should not be rendered valueless in the event that high inflation was to return.

There are two reasons why pension funds may not be managed in this way, both of which are dangerous. The first would be an over-adherence to a specific promise. (For example, to meet a nominal payment without considering the effects of inflation.) The second reason is that it can sometimes be to the advantage of one investor, or one company, to behave irresponsibly and allow others to pick up the cost. (For example, an investor may encourage a company to behave in a short-term way; or may not exercise their duty of ownership when they purchase a share.) They may turn a blind eye when a company behaves badly. Although such actions may be for their individual advantage, if everyone behaves in that way, the integrity of our capital markets will be undermined, and everyone will lose.

THE ARCHITECTURE OF A SUCCESSFUL PENSIONS SYSTEM

In the previous section of this report we noted that an effective pension system would require the following features:

- It would be low cost.
- It would offer pensions, rather than individual accounts, and hence ideally collectively provided.
- It would be governed through trustee law.
- It would invest responsibly.

In this section we will tease out the characteristics of a pension system that would meet these requirements.

Costs

We begin by looking at how cost can be minimised. There is agreement on the structural factors that drive costs. These are as follows:

- (a) A very large part of private pension costs relate to selling costs, and to ensuring that pensioners do not keep switching their provider. Therefore, selling costs must be kept to a minimum and persistency maximised.²¹
- (b) Costs reduce for larger providers of pensions. Therefore, pension organisations need to be of adequate size to enjoy benefits of scale.²²
- (c) That pensions that are provided collectively, rather than individually, have lower administration costs.²³

Government pensions policy in the United Kingdom aims to address the costs of selling and switching. In 2012, there will be a national system of auto-enrolment. For those not otherwise provided for, the government will provide an individual DC pension at modest cost, known as a personal account. Although the nature and scope of personal accounts remains controversial, all the stakeholders we have met support auto-enrolment, and indeed the RSA itself believes that this will be a necessary condition for creating an effective pension system.

Regulators have gone further. In the past, financial advisors were paid for every pension they sold. This encouraged them to sell, and then to resell private pensions. With the introduction of the Retail Distribution Review at the end of 2012, such incentives will be banned,²⁴ though some within the industry fear that less scrupulous suppliers will find ways to avoid the intent of the ban.

A second element that is needed to keep costs down is the fact that pension providers must enjoy economies of scale. Ideally, there should be a limited number of large providers, all of whom offer low-cost, responsibly invested pensions. The mechanism for achieving this is open to debate; however, we would note that there are other industries where regulators have created systems that enjoy both the benefits of

economies of scale and effective levels of competition. At a minimum, the government should establish a default pension along the lines of the 'My Super' proposals, which have been advocated in Australia and accepted by the Australian government. This ensures that any employee who is enrolled into the pension system is offered an effective low-cost 'default' option for their pension, which has the broad characteristics discussed in our proposal.

A third element in keeping down costs is collective provision. Collectively provided pensions, where there is no need to administer and report individual performance, should have lower cost than individual ones.

Therefore, a low-cost pension system will be characterised by large, auto-enrolled and ideally collectively provided pensions.

Returns

Collective provision also helps to ensure the highest returns. As we noted, the study by Almeida and Forna suggested that these could be as high as 83 per cent. A similar study by the Government Actuary concluded that they would yield, on average, 39 per cent more than individual accounts, but with less risk. Either way, the advantage of collective provision is high.

However, the UK law currently makes the provision of Collective Defined Contribution (CDC) quite difficult. In part this is understandable. A collective DC arrangement means that, unlike a DB plan, the pensioner has no certain entitlement. And unlike an individual DC plan, the pensioner has little discretion about how the collective funds will be used. There is, therefore, a natural reluctance, in an industry subject to mis-selling, to set up a system that may set expectations that it is unable to meet.

However, the benefits of collective DC are big; on the government's own figures they give a 39 per cent higher pension. The aim must therefore be to ensure that all collective DC pensions are properly sold, rather than to live with a highly sub-optimal architecture.

It must be understood that if returns change, then any DC pension will produce a different result. In fact, collective DC will have less

variability, but it will mean that trustees need to be careful about the expectations they are setting, and that they do not end up allowing high 'intergenerational transfers', where older pensioners benefit at the expense of younger ones, or vice versa. We have discussed this with actuarial experts. Some felt that it might be a significant hurdle, others that it would be more straightforward.²⁵

At their most extreme, some financial economists, such as Dr David McCarthy of Imperial College, have suggested that it is impossible for collective DC schemes to provide more than individual ones, because the risk must have transferred somewhere. Their assumption is that it will have moved to the next generation. We disagree with this analysis. The reason CDC is so effective is that some risk does indeed lie with the collective, and that they do not need to pay an agent entirely to mitigate that risk, as happens with the purchase of annuities.

Pensions, not individual savings

As we noted above, one of the reasons that individual DCs are expensive is because they are not pensions, they are individual savings accounts. Therefore, when a person dies, any residual is left in their estate. It is not available to pay others' pensions.

[In passing, we note that other researchers who are working in the field have rightly recommended a simplification of the pension system. However, one proposal that they have suggested is that pensions should be treated in a similar way to individual savings accounts. For the reasons given above, we would not support such a proposal.²⁶]

Trustee governance

As discussed above, pensions need a legal form that is trustworthy for its beneficiaries and focussed on maximising benefit for them. This suggests pension plans would ideally be trustee based (with some flexibility, to allow for marketing activities, such as those offered to the National Employment Savings Trust (NEST)), or with similar protection to savers.

Responsible investment

There is a general view that pension plans should promote responsible investment practice, though less agreement on what might constitute responsible investment, and how it could be enforced. However, we would note the growth in the 'Responsible Investment' movement over the past 15 years. Around \$25 trillion worth of investments now subscribe to the UN Principles for Responsible Investment.

Additionally, many services have been developed to assist investors in undertaking their duties as owners of securities. In the United Kingdom, Hermes EOS (of which the author of this report is a founder) and F&C both offer such services to institutions who feel that working together as owners is likely to be more effective than working separately. In our last report, we asked Hermes to quote on the fee for providing such a service. It was less than 1 per cent of 1 per cent. This means that, over the lifetime of the pension fund, this option would cost less than 0.25 per cent of the total pension paid. The effect it would have on company returns would, we suggest, more than repay the cost. However, it is not the only way to achieve responsible investment, nor is it mutually exclusive of other activities that a pension fund and its members might wish to contemplate.

Conclusion

Despite the many controversies in pensions policy, there is considerable agreement on the fundamental architecture that we need for private pension provision. We note that the structure that stakeholders desire is similar, though not identical, to the system of provision in Holland and Denmark, two countries that are credited with having the most effective non-state pension provision in the world.

ACHIEVING CONSENSUS TO BUILD THE SYSTEM

The above discussion has laid out how we can create an effective occupational pension system. The framework for doing so is not controversial, in the sense that we have met with few stakeholders or pensions experts who

disagree with our conclusions. Nor is its implementation contingent on any other major pension policy decisions, that is, whatever choices are made in response to the key policy areas outlined at the beginning of the article, it always makes sense to promote low-cost/high-return occupational and private pensions.

We are not claiming that the detail of every policy is agreed. However, there are few fundamental objections to the policy framework that we have outlined. And the prize is huge: a system that, for the same cost, can provide a 50 per cent improvement in the pensions that current practices are likely to achieve.

So why is it so difficult to reform the system?

The reason is that it is not possible to create an effective pension system just by passing a law. It requires not only a strong policy framework, but it also requires that pension stakeholders feel confident to purchase and pension providers are willing to provide the service. It is therefore worth reflecting on how a consensus might be built that can align policy with the various stakeholders who need to be brought on board. We begin with policy and policy makers.

Establishing the policy framework

At present, the structure of British pensions is restrictive. Either a beneficiary has a DB pension, where the sponsor is responsible for the promise made, or they have a DC pension, where it is all the beneficiary's risk. It is difficult to establish a pension in which a group of people save collectively.

This is because the legislation (Pension Schemes Act 1993 s1) treats anything that is not pure DC as DB – and then applies the full rigour of DB rules and regulation, which can frighten off employers. Indeed, a well-known law case (*KPMG*) treated what was considered by the employer to be a DC scheme as a DB scheme, leaving the employer with an unexpected liability.

However, it would be perfectly possible to change the law. If we did, we could create, in the United Kingdom, a pensions framework that might look like the one in Holland: a country generally acknowledged to have the best occupational pensions in the world.²⁷

Therefore, in policy terms there is no insuperable problem to be overcome.

But the government needs to do more than pass enabling legislation. It also needs to lead the debate and help create a new consensus for a pension system that we can trust. This consensus must be built on firm foundations, as pensions policy must last for generations.

The stakeholders

Therefore stakeholders need to be involved in these discussions. After all, it is the employers who pay for, and the workers who will benefit from, the new system we are suggesting. Further, representatives of the pension funds themselves are arguably the most knowledgeable constituency involved in this debate. [We note and are encouraged by the similarity between the RSA position and the 'Super Trust' proposals of the National Association of Pension Funds.]

We have also been very impressed by the discussions we have had with officers and committees of both the CBI and the TUC. We mentioned that there are real policy tensions between workers and employer representatives over pension provision in any individual workplace. However, there is no reason why such natural tensions should stand in the way of a wider dialogue about the architecture of future pensions, particularly if the government is willing to lead. It cannot be in the best interests of the workforce if their representatives are left with inadequate fallback arrangements should their members' DB plan be abandoned. And it cannot be in an employer's best interest to sponsor a benefit for the workforce, while knowing that a lower-cost/higher-return alternative is available.

Overall, we would be optimistic that, if the debate is properly framed, consensus can be reached with stakeholders.

Potential providers

One possible objection to the proposals is that no one would be willing to provide the low-cost pensions of the type described. Indeed it is because of the failure of the current structure to provide such pensions that it was necessary to establish NEST.

Therefore, the RSA has spent some time talking to providers who have experience with pensions of this type; particularly those in Holland and Denmark. We are pleased to be able to report that both would be interested in providing the sort of service that we have described. Indeed, the Danish pension fund ATP has announced an intention to do so.

We entirely understand that UK companies are likely to be hesitant about a change in pensions architecture. After all, their current operations have been designed to offer a different service. However, we believe that most UK providers would be perfectly capable of delivering the sort of services that we have in mind, as they already undertake all of the activities necessary to make such a system work. We have been asked whether they might object to the introduction of a new and more efficient architecture on the grounds that it might undermine their current business. But to argue in this way would be similar to a car manufacturer refusing to implement improvements in their car on the grounds that they profit from the inefficiency. In competitive terms, it simply invites in competition. Therefore we believe that, given the right architecture, UK pension providers will rise to the challenge.

Consumers

Ultimately, consumers need to be persuaded that the pension they are offered is trustworthy and of good value. Our research has shown that, at present, they are not. However, if consensus can be reached between the government and the political parties, the stakeholders and the providers, if they can be shown that a proper and trustworthy design has been put in place, we have little doubt that consumers will respond positively. Indeed, if consensus is not achieved, consumer distrust is likely to decrease still further, which will be damaging for all.

WHAT HAS BEEN DONE ALREADY?

Those who are familiar with British pension policy will note that the proposals we are putting forward build on existing government initiatives.

There are two of particular significance. The first is auto-enrolment. Beginning in 2012, most employees will automatically be enrolled in a pension, which will be subsidised by the employer and the government. As we have already noted, this policy is fundamental to the creation of a successful pension system and it is a necessary condition for the proposals that we have put forward.

The second is the establishment of NEST. NEST will be a national supplier of pensions when auto-enrolment is established. In principle, we are very supportive of NEST. It will offer low-cost pensions and, although the current plan is for these to be individual pensions, our understanding is that NEST could offer collective pensions if it were asked to do so. NEST promises to offer low fees; these are targeted to be 2 per cent of the initial investment, and then an annual charge of 0.5 per cent. Indeed, without NEST, auto-enrolment could backfire if workers discovered themselves enrolled into poor pensions. Therefore NEST, or something like it, is an important component of an effective pensions architecture.

However, there is a difficulty with the way NEST has been constructed, in that for the first years of its operations, it is restricted in the size of the payment that it can accept from any individual. Such payments are limited to £4200²⁸ in any year. The effect of this is that NEST will be handicapped in carrying out its business. Here is how we described the situation:-

The effect [of this limit] can best be understood by using an analogy. Consider a town which does not have adequate grocery shops. This is a problem for everyone, but particularly for poorer people. So the council decides it will open a new shop, which sells high quality low-cost produce. But it also restricts the amount anyone can spend in the shop. So if you have a big demand for groceries, you need to go shopping twice: once to the new store, once to another. Further, as the grocery manager doubtless points out to council officials, it is those who spend the most who help cover the costs of the grocery store. By restricting the amount people can spend, the costs and effectiveness of the new store will

be undermined; its revenue will be lower, and hence its profitability reduced. We believe that is precisely the effect the £3600 limit will have on personal accounts.²⁹

The reason for restricting NEST was to ensure that a subsidised government body, offering modest pensions, did not undermine better pension provision provided through the market. We would suggest that a better solution would be to allow NEST to compete with others who were willing to offer good pension provision, subject to rigorous standards.

If NEST is to be offered a subsidy, this should be because it provides a public service; that is, it is willing to provide a comprehensive coverage, at modest cost, even to the smallest businesses. However, it can make little sense, in public policy terms, for it to require a taxpayer subsidy because its operations have been intentionally handicapped.

But there is a still more acute problem with the auto-enrolment proposals. They offer no protection from the mis-selling of pensions. As we discussed above, consumers are confused about how charges work. It will be all too easy for less scrupulous providers to suggest that employers enter their employees into pension plans where much, if not most, of their savings disappears in fees and charges. In the past, the government had legislated to prevent this from happening. Although such legislation was imperfect, it had some positive effect. To now allow the flagship policy of auto-enrolment to be undermined by the sale of inappropriate pension products would be a tragedy.

CONCLUSION

This article has aimed to describe a sustainable framework for the provision of pensions in Britain. In doing so, we have touched on a number of issues, which may be of interest to pension reformers in other countries.

We would note that few of the proposals we have made are controversial. Yet few countries have been able to create the consensus to create the right pensions architecture. The reason is because it is all too easy to allow events to blow pension policy off course.

Much has been done in the UK pensions policy. However, the devil in the details threatens to undermine many years of work. It will be a continuing challenge for any nation to ensure it has a fair and effective pension system.

For private pensions, such a system will have four key features: low cost, collective pensions, governed through trustee law and collectively provided. It has been said that 'the condition upon which God hath given liberty to man is eternal vigilance'.³⁰ The lesson of UK experience is that the condition upon which we enjoy a healthy pension system requires a similar level of constant commitment to the best practice principles that we have outlined in this article.

REFERENCES AND NOTES

- 1 The Royal Society for the Encouragement of the Arts, Manufactures and Commerce (RSA) is one of the world's oldest 'think tanks'. Unlike many such institutions, it sees its role not just to transform government policy, but also to catalyse private and social enterprise to address social needs.
- 2 See for example the NAPF publication, *Fit for the Future: NAPF's vision for pensions*, whose opening paragraph declares, 'Our pensions system, which was once the envy of the world, has been transformed into one where 12 million people are not saving or not saving enough'.
- 3 National Insurance Fund. (2008) Annual Report 2008.
- 4 Office of National Statistics. Annual Survey of Hours and Earnings.
- 5 Family Resources Survey, Department of Work and Pensions 2004/2005.
- 6 Halsey, A.H. (ed.) (1988) *British Social Trends since 1900*. Basingstoke, UK: Macmillan.
- 7 In other countries, such as France, changing the retirement age has proved considerably more controversial.
- 8 One pension advisor was asked about the range of views among scientists as to future life expectancy. He said that some nutritionists felt that obesity and unhealthy lifestyles meant that life expectancy would plateau, or even fall. However, he had heard one geneticist declare that 'the first person who will live to be a thousand is already alive'.
- 9 See <http://www.statistics.gov.uk/pdffdir/le1007.pdf>.
- 10 See for example Johnson, M. (2010) *Simplification is the Key*. London: Centre for Policy Studies.
- 11 Some leading figures in the pension industry have also pointed out that this 'liability-driven' investment philosophy may end up having damaging effects on the financing of industry. If pension funds withdraw from equity investing and invest in bonds instead, they will starve companies of the long-term risk finance that they require to grow.
- 12 This was done as part of a 'Citizen's Jury' examination of pension issues.
- 13 For those interested in the maths, this example is explained in more detail at: http://www.thersa.org/__data/assets/pdf_file/0010/220141/Tomorrows_Investor_Pensions-for-the-people.pdf.

- 14 For example, Standard Life's *Your Pension Investment Choices* offers funds charging between 1 per cent and 2.92 per cent. The provisions of their policy also allow them to deduct 'any amounts we decide are appropriate to cover ... expenses taxes and other charges for buying, maintaining, valuing or selling assets ...'. Although discounts may well be applied to this price schedule, it does suggest that a total charge of above 1 per cent cannot be atypical.
- 15 Croll, A., Vargeson, E. and Lewis, A. (2010) Charging Levels and Structures in Money-purchase Pension Schemes. DWP research Report no. 630.
- 16 <http://www.moneymadeclear.org.uk/tables>.
- 17 See for example DWP. (2009) Money's Worth of Pension Annuities. DWP Research Report no. 563, (2009). It compares the actual cost of an annuity to that which the purchaser will receive. For nominal annuities, the figure is around 85–90 per cent. For index-linked annuities it is around 75 per cent.
- 18 Almeida, B. and Fornia, W. (2008) Better Bang for the Buck: The Economic Efficiencies of Defined Benefit Pension Plans. National Institute on Retirement Security, August.
- 19 DWP. (2009) Modelling Collective Defined Contribution Schemes. December, IBSH 978-1-84947-182-4.
- 20 A full discussion of the role of fiduciary duty in the field of pensions can be found in Berry, C. (2011) Protecting Our Best Interests, Rediscovering Fiduciary Obligation. FairPensions 2011.
- 21 See Turner, A. (2006) Report: A New Pensions Settlement for the 21st century. p. 7.
- 22 See Bikker and de Dreu, Operating costs of Pension Schemes, from Steenbeck, O. and cler Lecq, F. (2007) *Costs and Benefits of Collective Pension Systems*. Berlin: Springer.
- 23 See Almeida and Fornia.¹⁸
- 24 A summary of the Retail Distribution Review and its effects can be found at: <http://www.eacg.co.uk/documents/Concise-Guide-to-the-Retail-Distribution-Review.pdf>.
- 25 We would note that the nature of the promise it is possible to make on a pension depends on the investments that are held. Therefore, for example, ATP of Denmark offer a hard promise in a collective scheme, but have defrayed that promise through the investments that they have made. Keith Ambachtsheer, Head of the International Centre for Pension Management at Toronto University, would advocate systems such as those at TIAA-CREF, which have some collective elements but which may feel to the policy holder like a DC pension.
- 26 See Johnson.¹⁰
- 27 Indeed, one leading pensions expert, Robin Ellison of Pinsent Masons, reckons that you do not even need a change in the law. He has concluded that: *It is now clear that provided the scheme is carefully drafted (and in particular does not offer any annuity arrangements within the scheme) collective DC might be offered within the UK. Alternatively, and unfortunately preferably, it would be possible to offer a non-UK-based scheme (perhaps domiciled in Ireland, Gibraltar, Austria or Belgium) with the full advantage of UK tax reliefs under the European Pensions Directive, and cross-border recognition, but avoiding the excessive UK regulation and accounting rules which have made such schemes hard to offer.*
- 28 At 2010 prices.
- 29 RSA. (2009) Tomorrow's Investor: Pensions for the People. p. 36.
- 30 John Philpot Curran, see http://en.wikipedia.org/wiki/John_Philpot_Curran.