Original Article

Can collective pension schemes work in the United Kingdom?

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ABSTRACT ‘Defined Ambition’ is the latest buzzword to hit the pensions world. What does it mean, and can pension schemes run on these principles actually work? Members will need to be convinced by those running such schemes that they have the necessary skill to provide a fair outcome for all. Most importantly, a clear and stable regulatory environment, which cannot be easily overturned by future governments, will be needed to convince employers to back such schemes.

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There is a buzz in the pensions world at the moment about a new form of collective pension saving. In the United Kingdom, the Pensions Minister, Steve Webb, has introduced the concept of ‘Defined Ambition’ to encourage all within the industry to develop a better model of saving for members. In this article, I consider whether there really is a future for collective investing within the pensions world. First of all, I look at what we mean by collective investing. I then consider whether it can actually work, both by looking at examples from the past and by putting forward some of the behavioural considerations to be taken into account. Finally, I look at what regulatory hurdles, specifically in the United Kingdom, would need to be overcome in order for this concept to become reality.

What is collective investment? This is when individuals share risks between themselves. In the traditional defined benefit (DB) model of

pensions, the employer takes all of the risk. In the defined contribution (DC) model of pensions, every single individual takes all the risk relating to their pension saving themselves. In a collective pensions model, a group of individuals share risk between themselves.

Let me explain how this works. Imagine there are two people. These people know that one of them will die at 60 and the other will die at 90. They do not, however, know who will die when. For simplicity’s sake, let us assume that an individual needs £10 000 to live on from age 60 to 90. One option for these individuals would be for both of them to separately save £10 000 (the DC model). One of them would use this money to live on from 60 to 90, and another would not need it as they would be dead. Alternatively, they could club together and agree that they would each put £5000 into the pot. Whoever was lucky enough to survive would take the £10 000 pot. As they have no idea which one of them will survive, this is a good deal for both of them. This is an example of sharing mortality risk between individuals.

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Let us now consider how we might share investment risk. Imagine there are two people – one is of age 50 and the other of age 40. They are both going to work until they are 70 (they are very enlightened individuals about longevity). They are both going to invest all of their money in the equity market until they buy an annuity when they retire (they are unfortunately not as enlightened about investment risk!). They are worried that the equity market might be very depressed when they individually come to retire. They think there is a much lower chance of the equity market being depressed, both when the first individual retires and when the second individual retires. They therefore agree that they will pool their savings together and receive a pot when they retire based on average equity market returns for the period that they have been investing. This means that if they happen to retire when the equity market is doing well, the pot they receive will be a little bit less than the actual value they would have got if they had simply been investing on their own, and vice versa.

Now I am sure we can all see the immediate flaws in these examples.

In the mortality example, what happens if both individuals actually live until 90? They no longer have enough to live on. In the investment example, what happens if the equity market is depressed when both individuals retire? The question is, in the real world, can collective investing or sharing risk between individuals actually work?

We can begin to shed some light on this question by considering the results of some attempts at collective saving from the past. A well-known example is with-profits investing. The concept of with-profits investments involved the sharing of both mortality and investment risk between individuals. Individuals saved money into a bond. Every year an annual bonus was declared for the bond, and on the maturity of the bond a final bonus was declared. The bonus declared was based on a calculation of the investment returns that would be earned on the collective investment of all funds invested, and on a calculation of how many of the

population of savers would survive until the end of the bond's term.

As we all know, with-profits bonds are not very popular now. Why? For two key reasons, both of which can provide valuable lessons when we consider the use of collective investing in a pensions format. The first was that people were encouraged to use with-profits bonds for inappropriate purposes. In the United Kingdom, with-profits endowments were an extremely popular way of saving in order to repay a mortgage. This was based on the theory that the equity market would, largely, always go up. Clearly, this does not always happen. Effectively people were betting their house on the stock market. Moreover, the models used to 'price' the risk within the products were not very robust. They did not fully take into account different possible outcomes for the stock market. This resulted in too much money being paid out to investors when times were good, leaving not enough money for other investors still holding the bonds when things went sour.

This second point illustrates a critical difficulty with collective investing. It involves paying out monies now from a pot of assets based on an expectation of something that will happen in the future. No one knows how that future will turn out, but we can estimate it. If our estimates turn out to be very conservative, we will pay out more to people at the end of the queue than to the people at the beginning of the queue. If our estimates are not conservative enough (as happened in the case of with-profits), we will pay out too much to the people at the front of the queue and will not have enough left for those at the end.

When faced with the second alternative highlighted above – we pay out too much to those at the front of the queue – a solution might be to take some money back from those people to give to those at the end of queue. But what if all of that money has already been spent, or if those people with whom we made the agreement have died? In the case of pensions, it is likely that we would not be trying to take money back from them, but to reduce the

income stream that we have promised they will get in the future.

We have seen recently what happens when collective schemes try to reduce amounts promised to those first in the queue in order to make the payouts to those at the end of the queue more equitable. In the United Kingdom, the move in the escalation of public sector pensions in payment from Retail Price Index (RPI) to Consumer Price Index (CPI) was an example of this, and that was not a move that was well received. When individuals have been given an expectation of income, they see that as a promise. I did not detect much enthusiasm for solidarity with the younger generations among those fighting to keep their promised level of pension.

A similar situation is currently being played out within the collective industry-wide pension schemes in the Netherlands. Although these pension schemes are often referred to as collective DC schemes by some in the United Kingdom, they are in fact DB schemes. When the funding levels in these schemes fall below levels acceptable to the regulator, those charged with the governance of the schemes have three routes open to them:

1. Ask for more contributions from the sponsors of the scheme.
2. Reduce or remove indexation for pensions in payment.
3. Reduce the actual level of pensions in payment.

Owing to the prolonged economic difficulties, Routes 1 and 2 have largely been exhausted by schemes. Many are now considering exercising Option 3 and this is not something that is going down well with the members of the schemes. Again, the argument that members are sharing risk between themselves is not of much comfort to them – they perceive that their savings have been mismanaged and that promises made have been broken.

So, can collective schemes actually work? Although these examples might not appear to promote much confidence, looking at the lessons that these examples provide I would suggest that there are two fundamental

elements to making collective saving schemes successful:

- The future risks that are being shared between individuals must be able to be priced with some level of accuracy.
- There must be a common and continuing understanding between the individuals within the scheme that they are sharing risk with everyone else in the scheme and that this will have upside and downside potential for them.

The ability to price the future risks being taken with some level of accuracy is clearly difficult to achieve. It is in this area that schemes have fallen down in the past: with-profits schemes did not price investment risk effectively, DB schemes have not priced mortality risk effectively. If collective pension schemes are to be successful, I would argue that those providing the schemes will need to be able to demonstrate a long track record at successfully pricing future risks. This will be fundamental to enabling those who join the scheme to trust that they will not suffer in the same way as previous participants in collective schemes.

Individuals must also be prepared to give up some potential upside in order to reduce the risks of them suffering the worst of the downsides. And they must be prepared to continue to give up the upside, even when it becomes actual rather than potential upside that they are having to give up. Again, this is a difficult area. I believe that the financial and pensions industries have created a huge amount of distrust among the general public over the last few decades. In a world of collective saving, I am fearful that a move to reduce pensions income in order to equalise the benefits across the generations would be seen as a failure by those running the product, however well that product had been run. If the members of the scheme do not feel they can trust those running the scheme, any feeling of solidarity is overcome by the feeling that they are being ripped off by someone who has done a bad job. If collective pension schemes are to be successful, we will need to continually demonstrate that the governance of the schemes

is beyond reproach, so that the necessary elements of risk sharing between individuals can be seen as just that, rather than a management failure.

If we assume that both of these elements are in place, let us consider finally what regulatory hurdles there are in the United Kingdom to making such schemes a reality.

It makes sense that risk sharing between individuals works better the more individuals you have involved. For this reason, collective pension schemes need to have scale. In order for schemes to exist with the necessary level of scale, they must be multi-employer schemes, that is, open to non-associated employers to join. To my mind this means that collective pension schemes must be, in the employers' eyes, DC.

Once an employer has paid its level of contribution into the scheme, it should not be 'on the hook' for any further contributions. It is not appropriate to expect a business to take on the risk of having to pay for the pension liabilities of another, unrelated, business – certainly as an investor I would not be keen to invest in a business that took on this sort of risk as a result of providing a pension scheme for its employees. If employers join a DB scheme with other employers they also become responsible for the liabilities of the other employers in the scheme, if those other employers cannot meet their obligations at some point in the future. Therefore, I believe a collective scheme that was, in regulatory eyes, a DB scheme would never work. Currently in the United Kingdom, any scheme that can possibly have any sort of deficit must be a DB scheme – this is the regulatory pitfall that collective schemes will have to steer clear off.

My learned legal friends tell me this is not a problem – no level of benefit will actually be 'promised' to the members of the collective scheme, so there cannot possibly be a deficit. But will we manage to attract any members to join the scheme if we do not give them any sort of idea what level of benefit they will get? I believe members want something more concrete than simply to be told: 'Trust me, this scheme will deliver you a better pension than you would get

from an individual DC scheme'. That does not give them much confidence to make plans for retirement, and actually it may not be true – while overall we would expect the membership to be substantially better off than they would be under individual DC, there will be some members who could be worse off in the collective scheme.

As a provider, I want to be able to give the members of a collective scheme a good idea of what they can expect to get from the scheme, together with a realistic and easy to understand idea of the potential pitfalls. And I want to be confident that in doing this I am not creating a promise and therefore not running a DB scheme. I believe that the regulations around what constitutes DB and DC would need to be clarified with specific reference to a collective model of scheme, to give providers and employers the necessary confidence around these issues.

Providing this regulatory clarity is arguably not that difficult. What is more difficult is ensuring that that regulatory clarity persists into the future. Schemes that involve risk sharing between individuals, particularly inter-generational risk sharing, need to run for a very long time to get the full benefit of that risk sharing. A scheme set up today would be expected to still be running in 100 years time, if not far longer. And in order to work really successfully, they need to keep pulling in members at a reasonably consistent rate into the future, so they need to stay attractive for members, employers and providers for a very long time to come. This requires a stable regulatory environment for them to operate in. If I had to choose one word to describe the regulatory environment around pensions for the last half a century, it probably would not be 'stable'.

If we are able to convince employers that a collective pension scheme set up today truly is 'DC', how can we persuade them that it will continue to be so for the next 50 years? This is a significant and problematic barrier to the successful development of 'Defined Ambition' schemes. Having met Steve Webb a number of times, I am convinced that he genuinely wants to create a pension environment that does a much

better job for members. But I do not know how long he is going to be in the post of Pensions Minister, and I have no idea who will follow him. Perhaps the desire to make collective pension schemes a reality requires him to put in place a model for the development of the pensions regulatory environment that removes government from its centre.

There have often been calls, both from the public and the private sector areas of the

pensions industry, for an independent 'Pensions Commission' that could formulate long-term pensions policy outwith the government agenda. Maybe now the time is right for a Pensions Minister who, I believe, truly understands the complexities of delivering good pensions solutions, to put such a thing into place. Under this sort of environment, I believe there could be a bright future for collective pension schemes.