The Pensions Institute

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Dear Sir

Pension Inquiry: Call for Evidence

- Is there a 'crisis' in UK pension provision and, if so, what has caused it? How does the UK compare to other European countries in this area?

  The word 'crisis' may be an exaggeration, but it is certainly the case that within a few short years what was the envy of Europe, namely a good well-funded private pension system sitting on top of an admittedly poor-in-comparison-with-the-rest-of-Europe basic state pension system, appears to be on the verge of possible disintegration. The causes of this seem to be:
  - **the ending of tax relief on UK equity dividends,**
  - **the funding obligations required by the Minimum Funding Requirement,**
  - **the reporting obligations and the effect on corporate distributable reserves of FRS17,**
  - **increasing volatility in world capital markets leading to the increased risk of large fund deficits emerging,**

- **the difficulties in finding suitable matching financial assets in sufficient volume for pension liabilities during both the accumulation and decumulation stages,**
- **increasing longevity amongst pensioners leading to the pension promise being a much bigger burden to honour than in the past and the unwillingness to raise pension scheme contributions by the amount necessary to deal with the problem,**
- **an increasingly mobile workforce rendering company-based pension schemes increasingly unsuitable vehicles for long-term savings,**
- **a reduced sense of obligation by multinational corporations to 'look after' their workers more favourably in one part of the globe than another,**
- **and the British disease of indifference and neglect, allowing world-class arrangements and institutions to wither slowly away for whatever reason (poor management, inadequate funding, unwillingness to invest in new technologies), ignoring warning signs on the way, until it is too late and too expensive to do anything about it (other examples are the health service and universities).**

The UK is still in a much better shape than most of her continental neighbours who have built up huge unfunded and unsustainable state pension obligations. Our state pension obligations are sustainable because they are relatively small and their growth is not linked to earnings as is the case on the continent. And the accrued value of our private pension assets are almost as large as the rest of Europe put together.

So its still not too late to do something about the problem. But we should be realistic about how this can be achieved. Most people (except the poor and carers etc) cannot rely on the state to provide them with an adequate pension in retirement. Nor can they rely on company defined benefit (eg final salary) schemes (unless they are a member of a public occupational scheme). They will have to rely on defined contribution schemes provided by the company or provided by themselves through financial institutions such as insurance companies. What we need to ensure is that these DC schemes are well designed in order to help mitigate the range of risks (contribution risk, investment risk, mortality risk etc) that members of such schemes face.

We have been working on design issues in DC pension schemes at the Pensions Institute (see David Blake, Andrew Cairns and Kevin Dowd (2001) <u>Pensionmetrics: Stochastic Pension Plan Design and Value-at-Risk during the Accumulation Phase</u> (http://www.pensions-institute.org/wp/wp0102.pdf) and David Blake, Andrew Cairns and Kevin Dowd (2002) <u>Pensionmetrics 2: Stochastic Pension Plan Design During the Decumulation Phase</u> (http://www.pensions-institute.org/wp/wp0103.pdf)).

Briefly well-designed pension schemes are designed from back to front by addressing the following questions:

- **How long do I expect to live in retirement, bearing in mind my planned retirement age and improvements in life expectancy in retirement?**
- **What standard of living do I desire in retirement?**
- **What level of pension fund do I need to have accumulated over my working life in order to meet this standard of living in retirement, taking into account the expected returns and risks from investing in different classes of assets and my attitude to financial risk?**
- **Given this fund size and the asset classes in which I intend to invest, what level of contributions do I need to make to my pension scheme during my working life to meet my target pension fund with a specified degree of success, taking into account the anticipated length of my working life and the chances of being temporarily out of the workforce due to, say, spells of unemployment or child care?**

- What role should the DWP play in encouraging saving for retirement? Do Stakeholder Pensions and the State Second Pension (S2P) encourage individual saving for retirement? If not, how could they be improved? What role should tax incentives play?

The DWP should understand the effect of different types of pension scheme on both savings and retirement. Research at the Pensions Institute (see David Blake (2000) <u>The Impact of Wealth on Consumption and Retirement Behaviour in the UK</u> (http://www.pensions-institute.org/wp/wp199804.pdf) found the following relationships:

- **higher state pension entitlements reduce the need to save privately for retirement, but have no discernible effect on the timing of the retirement decision**
- **higher occupational (defined benefit) pension entitlements have the effect of increasing private savings, but also of encouraging earlier retirement**
- **higher personal (defined contribution) pension entitlements have the effect of increasing private savings, but also of delaying retirement.**

These findings may be the result of a selection effect. For example, the kind of people who rely heavily on state pension entitlements may be the kind of people who are prepared to live for today rather than for tomorrow, and if state pensions increase, such people would rather spend some of their accumulated savings now, since they see that they will need less in the future. On the other hand, the kind of people who choose to take out personal pensions may also be the same kind of people who are both thrifty and enjoy their work and would wish to keep working for as long as possible.

Therefore on the basis of the above findings, we can expect:

- **increasing entitlements to S2P (the successor to SERPS) to have the effect of reducing private savings: this may be due to the characteristics of S2P members rather than a 'fault' of the pension scheme**
- **increasing entitlements to stakeholder pensions (low cost personal pensions) to have the effect of raising private savings and also of delaying retirement, a double benefit of such schemes; so everything should be done to encourage participation in well-designed (along the lines proposed in the pensionmetrics studies mentioned above) and well-funded stakeholder pension schemes.**

The role of tax incentives depends on the degree of compulsion involved in saving for retirement. The lower the degree of compulsion, the greater the (tax) incentives needed to encourage people to switch from current consumption and short-term savings to long-term savings. But two factors need to be recognised.

First, the government's stated aim is that pension schemes are tax-neutral over a scheme member's life cycle: what is given in tax breaks during the accumulation phase is clawed back by taxing pensions in payment; if less tax is clawed back in present value terms during the decumulation phase than tax relief is granted in present value terms during the accumulation phase, this implies that there are implicit transfers from the general tax payer to the surviving beneficiaries of the scheme member (since pension assets can be bequested without attracting inheritance tax). The greater the tax breaks granted during the accumulation phase, the greater the restrictions that need to be imposed during the decumulation phase to frustrate these implicit transfers, but at the cost of alienating scheme members as we know from press coverage.

Second, there is evidence that tax incentives that favour one particular type of savings vehicle merely lead to substitutions away from other less favoured savings vehicles with little or no net increase in aggregate savings: so governments can spend a lot of tax payer's money changing the form but not the level of aggregate savings (see Blake (op cit)).

- What role should the private sector play in facilitating/encouraging individual saving for retirement? For example, can we expect it to provide value-for-money pensions for workers on low incomes?

The analysis conducted in Blake (op cit) would suggest that low-cost defined contribution pension schemes are an effective vehicle for encouraging individual long-term savings for retirement if only individuals can be persuaded to start them and persist in making

contributions throughout their working lives. Unfortunately these are big barriers to mount, since, as they say in the pensions industry, 'pension products are sold not bought'. A substantial fraction (at least one-third for a typical scheme and more for a scheme with low contributions) of the total costs involved with a personal pension scheme are initial marketing and set-up costs. Marketing costs can be substantially fixed and independent of the premiums collected on new policies.

This makes it unattractive for private sector pension providers (such as insurance companies) to market their products to low-income workers who are likely to make low contributions and, just as important, have low persistency rates.

This is a real problem since private sector financial institutions, unlike the state and companies, would seem to be the key vehicles of the future for delivering pensions. (See below my response to the question of compulsion.)

- Should individuals be compelled to save for their retirement by the Government? If so, into what 'device' should they be forced to save; how much of their income should they save; at what period in their lives; should employers be compelled to contribute too; and what about the self-employed?

The case for compulsion is gathering strength all the time. People are retiring earlier and they are living longer. As Alistair Darling said recently, many people are in retirement for almost as long as they are in work, so every day's pay must also provide a day's pension. Now this does not mean that we need to save half our income whilst in work, because of the benefits of compounded returns. But it does mean that we need to save around £1 in every £6 that we earn (however this is shared between the employee and the employer) for 40 years if we want to have a pension of two-thirds of our final salary in retirement (assuming real earnings growth is 2% pa, the real return on assets is 3% pa, and post retirement mortality is based on PMA92).

The average contribution rate into a DC pension plan in the UK is around 10% (evenly split between employee and employer). This will generate a pension of 40% of final salary in retirement if contributions are kept up for 40 years. If people only worked every other year and only contributed 10% of earnings while they were in work, the pension would fall to 20% of final salary.

Most pensioners claim that they have inadequate resources to live on in retirement. It is too late to do anything about it at this stage. Obliging everyone in work (both employed and self employed) to contribute 10% (evenly split between employee and employer) to a well-designed DC scheme (if they are unable to join an equivalent

occupational scheme) would provide a reasonable pension in retirement (especially when the basic state pension which equals 17% of average earnings is added in).

There is a definite case for considering compulsion and we should not be deterred by the inevitable claim that this is just another stealth tax.

The same rules should apply to the self-employed as to employees. The self-employed often claim that they are in different position from employees: they plan to work longer and have business assets which they can sell to provide a pension. But many self-employed people have modest incomes and many employed people also have assets (such as their house) which they could use to provide a pension. There is no guarantee that the self-employed will be a position to work for longer than employed workers and there is nothing to guarantee the value of the business assets that are sold to provide a pension.

- What negative effect have recent private pension crises had on public perceptions of saving for retirement and how can they be countered?

  They seem to have both highlighted the issue of pension provision (everyone is talking about pensions at the moment) and made the pensions mountain a bigger one to climb (why bother to save for retirement since there seems to be such little chance of ending up with what we thought we had initially contracted for?).

  The best way to counter this attitude is a public awareness campaign (beginning in schools) covering life cycle financial planning issues, making clear that pension provision is the longest duration financial planning issue of them all, and that as a result of the benefits of compound interest, the burden during the working life of transferring resources to the retired part of life (which is the essential purpose of a pension scheme) is smaller the earlier one starts.

- Whose role is it to ensure that future pensioners have sufficient information, and access to impartial advice, in order to make the necessary decisions for their future? What role should pension forecasts play?

  I believe the public awareness campaign should be led by the government, since private sector providers (either companies which are rapidly moving away from final salary schemes or insurance companies which are still tarnished by the pensions misselling scandal and the fiasco over Equitable Life etc) do not presently have the necessary credibility.

The government should come clean about the matter by stating very clearly that in future we cannot rely on the state to provide anything more than a minimum safety net (the ageing of the population has created a demographic imbalance which prevents anything better). It should point out that changing labour market conditions make it unlikely that companies will be willing in future to provide pensions linked to earnings. So it is left to us to make our own arrangements with private sector financial institutions. But for this to work the product (namely the DC pension) must be well-designed and quite frankly it is not at the moment.

DC pensions are barely adequately designed at present, since they are not treated as a single integrated product across the life cycle. Our pensionmetrics approach is designed to resolve this problem.

Pension forecasts are an essentially feature of good design, since they would demonstrate the adequacy or otherwise of the existing contribution and investment strategy.

- What role should methods of saving other than pensions play in the Government's strategy? Is a pension the best way of saving for retirement for all future pensioners?

Saving via a recognised pension scheme has certain key advantages, principally tax breaks and developing the habit of making regular contributions for a savings plan. But it also has certain disadvantages, particularly for the middle classes, since the way in which benefits can be taken and transferred within the scheme member's family are highly restricted. Other vehicles for accumulating wealth are tax-favoured savings plans such as ISAs and the residential home. Family members can also provide financial and other support to the elderly in their family.

At the same time, there may be other resource needs in old age that are not best met from a pension scheme. The main example here is long-term care. One in five of us will need long-term care for up to two years at a cost of around £20,000 p.a. Very few people insure themselves against this contingency with the consequence that the family home may have to be sold to pay for this care. Yet if an insurance policy were taken out when we were young, the cost would be very small.

We should identify the key resource requirements of the elderly and then consider how they should best be funded: eg, savings schemes for the pension and insurance policies for contingent liabilities such as long-term care.

The key messages that should be got across to the public are that retirement covers a much longer period of a person's life than

hitherto, that pensioners constantly complain that they do not have adequate resources in retirement, that it is too late to do anything about this in retirement, and that retirement planning is something that needs to start the day you start your first job!

- What role do policies on 'active ageing' have in ensuring increased prosperity in retirement? Should the age of retirement be examined? Should there be more flexibility about when people receive their pensions?

  Post-retirement work is known as the 'fourth pillar of support in old age' and it will become increasingly important in the future if it is not prevented from doing so by 'ageism'. We should not forget that retirement was a 20th century invention of the western world. People did not 'retire' before the 20th century, they worked until they dropped or were too infirm to continue working and they tended to die shortly afterwards. While state and company pension schemes began in the first half of the 20th century, their benefits were not really enjoyed until after WW2 as a result of the increasing longevity of the retired population. If the design of defined contribution pension schemes is not improved radically and there are not significant increases in pension savings, retirement may cease to be a 21st century concept: we may have to go back to keeping on working until we drop!

Yours faithfully

Professor David Blake

Required contributions into a pension scheme (estimated using the PensionMetrics Model)

Contributions (as % of salary) required for a male worker to achieve a pension of 2/3rds of final salary at age 65 at different starting ages (assuming real earnings growth is 2% pa, the real return on assets is 3% pa, and post retirement mortality is based on PMA92):

Starting age	25	35	45	55
Contribution rate (%)	17	24	37	72

A simple rule of thumb for those starting a pension scheme under 45 is to take the starting age and subtract 10 to find the required contribution rate.

The equivalent table for women using PFA92 is:

Starting age	25	35	45	55
Contribution rate (%)	19	27	42	84

The risk involved in pension schemes can be quantified by calculating value-at-risk confidence levels at different contribution rates (assuming the same volatility as experienced in UK and global securities markets over the last half century). The following table shows VaR confidence levels as a % of final salary at different contribution rates for a male worker starting a pension scheme at age 25 and retiring at age 65:

	Contribution rate (%)		
VaR confidence level (%)	9	17	21
50	37	67	84
80	22	40	50
95	15	27	34
99	10	19	24

With a contribution rate of 17%, the scheme member can be 50% confident that he will get a pension of at least 67% of final salary, 80% confident of getting at least 40% and 95% confident of getting at least 27%. If he wanted to be 80% confident of getting at least 50%, his contribution rate would have to be 21%.

Since average earnings are £24,000, a contribution rate of 17% amounts to £4,080 pa. With 25m workers, total labour income is £600bn and the total required contribution into pension schemes is £102bn. In 2001, total contributions into pension schemes amounted to £55bn (Blue Book 2002), indicating a shortfall of £47bn. Average contributions per worker in 2001 were therefore £2,200 pa, or 9% of average earnings, sufficient to purchase a pension of 37% of final salary after 40 years for a male worker.