The Ideal Pension Scheme

(From: David Blake, Pension Schemes and Pension Funds in the United Kingdom, Oxford University Press, 2nd Edition, forthcoming)

The natural starting point for designing an *Ideal Pension Scheme* is to ask what a pension is supposed to achieve. We argue that a pension scheme is nothing more than a long-term savings vehicle for retirement. This assumption is far from innocuous, however. At present, the occupational pension system serves other purposes as well, such as helping firms to reduce labour turnover, backload pay and recover training costs. We are, by assumption, ruling out these uses of pensions by focusing on pensions solely as a savings vehicle. If pensions schemes are to be used solely as a savings vehicle, they do not need to differ in concept from that underlying any other type of savings vehicle.

On this basis, an *Ideal Pension Scheme* has the following eight characteristics:

1. *Portability*. It would be fully portable and there would be no costs when switching jobs or pension scheme providers.[1]
2. *Adequacy*. It would provide an adequate pension for the member in retirement and also provide some additional standard benefits such as disability benefits and possibly death-in-service benefits and a spouse's pension.
3. *Parity of treatment*. Employers would be required to treat all employees equally (for example, in respect of employer contributions), whether the employee is male or female, full-time or part-time.
4. *Flexibility*. Individuals would be able to build up larger pensions by making additional contributions; there would be limitations on tax relief but not contributions. There could be gaps in the contribution record, as, for example, when women temporarily leave the labour force to have children. However, an adequate pension requires adequate contributions to be made into the pension scheme.
5. *Simplicity*. The pension benefits and necessary contributions would be easy to understand.

6. *Security*. The assets in the pension scheme would be held in safe custody. The assets would be excluded from litigation in the event of bankruptcy, unless there was evidence of fraudulent intent. However, the pension assets would not be protected in the event of either divorce or criminal settlement.
7. *Inexpensive*. Competitive pressures and economies of scale would ensure that distribution, administration and fund management services were provided efficiently and at low cost.
8. *Transparency*. Information about pension schemes (including charges and investment performance) would be open and publicly available.

We have shown in Chapter 3 that SERPS is not *adequate, flexible,* or *simple*. In addition, given that the government has already reduced SERPS benefits before substantially, it may not even be *secure*. Occupational pension schemes are not *portable, simple,* or *transparent*, and the Maxwell Scandal has led many to believe that these pensions are not *secure*. Personal pension schemes are not *transparent* or *inexpensive*, various costs make these pensions often not *flexible* or *portable* between providers.

Our *Ideal Pension Scheme* satisfies the eight characteristics above and hence avoids the defects of the existing systems. The *Ideal Pension Scheme* has the following features:

1. It would be fully portable and independent of any employers.
2. Mandatory minimum contribution related to the employee's salary and possibly age are made into the scheme. These contributions which attract tax relief will typically be made by both the employee and employer. The contribution rates would be set to reflect the pension level desired in retirement which may, for instance, be related to a forecast of salary at retirement.[2]

[1] In particular, there should be no incentives in the system for *churning* customers between different pension providers, as has been a problem, for example, in the case of Chile.

[2] Data on investment returns, salary growth rates, mortality and the volatilities of these would be used to estimate the value of the fund needed at the target retirement date to purchase the target pension annuity. Then working backwards an estimate is made of the required contributions into the scheme. Clearly the later the starting age the higher the contribution rate. Confidence intervals could also be estimated, indicating the probabilities of different contributions rates delivering the target pension.

3. Individuals would also be required to buy some related pension benefits such as disability benefits (up to a minimum threshold) and would have options for other benefits such as death-in-service benefits and a spouse's pension.
4. Both the employee and employer would be free to contribute additional voluntary contributions. Contributions in excess of specific employee and employer limits would not attract tax relief, however. There would be parity of treatment with the employer's own scheme.
5. The investment income and realised capital gains in the fund would accrue with income and capital gains tax relief.
6. The pension age would be flexible and not necessarily linked to actual retirement. In other words, an individual could draw the pension without actually having retired. However, the individual would be warned about the dangers of retiring too early and drawing a pension before the normal retirement age would ordinarily be restricted to those who had built up sufficiently large pension funds to provide an adequate standard of living in retirement.
7. Individuals would be required to have converted a mandatory component of their pension into an annuity at retirement. Individuals would be permitted to purchase a deferred annuity before retirement. The mandatory component of the pension would be fully linked to retail price inflation. The pension would be taxable.
8. Part of the pension entitlement (up to a specified limit) could be taken as a lump sum. The lump sum would be taxable.[3]
9. Pension schemes would operate according to a standardised set of deeds, similar to company articles of association.
10. The scheme would be administered by an independent pension scheme administrator, independent of any employers and the investment manager of the fund. This would be necessary to ensure safe custody of the scheme assets.
11. Pension schemes would have an auditor and would be required to submit annual audits.
12. The scheme administrator would ordinarily seek advice from professionals (such as economists, actuaries and pension consultants) on the adequacy of contributions.

[3] This is necessary to ensure tax neutrality over the life cycle.

13. Pension fund management groups would operate on a similar basis to unit trusts in the UK (or mutual funds in the USA). They would collect, pool, and invest contributions on behalf of individuals. In return, the individual would be allocated accumulation units whose transfer values (calculated on the basis of single pricing) are published on a daily basis.
14. Charges must be kept low and not be frontloaded.[4] There should not be a high initial fixed costs that in effect ties an individual to a particular (and possibly inefficient or uncompetitive) organisation providing particular services such as fund management. To this end, pension fund managers should be encouraged to invest in passive index funds with a consequent reduction in costs or to accept performance-related fees.
15. Pension-scheme members would be provided with full and regular information about their schemes in precisely the same way that shareholders receive information about their companies. The information would cover:

    - the status of employee and employer contributions into the scheme;
    - the value and type of assets in the pension fund;
    - the rates of return generated on the assets;
    - the fees or commissions charged by the scheme administrator and pension fund manager.
    - an estimate of the weekly pension that the current value of the assets can be expected to buy at normal retirement age.

    Summary information on scheme structure and performance would be made publicly available.

16. The pension industry would be supervised by a pensions regulator who would also operate a compensation scheme to compensate scheme members in the event of fraud or malpractice. The compensation scheme would be financed by a levy on all pension schemes. The regulator should also be responsible for implementing a one-stop dispute-resolution system for all privately organised pension schemes (as recently suggested by the (Office of Fair Trading 1997)).

What are the advantages of this pension scheme? The main advantage is that it individualises or personalises pension arrangements in precisely the same way that most other financial matters that we face are personalised. In doing this, it eliminates all the potential conflicts of interest between the employee and the company, between part-time and full-time workers, or between early leavers and long stayers.

Furthermore, it explicitly identifies where responsibilities lie:

- the responsibility of the employee and the employer for making adequate and timely contributions;
- the responsibility of the independent scheme administrator for operating the scheme;
- the responsibility of the fund manager for managing the scheme's assets;
- the responsibility of the annuity provider for delivering the pension annuity;
- the responsibility of the state for regulating the industry.

Most significantly the *Ideal Pension Scheme* meets John Denham's (1997) challenge for a 'sustainable long-term framework for new second pensions … based on the investment of pension contributions into cost-effective, value-for-money, funded schemes'.

One potential disadvantage with a scheme such as this concerns the size of fees and commissions charged by those institutions involved in servicing it. Great care would be needed to ensure that individual scheme members were not subject to excessive charges. Publication of fees and commissions would help to achieve this. But the main way of keeping fees down is to keep the scheme structure simple. In this way pensions can be turned into a commoditised product in the same way that many other personal finance products (e.g. mortgages) have become commoditised over time. And the one thing about a commoditised product is that it can be marketed cheaply on the basis of price, since with a simple structure there is no real service being offered that requires high commissions to be paid.

---

[4] In particular, it may be desirable for charges to be restricted to annual fund management charges. Some US pension funds such as Vanguard charge only annual fund management charges (of 30 basis

Another disadvantage of the scheme is that it cannot 'guarantee' a pension at retirement that is linked to final salary as with occupational pension schemes, although, as we have seen, very few members of occupational schemes get the best (i.e. two-thirds of final salary) pensions that are available from such schemes. The *Ideal Pension Scheme* is, by design, a money purchase scheme. However, there is no reason why money purchase schemes cannot be used to deliver a salary-related pension, i.e. be a *targeted money purchase scheme*. It could not be a strict final-salary scheme, since it would always be possible for an individual to negotiate a 'final' salary with his or her employer that was well in excess of previous salary experience and hence the contribution record. However, it would be possible to design a scheme that was based on career-revalued earnings. The revaluation factor could be related to national average earnings (as with SERPS) for example. Salary-related schemes are clearly feasible since occupational schemes already promise this. What is being proposed here is that the scheme should be provided by the market, rather than by the company.

We believe that the *Ideal Pension Scheme*, as outlined above, would be good enough in practice to warrant replacing both the existing components of private-sector second tier pension provision in the U.K., namely occupational and personal pension schemes. Both deliver inferior pensions to far too many people. Existing personal pension schemes could be reconstituted as *Ideal Pension Schemes*. Occupational pension schemes could also be restructured into *Ideal Pension Schemes*. Companies would either recover surpluses or fund deficits and the remaining pension fund assets would be divided according to *investment roll-up* on contributions (i.e. unitised). Transfer values from occupational schemes would be mandated to be calculated on the same basis. Accordingly, it might be sensible for occupational pension schemes to establish themselves as independent scheme administrators for the individual accounts of the former occupational scheme members. They could immediately compete for new business, but individuals would be free to transfer their units elsewhere.

Capital markets have an extremely important role to play in making the *Ideal Pension Scheme* work, both in terms of building up the pension fund and in delivering the pension annuity. But financial institutions operating in the capital markets need to

---

points or less on its index funds) (*Financial Times*, 20 October 1997).

be considerably more inventive in designing new financial products that help to deliver the *Ideal Pension*. For example:

- **Portfolio insurance products** such as equity guarantee products to reduce the risk of a catastrophic fall in the equity market. Portfolio insurance strategies allow us to design products for DC customers to deliver (with a high degree of probability) a particular level of benefits as with a traditional DB scheme.
- **Age phasing products** to reduce the risk of a fall in equity values in the period leading up to retirement. Alternatively, rather than switching into bonds before purchasing an annuity at retirement, individuals should be able to make phased annuity purchases.
- **Annuities** that help to deliver a reasonable and reliable pension in retirement without investing in low yielding fixed-income or index-linked bonds. Equity-linked annuities could be coupled with fixed-income guarantees. In addition, there is room for further development in the market of group annuities and for the integration of income drawdown products with annuities (a two-tier annuity in which individuals would be able to drawdown parts of the capital sum in accordance with the legal limits before age 75).

If new financial products such as these are introduced then the capital markets can help to deliver the *Ideal Pension Scheme*. We believe it is essential that they do so.