



OFFICE OF FAIR TRADING

Report of the Director General's Inquiry into Pensions

Volume One

Summary, background, the issues, provision
overseas, conclusions & recommendations, glossary
and bibliography

July 1997

CONTENTS

Volume 1

Foreword

by John S Bridgeman, Director General of Fair Trading 7

Summary 11

Chapter 1: Introduction 21

1.1 The powers and duties of the Director General of Fair Trading 21

1.2 The inquiry team's terms of reference 21

1.3 Forms of investigation/methodologies 22

1.4 Structure of the report 25

Chapter 2: History 27

2.1 Introduction 27

2.2 Beginnings of state intervention 27

2.3 The Beveridge Report and the blueprint for the welfare state 28

2.4 Changes initiated 1979—1997 29

2.5 Pensions Act 1995 32

2.6 Further changes proposed to pensions 33

2.7 Budget Statement 2 July 1997 35

Chapter 3: Background and trends 37

3.1 Introduction 37

3.2. Levels of pension contributions 38

3.2.1 National insurance contributions (NICs) 38

3.2.2 Occupational pension scheme contributions 40

3.2.3 Personal pensions contributions 43

3.3	Market structure	44
3.3.1	Pension funds	45
3.3.2	Pension business of life companies	46
3.3.3	New entry	47
3.3.4	Sources of personal pensions business	47
3.4	Demographic trends	47
3.5	Present and projected sources of retirement income	48
3.6	Working patterns	52
3.7	Shift from DB to DC money purchase schemes	54
3.8	Tax treatment	55
3.8.1	Occupational DB final salary schemes	56
3.8.2	Occupational DC money purchase schemes	56
3.8.3	Personal pensions	56
3.9	Other sources of retirement income	57
3.9.1	Asset-based sources	57
3.9.2	Income-based sources	58
	Chapter 4: The consumer problems we identified	59
4.1	Introduction	59
4.2	Consumer problems inherent in Defined Benefit pensions	59
4.2.1	Transfer values	61
4.3	Consumer problems with Defined Contribution pensions	69
4.3.1	Introduction	69
4.3.2	Investment risk	70
4.3.3	Charges	73
4.3.4	Annuities	78
4.3.5	Contributions and earnings	81
4.3.6	Selling personal pensions	84
4.4	Complexity and inflexibility in pensions	88
4.4.1	Level of consumer understanding	88
4.4.2	Tax treatment	89

4.4.3	Consumer redress	90
4.4.4	Regulation: costs and benefits	93
4.4.5	Public educational campaign	94
4.5	Pension problems facing particular groups in the population	95
4.5.1	Women	95
4.5.2	Ethnic minorities	98
4.5.3	Unmarried partners	99
4.5.4	Self-employed	100
Chapter 5:	How other countries provide for retirement	101
5.1	Introduction	101
5.2	Compulsion	102
5.3	Transfer values and vesting	104
5.4	Funding	105
5.5	Consumer knowledge	106
5.6	Redress	107
5.7	Tax	108
5.8	Women	109
5.9	Minorities	110
5.10	Annuity rates	110
5.11	DB and DC	111
5.12	Mis-selling	112
5.13	Simplified products	112
	References for Chapter 5	113
Chapter: 6	Conclusions and recommendations	115
6.1	Introduction	115
6.2	Problems with DB pensions	116
6.3	Problems with DC occupational and personal pensions and proposals for a designated personal pension (DPP)	119
6.4	Alternative solutions to personal pension problems	129

6.5	Level of contributions: the case for greater compulsion	131
6.6	Non-core recommendations	133
6.6.1	Rules governing the tax deductibility of pension contributions	133
6.6.2	Regulation of other pension products	133
6.6.3	Redress	134
6.6.4	Consumer information	135
6.6.5	Annuities	135
6.6.6	Unmarried partners	135
	Glossary of terms	137
	Bibliography	161

Volume 2

Reports of research undertaken by the Office of Fair Trading for the Pensions Inquiry

- Appendix A Consumer survey
- Appendix B Structured interview process
- Appendix C The potential for minimising consumer detriment in pensions
- Appendix D International comparisons

Volume 3

Reports of research commissioned by the Office of Fair Trading for the Pensions Inquiry

- Appendix E Portability and preservation of pension rights in the United Kingdom — by David Blake and Michael Orszag, The Pensions Institute at Birkbeck College, University of London
- Appendix F Passive Fund Management — a research report by Paul Klumpes, University of Lancaster

FOREWORD

by John S Bridgeman, Director General of Fair Trading

Governments in many countries are facing the problem of an ageing population and tough decisions about how state-financed health care and pensions should be paid for. In the United Kingdom, the proportion of the population who are aged 65 and over is expected to increase from 16% in 1990 to 23% by 2030. Consumers are having to become more proactive about pensions. They are now more worried about living too long than they are about dying early.

On 19 September 1996, I announced a review of the provision of occupational and personal pensions in the United Kingdom in order to identify any practices that adversely affect the economic interests of consumers. There had been other inquiries into pensions, but this one was to be carried out from a consumer perspective. The inquiry would investigate consumers' experience in buying pensions, the effect of their choices on pension entitlements and the potential for detriment.

Sadly, as we all know, in the past legitimate expectations have been betrayed: the misappropriation of large sums from Mirror Group Pension Scheme and the mis-selling of personal pensions to those induced to abandon existing entitlements in favour of less advantageous personal schemes attest to that.

These scandals and their immediate causes are being addressed: the Occupational Pensions Regulatory Authority came into operation earlier this year, and the City's financial regulators recently announced strict deadlines for the completion of the personal pensions review, to identify and to compensate investors who suffered loss through mis-selling. The time has therefore come to address another, even more fundamental issue: how adequate are the products currently available to consumers?

The inquiry team have met with representatives of the industry, regulators, government departments, academics and consumer groups in order to obtain their views. They also

undertook a study of pension systems in a selected group of countries and compared their systems with the United Kingdom system and its problems.

I find that currently available products often fail to meet consumers' needs. The transferability of pension entitlements accrued from an occupational pension may have improved in recent years, but the majority of us who do not stay with the same employer for forty years and leave occupational schemes early — particularly salary-related schemes — run a high risk of losing out. Many personal pension plans are, on the other hand, simply poor value. Their benefits are consumed in the high levels of expenses needed to support the marketing effort and the active management of the funds. These expenses are often loaded on the early years of the plan, so that they bear disproportionately on plans where the contributions are discontinued because of changes in personal circumstances. In comparison with most occupational schemes, the level of employers' contributions may be inadequate or non-existent.

The principal remedy I am proposing in this report is the provision of something which I have chosen to call a Designated Personal Pension product, which will enjoy a contribution from the employer when an employee opts not to join an occupational scheme. The fund would be passively managed, avoiding both the cost of active fund management and the opportunity to confuse the consumer with specious claims about superior investment performance. Risk would be managed by a systematic reduction in the exposure to equities over the working life of the consumer. The taxation system should encourage its wide provision.

An appropriate regulatory framework is essential for such a product to thrive, or even emerge. I welcome the changes recently announced to financial regulation which should enhance the prospects for this.

I was of course aware before this inquiry was announced that there had been a number of other reports published into pensions and retirement income. As the extensive bibliography shows, the inquiry team have been able to draw on a very wide range of such material. In the

run up to the recent election, it became clear that, whatever the result, the newly elected government would be tackling pensions as a relatively high priority and that this could well involve the consideration of a form of pension scheme broadly comparable to the DPP I am proposing.

The inquiry team and their researchers have produced an extensive report which runs into three volumes. I should like to take this opportunity to thank all those who have contributed in any way to its compilation. I hope it will go some way to creating a climate in which people can look forward to old age with more peace of mind.

SUMMARY

This report examines pension provision in the United Kingdom and the nature and extent of any detriment suffered by consumers through this provision. It concludes that consumer detriment is endemic in both defined benefit (DB) and defined contribution (DC) schemes. The principal recommendation is for a Designated Personal Pension (DPP), a DC pension which would reduce or eliminate consumer detriment arising with both DC and DB products.

Chapter 6: Conclusions and recommendations

Problems with DB pensions

Defined Benefit (DB) pensions have provided and will continue to provide a comprehensive range of benefits which meet many of the needs of consumers. However, as reported in Appendix E, long stayers are rewarded at the expense of early leavers. This is implicit in the design of all DB final salary pension schemes.

Problems with DC pensions

Problems with the currently available DC pension products include poor investment returns and exposure to avoidable risk; charges which are both high and penalise the flexibility most contributors need; and annuities which may be poor value and inappropriate. Other problems relate to contributions — starting early enough, keeping up the level and securing an employer's contribution.

Recommendations

The Designated Personal Pension (DPP) would provide a viable alternative to those who would be most severely disadvantaged by joining an occupational DB pension scheme while avoiding the consumer detriment found in many existing DC pensions. To achieve this, the DPP should have the following characteristics:

- *an underlying investment in a well diversified portfolio of equity shares, the portfolio overall having average risk;*
- *passive fund management of the portfolio;*
- *the use of gearing to regulate the individual consumer's exposure to investment risk;*
- *systematic reduction of gearing as the individual consumer approaches retirement so that the investment return on the fund is maximised in relation to the overall level of investment risk assumed;*
- *an annuity purchased on the open market;*
- *an annuity which is fully index linked;*
- *equal annuity rates for men and for women;*
- *expenses fixed as a proportion of fund value with no hidden element;*
- *a structure which enables economies of scale to be exploited and gearing in respect of individual consumers to be aggregated;*
- *an entitlement for an employee, on becoming eligible to join an occupational scheme, to receive in lieu a contribution from the employer to a personal pension scheme with the characteristics listed above;*
- *unbiased and objective recommendations on the levels of contribution needed for consumers of different ages and with different levels of accumulated savings.*

Alternative solutions

We look at a number of alternative solutions. There are no easy solutions to the early-leaver problem with DB schemes as it is not practicable to index deferred benefits on the basis of individual earnings. For example, transfers of year-to-year service (via transfer clubs as in the Netherlands) can work only if scheme benefits are similar, as in the public sector. The immediate conversion of schemes from DB to Defined Contribution (DC) would precipitate the very consumer detriment we have identified with the existing DC schemes. In the longer term the only solution is the availability of a good, fully portable DC scheme which would be adequately funded by both the employee (including the self-employed) and, where appropriate, the employer. Halfway measures to improve the quality of DC schemes could result in renewed problems with mis-selling. The fundamental characteristics of the DPP which we identified are essentially *indivisible, essential and interrelated*. Thus, their partial adoption might do little to improve matters and could actually increase consumer detriment.

The case for greater compulsion

Above certain income levels, employees are required to contribute to the basic state pension and SERPS (or an equivalent in a contracted-out scheme). We look at experience in other countries which have a wide variety of combinations of compulsion and tax incentives. We make no particular recommendation.

Non-core recommendations

The DPP addresses most of the problems which we have identified. Other non-core recommendations cover:

- the elimination, where practicable, of the differences between the tax treatments of different forms of pension;
- the regulation of other (non-DPP) products to pay greater attention to non-client- specific information and the need of the majority of consumers for flexible products;

- provision of a single initial contact point for all pension problems other than those relating to the state pension.
- annual statements on projected maturity values in current prices of portable pensions;
- no penalties for buying annuities independently (exercising the open-market option);
- wider use by trustees of their discretion to pay survivors' pensions to unmarried partners.

The evidence and analysis that supports these recommendations is contained in Chapters 1—5, summarised below, and in two further volumes of supporting analysis.

Chapter 1: Introduction

This inquiry represents a logical extension of other work undertaken by the OFT in the area of financial services. Earlier reports highlighted consumer problems with investment and savings products and endowment mortgages, in particular the impact of front-loaded charges, driven by the level and structure of commissions paid to salesmen.

Chapter 2: History

We look briefly at the recent history of pensions starting with their introduction by Lloyd George in 1908 and the origins of the welfare state in the Beveridge report of 1942. We then cover the introduction in 1975 of the state earnings related pension (SERPS). Changes in the mid-1980s were designed to encourage private pension provision and greater portability of occupational pensions. Unfortunately, significant numbers of personal pension plans were *mis-sold* to those for whom they were not appropriate. Progress in investigating over 0.5 million cases has been far slower than planned. Problems also arose with the security of occupational schemes leading to the Pensions Act 1995.

Chapter 3: Background and trends

We examine the levels of contribution to all types of pension — to the state pension through National Insurance, and to occupational and personal pension schemes. We look at the providers of pensions and the take-up by consumers: 49% of employees are members of an occupational pension scheme and 24% contribute to a personal pension so, overall, 73% of employees belong to some form of private pension. Demography is a driving force with pensions as with other welfare services. Reports by the World Bank, the IMF and the OECD highlight that many countries are experiencing, or expect to experience, problems in meeting the costs of paying pensions to a rising proportion of the population. We then set out the present sources of retirement income for different pensioner income groups and projections over the next 30 years or so. Next we look at employment patterns, in particular the number of changes of jobs and of pension schemes over the working life, highlighting the need for flexibility in pension arrangements. This is *not* a new feature of the job market - it has always been with us. Less than 5% of men (1% for women) in the workforce spend more than 30 years in the same job. Finally we note the gradual shift from defined benefit (DB) pensions to defined contribution (DC) pensions.

Chapter 4: The consumer problems we identified

Consumer problems with pensions have three causes: low income from which to contribute; making a low level of contribution, relative to income (or starting contributions too late in life); and getting poor value from those contributions. Income levels are outside the scope of this report. Getting the contribution level right and achieving good value from those contributions both involve consumers in choices and it is these choices which are the subject of the remainder of this report.

Problems with Defined Benefit pensions and transfer values

DB pensions are mostly based on final salary. Benefits are *back-loaded*. A transfer value will normally buy fewer years in a new scheme than in the previous one. (In the public sector year-for-year transfers of service are more usual.) An employee who moves, say, five times can end up with a pension worth up to 30% less than someone who stayed in the same pension scheme.

Some can lose a great deal more. Not everyone moves voluntarily or to a new job at a higher salary. In most countries we researched, pension rights in DB schemes do not belong to the employee until a period of between 1 and 5 years (2 years in the United Kingdom) has been worked.

Problems with Defined Contribution pensions

DC pension schemes expose contributors to different forms of consumer detriment. Much of this detriment in present-day DC pensions would be avoidable if they were designed suitably.

Avoidable investment risk

Active fund management, employed in many DC pensions, does not represent the cheapest way for the consumer to secure the equity risk premium. Yet there is little or no evidence that active fund management can deliver sustained, above-average performance and thereby secure the consumer anything better than the equity risk premium. Reliance on active fund management does, however, necessitate the use of expensive distribution channels directed at persuading the consumer to invest not on the basis of the cheapest product, that is, the one with the lowest expenses, but on the basis of specious claims about investment returns.

High and front-loaded charges

As we found in our earlier reports on endowments, charges can make a large hole in the returns from investing contributions. There are very wide ranges which, combined with variations in fund performance, can lead to substantial differences in the sums available at retirement. Disclosure of charges has had a limited impact. Front-loaded charges, driven by the commissions paid to salesmen, penalise those who are unable to contribute for the whole period of a pension plan. Inflexible products have been widely criticised both from within and outside the industry. As recently as last January, Which? reported that many personal pension plans still on sale were poor value because of their high charges and inflexibility.

Poor value annuities

At retirement, contributors to personal pensions find themselves faced with another choice — that of purchasing an annuity. Failing to purchase a competitively priced annuity in a market with a wide range of choices is another reason for consumers retiring on low incomes. Consumers should not face a penalty, as some do, if they take their annuity from a source other than their pension plan provider.

Inadequate contributions

Many contribution levels are inadequate. We have explored the desirable level of retirement income, somewhere between that provided by the basic State pension (and means-tested benefits) and two-thirds of final salary. Often it comes down to not what is desirable but what can be afforded. Consumer surveys suggest a degree of unwarranted optimism over what contributions will generate.

Selling personal pensions

The majority of single premium policies are bought through IFAs offering a choice of providers, whereas regular premium policies are more likely to be bought from sources only offering

products from a single provider. We look at the role of product advertising, the impact of direct selling (including telephone selling) and the competency of intermediaries.

Complexity, tax, redress and regulation

All the survey evidence suggests that consumers find pensions confusing, emphasising the need for simplification. The separate development for occupational and personal pensions of tax treatment, consumer redress mechanisms and regulation causes problems for consumers seeking advice about pensions. Opportunities to reduce this confusion should be grasped.

Pension problems facing particular groups in the population

Here we look at particular groups who might be disproportionately affected by some of the problems we have already identified. We ask if their problems are exacerbated by the pensions system.

- *Women* need more flexible pension arrangements to take account of time out of the workforce caring for children or elderly relatives. Home Responsibilities Protection is limited to the basic state pension, which is declining in value relative to earnings. Annuities for women are about 10% lower than those for men to allow for their longevity. We make the case for equalising annuity rates if women with personal pensions are not to be penalised in comparison to those covered by occupational pensions or SERPS.
- *Ethnic minorities.* Our investigations did not reveal particular problems caused by the pension system.
- *Unmarried partners.* Occupational pension schemes are more likely than personal pension schemes not to recognise the claims of unmarried partners in survivors' benefits.
- *Self-employed.* As a group they do not participate fully in the current pension system. They are not covered by SERPS and are thus not faced with the same pressures as

employees to contribute something above basic state pension. The value of their businesses is an uncertain way of providing for retirement.

Chapter 5: Issues and comparisons with international pensions systems

We undertook an extensive survey of how eight countries (Australia, Canada, Chile, Denmark, the Republic of Ireland, Netherlands, Singapore and the United States) provide for retirement, looking for comparisons of issues from which we might draw lessons for the United Kingdom. The International Research Unit of the inquiry visited four of these countries (Denmark, Netherlands, the Republic of Ireland and the United States). Appendix D sets out an analysis of the meetings conducted, more detail of what we found and an overview of each country's retirement framework.

Chapter 1: INTRODUCTION

When the Director General of Fair Trading launched this report, he set out to review the provision of occupational and personal pensions in the United Kingdom in order to identify any practices that might adversely affect the economic interests of consumers of pension products. The inquiry would investigate consumers' experience in buying pensions, the effect of their choices on pension entitlements and the potential for detriment. This is a logical extension to the other work undertaken by the Office of Fair Trading (OFT) in the area of financial services. Earlier reports highlighted consumer problems with investment and savings products and endowment mortgages, and in particular the impact which front-loaded charges, driven by the structure of commissions paid to salespeople, have on contributions in the early years.

Set out below are the powers under which the Director General commissioned this report, the inquiry team's terms of reference, and an introduction to the forms of investigation used during the conduct of the inquiry, together with a brief explanation of how the report is structured.

1.1 The powers and duties of the Director General of Fair Trading

Under the Fair Trading Act 1973, the Director General has powers to keep under review practices affecting the economic interests of consumers (S2(1)) and to publish information and advice (S124).

1.2 The inquiry team's terms of reference

The inquiry team at the launch of the report were asked to review the provision of occupational and personal pensions in the United Kingdom in order to identify any practices which adversely affect the economic interests of consumers, and to compile a report which, if appropriate, might include recommendations to ministers, self-

regulatory organisations (SROs) and consumers on how such detriments of various types could be minimised or reduced.

Two aspects of the provision of pensions would be reviewed:

- a the market and industry structure, including its statutory and regulatory framework; and
- b consumers' behaviour and the effect on pension entitlement of specific arrangements they make.

In order to meet the terms of reference, the inquiry team carried out initial desk research to establish the current market and industry structure including its statutory and regulatory framework. We also examined selling processes within the market using the rules of the Personal Investment Authority (PIA) and other SROs as a starting point. This research was then used as a basis on which to conduct a series of interviews with academics, consumer groups, government departments, regulators and representatives of the pensions industry, and to commission research from certain academics, as well as a consumer survey. The International Research Unit of the inquiry team also carried out a study of the pensions systems used in other countries looking for comparisons of issues which related to the inquiry.

1.3 Forms of investigation/methodologies

The inquiry team used a variety of information sources, each requiring an appropriate methodology to collate and analyse it. Five modes of research were used:

- a desk research;
- b structured interviews;

- c a consumer survey;
- d international comparisons;
- e commissioned research from academics.

The inquiry team also made use of correspondence received by the Office in response to the inquiry's announcement.

a ***Desk research***

The initial desk research established the current market and industry structure, including its statutory and regulatory framework, and identified the leading participants in the industry, including pension providers, consultants, investment managers, and consulting actuaries. These findings would be utilised in the structured interview process.

b ***Structured interviews***

By drawing on the desk research to identify participants and areas of detriment, a questionnaire was drafted in order to structure and prepare interviews with selected groups. Interviews were conducted with academics, consumer groups, government departments, regulators and representatives of the pensions industry. A summary of the results of these interviews held in the United Kingdom is contained in Appendix B of Volume Two of this report.

The inquiry team also received a number of letters from members of the public. These were of an anecdotal nature and addressed single issues such as mis-selling of pensions, charges and low transfer values. A number of letters were also received from the pensions industry and expressed concern on issues such as the complexity of the regulatory regime and transfer values.

c ***Consumer survey***

One of the initial tasks embarked upon by the inquiry team was to establish the availability of information from market research by pension providers and others. Experience with earlier reports suggested that industry-sponsored surveys tend naturally to be angled towards obtaining marketing information rather than exposing consumer problems, or may be designed to show satisfaction rather than dissatisfaction with products. The Office commissioned its own survey, and purchased space on Research Surveys of Great Britain Limited's random location omnibus survey. A representative sample of over 3,800 adults, aged 16 and over, throughout Great Britain, were interviewed during the period 6—17 November 1996. The findings of the consumer survey are contained in Appendix A of Volume Two of this report.

d ***International comparisons***

A further dimension was added to the project by the inclusion of a study of the pension systems operating in certain other countries and any advantages or disadvantages associated with them. A comparison could then be drawn between the systems studied and the structure of pension provision in the United Kingdom. The International Research Unit of the Inquiry Team carried out structured interviews with academics, consumer groups, government departments, regulators and industry representatives in Denmark, Netherlands, the Republic of Ireland and the United States. They also carried out studies of the pension systems operating in Australia, Canada, Chile and Singapore. The results of these international comparisons are contained in Chapter 5 and Appendix D of volume two of this report.

e ***Commissioned research from academics***

The Office also commissioned research from academics which resulted in the *Portability* and *Preservation of Pension Rights in the United Kingdom* and *Passive Fund Management*. David Blake and Michael Orszag of The Pensions Institute of

Birkbeck College, University of London were selected to conduct the first study. Paul Klumpes of the Department of Accounting and Finance at Lancaster University carried out the second. The results of this research are contained in Appendices E and F respectively of volume three of this report.

1.4 Structure of the report

This report is published in three volumes, the first setting out the main investigation, conclusions and recommendations, the second and third the results of our own and external research.

Volume One opens with a review of the history of pensions in the United Kingdom, and goes on to examine the background to the current market and industry structure. We then look at the issues in today's labour market that affect retirement provision, and examine the apparent shift in occupational pensions from defined benefit (DB) schemes to defined contribution (DC) schemes. Recent years have seen significant growth in the market for personal pension products, and we have examined various issues relating to the design, marketing and tax treatment of personal pensions. Having examined (in Chapter 4) the problems identified with various types of pension, the report next sets out our proposals for a flexible, portable Designated Personal Pension (DPP). Before finishing with a summary of conclusions and recommendations, it presents a survey of pension systems in other countries, and offers a comparative analysis of these systems in relation to those operating in the United Kingdom.

Volume two contains the results of the consumer survey, an analysis of the interviews carried out by the inquiry team and the results of our own research especially into international pensions systems.

Volume three contains the findings from the externally commissioned research.

Chapter 2: HISTORY

2.1 Introduction

201 In the early years of this century the majority of those who became too old and infirm to work were dependent on charity or the Poor Law. Comparatively few survived to an age when a pension might have been collected. In 1901, life expectancy at birth was 51 years for men and 58 years for women. By 1991, these figures had increased to 71 and 77 respectively. Of greater relevance to pensions is the expectation of life on first joining the workforce and at the approach to retirement. In 1901, at age 15, life expectancy for men and women was 46 and 48 years respectively so, on average, those just starting work were unlikely to survive to retirement. By 1991, life expectancy at age 15 had improved to 59 and 65 years respectively, so for someone joining the workforce planning for retirement had taken on a new relevance. Nearer to retirement age, in 1901 at age 55 years life expectation was 16 years for men and 18 years for women . By 1991 life expectation had improved to 22 and 26 years respectively (Charlton, 1997, Volume 1, Table 3)

202 Over this same period, there has also been a strong downward trend in fertility rates in the United Kingdom and in most OECD countries. The indicator of fertility levels is the total period fertility rate¹. Some fluctuations in this indicator could result from changes in the timing of fertility choices. However, with a strong downward trend, this indicates that childbearing has shifted to later years *but also* corresponds to decreases in the average family size for successive generations of women.

2.2 Beginnings of state intervention

203 In 1908, Lloyd George introduced a non-contributory state old age pension of up to five shillings (25 pence) per week for those over 70 years of age and with an income of not more than eight shillings (40 pence) per week. The National Insurance Act 1911

¹ Derived as the sum of individual age-specific fertility rates in year in question.

introduced a compulsory insurance scheme for those in certain heavy manual trades such as building and engineering. Participants in these schemes were also protected against the financial consequences of sickness, disability and unemployment.

2.3 The Beveridge Report and the blueprint for the welfare state

204 The Beveridge Report of December 1942 proposed a wide-ranging reform of health services and social security. One of its main recommendations was that a basic state pension should be paid on retirement. It was to be claimed at any time after the minimum retirement ages of 65 for men and 60 for women and at a rate which increased above the basic rate if retirement was postponed. Widows' pensions were also brought into the new system. These pension benefits would not be means tested and would be available universally.

205 However, the value of the basic state pension was not subject to regular review and was eroded through inflation. It was supplemented by means-tested benefits so that by 1974 two million pensioners were drawing supplementary benefits (Castle and Townsend, 1996). At this time, about half of the workforce was covered by occupational pensions, but only 30% of women workers.

206 In 1975 the government made two main changes:

- a First, it raised the value of the basic state pension, by the largest amount since Beveridge, and to ensure that the value was maintained in future it introduced indexation to the higher of the increase of earnings or consumer prices².
- b Second, in order to provide an addition to the basic state pension for those not in occupational schemes, a second-tier earnings-related pension was introduced. The

² Introduced by the National Insurance Act 1974.

*State Earnings Related Pension Scheme (SERPS)*³ guaranteed contributors to the scheme an additional pension of 25% of their earnings between lower and upper earnings limits. It was compulsory: employers and contributors could contract out of SERPS only into a salary-related occupational scheme if it offered benefits at least equal to those provided by SERPS. Each year's earnings in the best 20 years counted towards the pension at a rate of 1.25% of earnings between lower and upper limits. Earnings limits were revalued in line with average earnings. Once payments commenced, the additional pension was uprated annually in line with consumer prices. The cost of uprating the basic pension and SERPS was met by the National Insurance Fund.

- 207 Pensions under SERPS matured in 20 years and, as a result of the *20 best earning years* formula, were especially advantageous to some groups: manual workers, previously disadvantaged because their earnings tended to peak in their middle years and who therefore received less through final salary schemes, or women whose careers had been interrupted due to family responsibilities and who often found it difficult to return to a well paid job after a lapse of some years.
- 208 Women also benefited from the introduction of *home responsibility protection*. Time spent out of the workforce caring for dependants was to be counted towards qualifying years for basic pension, though not for SERPS.

2.4 Changes initiated 1979—1997

- 209 By 1979 there was increasing concern that the cost of the state pension would lead to an unsustainable level of National Insurance contributions due to increasing life expectancy and decreasing fertility rates. To ease that burden, the Social Security Act 1980 broke the earnings link for annual uprating of the basic state pension and linked it instead to the Consumer Price Index. The result was that as real earnings increased, the state pension replaced an ever-reducing proportion of average earnings. In 1977, the basic state

³ Introduced by the Social Security Pensions Act 1975, with most of the provisions coming into force in April 1978.

pension replaced about 20% of average male earnings on retirement. By 1994 this proportion had fallen to 15%. If earnings continue to increase by 1.5% per year in real terms⁴, by 2030 the basic pension is projected to replace only 9% of average earnings.

- 210 More far reaching changes were made in the Social Security Act 1986 which provided that from 1999 onwards, SERPS additions to the basic state pension would be calculated not on the basis of the *best 20 years* rule but instead on lifetime average earnings. The additional component would also be gradually reduced from 25% of pensionable earnings to 20% for those retiring after 2008/9.
- 211 Other measures were designed to extend private sector pension schemes to employees not covered by occupational pensions and to make pensions provision more flexible.
- 212 To encourage private provision, the tax advantages of personal pension plans, previously available to those in non-pensionable employment, that is mainly the self-employed (known as section 226 plans), were extended to all employees to provide:
- a private sector pension for employees not covered by occupational schemes;
 - b a means for those not in occupational pension schemes to opt out of SERPS; and
 - c a portable pension for those who were disadvantaged by the inflexibility of occupational schemes.
- 213 Personal pensions enjoyed broadly the same tax advantages as occupational pensions, as a means of encouraging saving for retirement. Contributions by the employee or the self-employed were subject to tax relief and the funds in which these contributions were invested were exempted from tax on capital gains. Apart from a tax-free lump sum

⁴ Which is a modest estimate relative to past trends.

payable on retirement, pensioners paid tax on the pension benefit when it was received. To prevent abuse, all of these tax reliefs were subject to limits, on the levels of contributions or the extent of the pension benefits which could be paid. In addition to insurance companies, unit trusts, banks and building societies were able to provide personal pensions.

- 214 As a further aid to flexibility, employers were no longer able to make membership of an occupational scheme compulsory. For those leaving an occupational scheme before the normal retirement age, a number of improvements were introduced. Previously any accrued pension rights in a deferred pension tended not to be indexed and were thus seriously eroded by inflation by the time they came to be paid. Now they were to be indexed to the Consumer Price Index (CPI) up to a maximum of 5%, termed Limited Price Indexation (LPI)⁵. Anyone leaving an occupational scheme was to have a right to a transfer to another occupational scheme (at the receiving scheme's discretion), to transfer to a personal pension plan or to purchase a single premium annuity. To encourage a high level of contracting-out of SERPS, the rebate of National Insurance contributions was increased by 2% for a five-year period for members of all schemes contracting out for the first time.
- 215 Contracted-out occupational schemes could be of the money purchase type, the minimum contribution being the contracted-out rebate itself.
- 216 Many members of occupational schemes lacked entitlement to a full pension. New provisions enabled scheme members to increase their pension entitlement, either through *additional voluntary contributions* (AVCs) where the plan was arranged by the pension scheme⁶ or through *free standing additional voluntary contributions* (FSAVCs) where the employee was able to select a plan from any provider. The amount of any of these additional contributions was limited by an annual ceiling on *total* employee contributions set at 15% of pensionable pay.

⁵ Introduced by the Social Security Act 1990.

⁶ First time AVCs have to be provided by pension schemes on request from their members.

217 The take up of *Approved Personal Pensions* was more rapid than expected. Between their introduction in 1988 and April 1993, the number of employees with personal pensions (including those approved for the purposes of opting out of SERPS) reached 5.7 million.

218 Unfortunately many of these early sales of personal pensions were made with insufficient safeguards for consumers, many of whom were unlikely to benefit from them. For example, those who opted out of an occupational scheme lost their employer's continuing contributions. Another group affected were those who had insufficient time before retirement for their contributions to build up to buy a viable annuity. Many might also have been better advised to join or remain a member of an occupational scheme. At the time of writing, some 570,000 pension plans were the subject of an on going investigation on the grounds that they had been missold. Just 50,000 cases had been reviewed and about 12,000 offers of compensation accepted.

219 The inadequacy of the law surrounding occupational pensions was demonstrated by events, such as the Maxwell scandal, which led to the setting up of the Pensions Law Review Committee (PLRC) chaired by Professor Roy Goode (see Goode, 1993).

2.5 Pensions Act 1995

220 The Pensions Act 1995 stemmed mainly from the recommendations of the PLRC. The Act (most of which came into effect from April 1997) aimed to improve the security of occupational pensions. It clarified the respective roles of trustees, employers, members and professional advisers and established the Occupational Pensions Regulatory Authority to oversee the new requirements. Scheme administrators are given enforceable deadlines within which transfer values must be quoted. Guidance Notes⁷ on their calculation have since been revised.

221 The Act also makes further changes to the state basic pension and to SERPS. Retirement age for the state pension will be equalised by a phased increase of the women's retirement

⁷ Published by the Institute and Faculty of Actuaries (for example, 1997a)

age to 65⁸. For SERPS, age-related rebates may make it worthwhile for older employees to contract out. The system of *annualisation*, the basis by which earnings are revalued, has been subject to a technical adjustment. The abolition of the Guaranteed Minimum Pension (GMP) means that the pension provided in place of SERPS will no longer be fully price indexed. Previously, pension schemes approved for opting out of SERPS were required to provide consumer price indexing of the GMP earned since April 1988 up to a maximum of 3 %, with any excess provided by SERPS.

222 For personal pensions, the contracted-out part of the pension was protected by LPI up to a maximum of 3%. The Act increased this LPI to 5%. For those rights that are not protected, the scheme does not have to offer any form of indexation.

2.6 Further changes proposed to pensions

223 Over the last year or so, further proposals have been made aimed at encouraging additional pension provision to supplement the basic state pension and SERPS.

224 The Retirement Income Inquiry (RII), chaired by Sir John Anson, recommended the establishment of an *Assured Pension* which was designed particularly to avoid reliance on income support by those who would otherwise have been dependent on the basic state pension (RII, 1996a). The RII had undertaken a very wide range of research and analytical work, which has been invaluable to this inquiry (see bibliography).

225 John MacGregor (1996) recommended the setting up of *Provision for Retirement Accounts* to replace TESSAs and PEPs to supplement existing pension provision.

226 The Welfare Reform Group (1996) made wide-ranging recommendations as to how the insurance industry might supplement or substitute for state benefits in pensions, health insurance, long-term care, legal expenses, death and incapacity insurance.

⁸ To be phased in over a 10-year period from 2010 to 2020.

- 227 The Labour Party (1997) proposed a stakeholder pension. This was to be aimed at those employees who did not have the opportunity to join an occupational pension. It was to enable significant reductions to be made in the costs of providing individuals with their own stake in a funded collective pension with the security that comes from an approved scheme.
- 228 During 1996, the government put forward in broad outline further possible changes to pensions. To improve flexibility, new regulations enabled an employee who joined an occupational scheme to transfer their existing personal pension fund into an FSAVC scheme and hence retain *personal* ownership of their pension savings in a single plan, separate from their new employer's occupational pension plan. Measures were also proposed to simplify the administration of group personal pensions (where an employer arranges a pension plan for his individual employees) with a view to reducing their administrative costs.
- 229 More radical was the proposed *Basic Pension Plus* (DSS, 1997). This was to apply only to those joining the work-force in the future, once legislation had been enacted. Essentially, the state basic pension and SERPS were to be replaced by a personal pension funded from a partial refund of National Insurance contributions, with a minimum pension equal to the existing basic state pension (indexed to consumer prices as now) guaranteed by the government. Existing home responsibility protection would be included. Means-tested benefits would remain for those with insufficient contributions. The tax treatment of these new pensions was to reverse the present arrangements — that is, contributions were to be made from taxed income but benefits paid tax free (similar to personal equity plans (PEPs)). Wide-ranging changes were proposed in how personal pensions would operate in order to remedy many of the existing problems which are outlined in Chapter 4 of this report.

2.7 Budget Statement on 2 July 1997

230 On 2 July 1997, the Chancellor of the Exchequer announced in his Budget Statement that, with immediate effect, tax credits paid to pension funds would be abolished.

Chapter 3: BACKGROUND AND TRENDS

3.1 Introduction

301 The idea of a pension is a very simple one — to redistribute income from a period of work to a period of retirement. This can be done in two ways. Existing workers can fund the retirement incomes of previous workers. This is termed the pay-as-you-go (PAYG) approach and involves transfers between generations. In the case of state pensions, the pension may be paid out of general taxation, for example Denmark or, as in the United Kingdom, from National Insurance contributions (NICs). Alternatively, contributions may be invested in a fund which in turn provides pensions as they become due. Pension schemes of this kind are referred to as *funded*.

302 Pension entitlements may be defined in terms of guaranteed benefits to be paid out or the overall value of the contributions made. The pension may be for the employee alone or may extend to dependants. Provision may be included during employment for life insurance or for early retirement on grounds of ill-health.

303 Defined benefit (DB) pensions may be based on a combination of years of service in a pension scheme and the level of earnings attained at or near retirement, over the whole period of employment or, say, the best 10 years. In a funded scheme⁹, contributions by the employer, employee or both will be set at levels deemed necessary to fund the defined level of benefit and to cover expenses. The pension when due is paid by the fund.

304 Defined contribution (DC) pensions are determined by returns received on the invested contributions. Contribution levels may be set initially so as to achieve a desired pension after allowing for the expected investment return and for charges. Contributions may be defined in relation to a percentage of salary for occupational schemes, a fixed amount per

⁹ In the United Kingdom SERPS is paid on a PAYG basis but, unlike some countries in the rest of Europe, all private sector United Kingdom occupational schemes are funded.

month (changed from time to time) or a single premium payable from time to time. The accumulated sum is used at retirement to provide a tax-free lump sum and to purchase an annuity which will provide a regular income for the contributor or dependants.

3.2 Levels of pension contributions

305 This section outlines the level of contributions by employees and employers via NICs to the basic state pension and SERPS (DB); and via contributory payments to DB and DC occupational schemes; and finally directly to personal pensions (also DC).

306 Contributions to any type of pension scheme are a form of savings. For DC schemes, these contributions will be invested direct to provide at retirement a sum of money with which an annuity can be bought, to provide in turn a guaranteed income stream until death, or death of surviving dependants. For DB schemes, members are provided with a certain level of pension benefits, conditional on their length of service and some measure of their earnings. For these schemes, contributions are usually made by employers (and often by employees), so this is indirectly a form of savings. Occupational and personal pensions are thus part of the wealth of the personal sector of the economy. In 1971, pensions and life insurance policies accounted for 15% of such wealth. Other significant sources were housing 26% and directly owned stocks, shares and unit trusts 23%. By 1994, pensions and life insurance policies accounted for 33% of the wealth, overtaking housing at 28% and stocks, shares and unit trusts at 10% (Mintel, 1997).

3.2.1 *National Insurance contributions (NICs)*

307 NICs are set annually in the Budget. The Lower Earnings Limit (LEL) and Upper Earnings Limit (UEL) for 1997/98 were set at £62 and £465 a week; these limits are adjusted annually in line with consumer prices. Employees (or employers) do not make any contributions if earnings are below the LEL. Employees pay contributions on earnings up to the UEL. Employers' contributions are payable on all earnings above the UEL as well as below it. The rates for 1997/98 are shown in Table 3.1.

Table 3.1: NATIONAL INSURANCE CONTRIBUTION RATES 1997—98

<i>Earnings per week</i>	<i>Employer</i>			<i>Employee</i>		
	<i>Contracted out COSR (%)</i>	<i>Contracted out COMP (%)</i>	<i>Not contracted out (%)</i>	<i>Initial (%)</i>	<i>Contracted out (%)</i>	<i>Not contracted out (%)</i>
LEL - £109.99	0	1.5	3	2	8.4	10
£110 - £154.99	2	3.5	5	2	8.4	10
£155 - £209.99	4	5.6	7	2	8.4	10
£210 - UEL	7	8.5	10	2	8.4	10

Notes: COSR: Contracted-Out Salary Related. COMP: Contracted-Out Money Purchase.

Source: Bacon and Woodrow (1997, p. 27)

308 The basic state pension is paid on the basis of the number of years in which contributions are made. In the case of a man, contributions are needed in 44 out of a possible 49 years for the full pension to be paid. For women, contributions are needed in 39 years out of 44. NICs are credited for those who are unemployed or receive certain Social Security benefits and for those who take time out of the labour force to care for children and the elderly. Those contracted into SERPS pay higher NICs. Those contracted out receive a rebate.

3.2.2 Occupational pension scheme contributions

309 Occupational DB schemes promise the member a certain level of benefits, conditional on the member's years of service and some measure of earnings. Contributions by the employer (and usually the member) are based on actuarial estimates, which means that usually the employer's contribution can vary from year to year according to the performance of the fund. NAPF (1997c) found that, for about 75% of pension schemes, the employer would bear the cost of any shortfall in contributions (or benefit from any surplus). In most of the remainder, costs (or benefits) would be shared with the employees. However, in DC schemes, members pay a certain level of contributions, with no explicit commitment for a certain level of pension benefits at retirement. The pension paid at retirement will depend on the level of contributions, the rate of return accrued on the fund and the costs involved in converting the final fund into an annuity. For such schemes, the investment risk is wholly borne by the member. An analysis of the proportion of total contributions paid by members of occupational schemes (DB and DC) as compared with their employers' contributions is provided in Table 3.2.

Table 3.2: PRIVATE SECTOR OCCUPATIONAL PENSIONS (DB AND DC): PERCENTAGE OF MEMBERS PAYING VARIOUS PROPORTIONS OF TOTAL CONTRIBUTIONS

<i>Proportion of contributions</i>	<i>Private sector</i>
n/a	2.9
nil	15.2
1—9	3.1
10—19	4.8
20—29	14.8
30—39	20.6
40—49	8.3
50—99	20.1
100	10.2
<i>All members</i>	<i>100</i>

Source: GAD (1994a, p. 39)

310 Just over one-third of members contribute between 20% and 39% of the total amount, although nearly one-third contribute more than 50%. Coverage of private sector occupational pension schemes is presented in Table 3.3. This shows that there were 5.6 million members of private sector occupational DB schemes and 0.9 million members of private sector occupational DC schemes.

Table 3.3: MEMBERSHIP IN PRIVATE SECTOR OCCUPATIONAL PENSION SCHEMES (MILLIONS)

<i>Type of scheme</i>	<i>Contracted-out</i>	<i>Not contracted-out</i>	<i>Total</i>
DB Scheme	5.04	0.56	5.6
DC Scheme	0.43	0.47	0.9
<i>Total</i>	<i>5.47</i>	<i>1.03</i>	<i>6.6</i>

Source: GAD (1994a, p. 40)

The most common member's contribution rate for contracted-out occupational DB schemes was between 5% and 7% of salary (representing just over 50% of all contracted-out private sector members) (GAD, 1994a, p.42). Nearly one sixth of all members of contracted-out private sector schemes made no contributions themselves (GAD, 1994a, p.42).

311 Employees' contributions are only part of the story. The NAPF 1995 Annual Survey (1996a) found that the average contribution by employers for contracted-out *non-contributory* schemes was 10.9%. For *contributory* schemes, NAPF found that employers contributed 7.1% and members' 4.6%, making a total contribution of 11.7%. A survey of small businesses by the Association of Consulting Actuaries (ACA, 1996) found that the average contribution to DB schemes was 11.1% by employers and by members 4.3%; making a total contribution of 15.4%.

312 The most common level of contribution for contracted-out occupational DC schemes was the employee's share of National Insurance contracted-out rebate. Further, about one-quarter of all members contribute less than 4% of salary. The ACA Survey (1996) found that the average contribution of smaller firms to DC schemes was 5.6% by employers; 2.6% from members, making a total contribution of 8.2% (compared to 15.4% for small DB schemes). Of course, as indicated by Table 3.3, a larger number of DC schemes are contracted-in, but even allowing for this there remains a real gap of some 5.6%.

313 The average monetary contribution rates to occupational DC schemes are shown in Table 3.4.

Table 3.4: AVERAGE CONTRIBUTION RATES TO OCCUPATIONAL DC SCHEMES IN 1995/96

	<i>DSS</i>	<i>Employee</i>	<i>Employer</i>	<i>Total</i>
£ per month	£12.96	£16.97	£9.88	£39.81

Source: Inland Revenue Statistics (1996) and OFT's own calculations.

314 As the ACA conclude:

Levels of pension contributions by companies are significantly lower in defined contribution arrangements compared to defined benefit schemes. There is a danger that the degree of funding in many defined contribution arrangements is likely to be insufficient to provide the levels of pensions needed or expected by tomorrow's pensioners (ACA, 1996, p. 22/23).

As noted above, one of the main causes of the differing level of pension contributions to DB and DC schemes is the employer's contribution falling, in most cases, to zero (also for personal pensions see Section 3.2.3 below).

3.2.3 Personal pensions contributions

315 Inland Revenue Statistics (1996a) show that overall, in 1995—96, there were 3.14 million rebate only personal pensions, and 1.55 million with the contracted-out rebate and employee contributions. Additionally, there were 3.56 million *other types*¹⁰ (including AVCs) and 850,000 FSAVCs.

316 In 1995/96, the DSS contributed £1.41 billion to rebate-only personal pensions, £755 million to contracted-out personal pensions (with employee only contributions) and £55 million to other schemes, which probably includes the self-employed contributing to individual schemes and employees making AVCs and FSAVCs. Employees contributed

¹⁰ Other schemes including those with contributions from the DSS and employers (but not employees) and schemes not approved for National Insurance Contribution rebates (which may receive contributions from individuals and/or employers).

£725 million to contracted-out personal pensions and £1.35 billion to other schemes.

Employers contributed £520 million to other schemes.

317 These contributions are better understood in terms of the average monetary contribution rates shown in table 3.5.

Table 3.5: AVERAGE CONTRIBUTION RATES TO PERSONAL PENSIONS IN 1995—96 (£ PER MONTH)

<i>Type of Scheme</i>	<i>DSS</i>	<i>Employee</i>	<i>Employer</i>	<i>Total</i>
Rebate Only	£37.42	—	—	£37.42
DSS and Employee	£40.59	£38.98	—	£79.57
Other	£64.71	£31.60	£9.83	£106.14

Source: Inland Revenue Statistics (1996) and OFT's own calculations.

This shows the relatively low value of contributions for rebate-only pension schemes, compared to those where the employee makes a contribution. Also, contributions to personal pensions have to be seen in the light of the charges which are levied — see Chapter 4.

3.3 Market structure

318 The penetration of pension scheme membership in the United Kingdom is set out in Table 3.6. Overall, some 73% of employees were members of either an occupational or a personal pension scheme (see Chapter 5 for penetration of pension provision in the other countries studied).

Table 3.6: PENSION COVERAGE IN 1991

	<i>% of employees</i>
Contracted out DB occupational pension	42
SERPS plus DB occupational pension	3
Contracted out DC occupational pension	2
SERPS plus DC occupational pension	2
Personal pension (all DC)	24
SERPS only	12
Below LEL (basic state pension only)	12
Married women's rate	3
<i>Total with an occupational pension</i>	49
Contracted out (of SERPS)	68
Contracted in (to SERPS)	17
<i>Total DB</i>	44
<i>Total DC</i>	28

Source: Dilnot et al., 1994 Table 2.3, p.24

319 In the remainder of the section we look at the suppliers of pensions, both occupational and personal.

3.3.1 Pension Funds

320 In their 1995 Annual Survey (NAPF, 1996a), the NAPF covered some 880 separate schemes with funds under management of £370 billion (excluding insured schemes)¹¹. Contributions income of the funds surveyed was £9 billion and investment income nearly £12 billion. Benefits of £14 billion were paid out on pensions, one-seventh to dependants, the remainder to former employees. The average fund size was just under £500 million and 70% of funds were in the range £10 to 500 million. The average

¹¹ The DSS estimate that at the end of 1995, the market value of the financial assets of self-administered and insured funded occupational schemes — including funded public sector occupational schemes, but excluding personal pensions — amounted to around £570 billion.

scheme was provided by an employer with 8,630 employees of whom 5,600 were scheme members; 5,600 were pensioners and 3,400 deferred pensioners.

3.3.2 *Pension business of life companies*

- 321 In 1995, premium income from the pension business of life insurance companies came from administering pension funds (£5.7bn), from personal pension plans (£5.5bn) and from FSAVCs (£0.6bn) (ABI, 1996).
- 322 The market in personal pensions and indeed in other life products has not been buoyant for the past few years. Having peaked in 1993, penetration of personal pensions has fallen back, although the average expenditure per household on personal pensions has seen a further increase. The numbers of policies in force and the total premium income reflect a combination of new business and the lapsing of existing policies. Between 1991 and 1995, the number of new annual premium and single premium policies declined substantially, by 50% and 70% respectively. New premium *incomes* have held up rather better.
- 323 Market share information has been collated by Merryll Lynch (Mintel, 1996b) in respect of all personal pension plans sold since 1988. Of the commercial insurers, Prudential had 10% of the new personal pension plans sold, Legal and General and BAT (Allied Dunbar and Eagle Star) 5% each. Of the mutuals, Standard Life and Equitable Life had shares similar to the Prudential. Overall, around 80% of sales were made by 10 companies. A number of smaller providers have left the market and further consolidation is expected by industry commentators (Bacon & Woodrow, 1996b).

3.3.3 *New Entry*

324 Since 1988 the personal pensions market has been open to unit and investment trust groups selling in their own right, rather than as fund managers for life offices. Experience in the marketing and administration of PEPs has provided a springboard. A strong brand name appears to facilitate entry. The entry of Marks & Spencer and Virgin into this market suggests that the brand does not need to be associated primarily with financial services.

3.3.4 *Sources of personal pensions business*

325 For single premium policies, the majority were bought through outlets offering independent advice, that is able to advise on a range of competing products. In contrast, the majority of annual premium policies were bought through company agents or representatives able to advise on products from only one provider (Mintel, 1997).

3.4 Demographic trends

326 World-wide, people are living longer, life expectation is increasing, birth rates are falling and the proportion of the elderly in the population is increasing. In many countries, where state pensions are provided on a PAYG basis, it is this burden relative to public expenditure and to GDP which has become a cause for concern. Similar considerations apply to other services for the elderly outside the scope of this report, notably primary health care and long term-care.

327 In OECD countries the proportion of the population over 65 is projected to increase from 13% in 1990 to 23% by 2030 (OECD, 1996a, Table A2, p.101). The rate at which the population is ageing varies considerably from country to country. Comparable figures are: for the United Kingdom from 16% to 23%, for the

Netherlands from 13% to 26% and for Japan from 12% to 26% for the same years. In Chapter 5 and Appendix D we examine a number of countries in greater depth.

- 328 More important than age is the ratio of those in work to those drawing pensions. In practice the working life is becoming shorter as increasing numbers are joining the workforce later after longer periods of education and leaving the workforce earlier, before the normal retirement age. Projections of the *contribution ratio* of those in the *active* labour force (the contributors) to those in receipt of pensions made by the government actuary indicate a fall from 2.1 in 2000 to 1.6 by 2030 (RII, 1996a).
- 329 The impact of ageing on the costs of the United Kingdom basic state pension and of SERPS is projected as being less severe than for a number of other OECD countries. One reason is the growth of benefits in line with consumer prices, as opposed to wages or earnings. Further, the retirement age for women for the basic state pension will be increased from 60 to 65 and be phased in over a 10-year period from 2010. Another reason is the substantial level of private funding of the second tier pension already in place through the process of contracting out.

3.5. Present and projected sources of retirement income

- 330 In 1994 less than half (44%) of retirement income was made up of the state basic pension, paid at a level equivalent to 15% of the average wage. By 2025, these proportions are projected to have declined further to just over a quarter (28%) and 9% respectively. In the remainder of this section we will examine the detail of these projections using output from the Department of Social Security's PENSIM model (Curry, 1996 and RII, 1996a). This takes account of other sources of retirement income, such as investments and earnings from continued employment.
- 331 The PENSIM model estimates pensioner incomes using data from the *Survey of Retirement and Retirement Plans*, conducted by the Office of Population Censuses and Surveys (DSS, 1992), the *Family Expenditure Survey* (CSO, 1988) and the *Social*

Change and Economic Life Initiative, conducted by the Economic and Social Research Council (Gallie, 1991). The results from the simulations carried out on the PENSIM model forecast pensioner incomes from the present day (1994) up to the year 2025. The base line model assumes a real earnings growth averaging 1.5% per year and a real rate of return on investments of 3.5% per year. The main changes introduced by the Pensions Act 1995 — State pension age equalisation and the breaking of the link between the guaranteed minimum pension and SERPS — were incorporated into the model.

- 332 The PENSIM results suggest that the mean income of all pensioners will be much higher (75% for single pensioners) in 2025 than in 1994. However, the gap between those pensioners in the lowest quintile and the highest will increase by a significant margin — only those in the highest quintile will see their income increase by more than average earnings. For those in the lowest quintile, mean income for single pensioners will increase by little over 10% by 2025; for those in the highest, mean income will double.
- 333 For the average single pensioner in 1994 and again in 2025, gross income per week can be broken down as follows.

Table 3.7 AVERAGE SINGLE PENSIONER'S GROSS INCOME PER WEEK FOR 1994 AND 2025

<i>Component of Gross Income</i>	<i>1994</i>		<i>2025</i>	
	<i>(%)</i>	<i>£/wk</i>	<i>(%)</i>	<i>£/wk</i>
Basic state pension	44	46.4	28	50
SERPS	4	4.1	16	29.7
Occupational pension	17	18.2	18	33
Personal pension	0	0.4	11	20.3
Investments/earnings	16	17	24	42.5
Income support/housing benefit	16	16.4	2	4.5
Other	2	1.9	0	0.8
TOTAL	100	104.4	100	180.8

Source: Curry (1996)

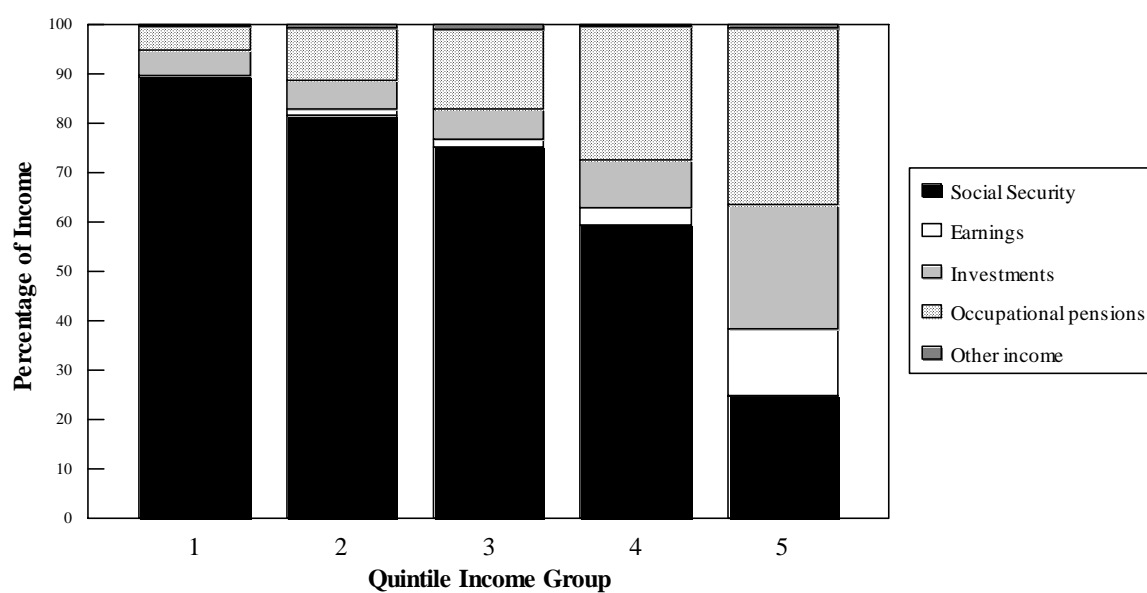
334 The real increase in the average income from the basic state pension arises from consumers having built up a longer record of contributions so that more (women) will be drawing a full pension. Income derived from personal pensions and SERPS is projected to grow substantially in both relative and real terms, from a very low base in 1994, with a decreased reliance on the basic state pension and income-related benefits. However, for the lowest quintile of single pensioners, the basic state pension will still comprise a significant proportion of gross retirement income (57% in 2025, down from 63% in 1994). For the highest quintile of single pensioners there will be further decreased reliance on this (12% in 2025, down from 26%).

335 Like any simulation, these results are dependent on the initial data inputs and the detailed assumptions made to project them. The PENSIM model report (Curry, 1996) refers to a number of shortcomings with the 1988 survey and makes proposals for improving the data on retirement plans using a variety of other sources. Projections of retirement incomes will depend on a number of factors which we will consider later in our report, including how occupational pensions accommodate job changes and the take up and performance of personal pensions. At the time of the 1988 survey, a considerable number

of changes were taking place and these are likely to have affected retirement plans and future pension levels.

336 The differing sources of pensioner incomes according to income levels can be seen in Figure 3.1 reproduced from analyses undertaken for the *Retirement Income Inquiry* (RII, 1996a), based on the *Family Expenditure Survey* (ONS, 1996b). The retired population has been allocated to five income groups or *quintiles*. In these figures *social security* embraces all payments from the state: the basic state pension, SERPS and means-tested benefits. As thus defined, *social security* accounted for over half of or all pensioner incomes and was the majority source of income in all but the top 20% of pensioner incomes.

Figure 3.1: Pensioners Income by Source and Income Group 1994/95



Source: ONS (1996b)

3.6 Working patterns

- 337 Using data from the 1988 retirement survey on incomes, previous employment and pension scheme histories, RII went on to examine in some detail the factors behind these income sources. In this analysis, the results were presented for five bands of retirement income, each covering 20% of incomes.
- 338 On average, *males* in the top band of retirement income had a longer period in employment, a shorter period not working and a shorter period in self-employment than the lowest quintile. Moreover, more of the period not working was spent in education. Those in the central band had worked longer than either of these extreme groups and spent the least time self-employed. On average *males* held eight jobs (seven for those in the top band of retirement income). The average duration of job was between 80 and 90 months, depending on the income band.
- 339 For *females* the average number of jobs varied across the income bands from 5.0 to 5.9. The average job duration varied between 58 and 69 months. Those in the top income band had worked for the longest period over the life cycle, held more jobs, for a longer period in each case, and were more likely to be self-employed than those with lower retirement incomes.
- 340 Males in the highest retirement income band had on average belonged to 3.6 occupational pension schemes and were receiving payments from 1.2 of these. By contrast, males in the lowest band had belonged to only 0.9 schemes on average and were collecting a pension from 0.1. Those in the central band belonged on average to only 1.6 schemes but were collecting pensions from 1.0. Females across all retirement income bands had joined fewer pension schemes than men, 1.6 in the highest band, 0.5 in the central and 0.2 in the lowest. Except in the highest income band, women were receiving a pension from a lower proportion of the schemes they had joined than men.

- 341 Job changes are not confined to movement between different final salary occupational pension schemes. Employees may move to jobs which are not covered by occupational schemes and may elect to take out a personal pension or to rely on SERPS. Further, employees may become self-employed. Conversely, those with existing personal pensions (employed or self-employed) may move into jobs where membership of an occupational scheme is an option. In such instances, electing not to join an occupational scheme would generally result in the loss of the benefit of the employer's contribution and in the loss of scheme benefits additional to the retirement pension.
- 342 Any consideration of pensions, both at the policy level and as regards the choices individuals make, must recognise that switching between types of pension scheme takes place. The extent to which personal pension products are sufficiently adapted to actual labour market conditions is considered in Chapter 4. Pension entitlement is also affected by part-time working and by time spent outside the workforce. These and other factors which particularly affect women are considered in more detail in Chapter 4.
- 343 There is a popular perception that employment is becoming less secure and that the rate at which job changes take place has increased since the 1980s. Evidence on this is inconclusive. The thirteenth report of the *British Social Attitudes Survey* (BSAS, 1996) shows trends measured from 1983 to 1995. Over the decade to 1995, there has been an increase in the proportion of part-time employment from 16% to 20% and in self-employment from 12% to 17%. In both of these categories the likelihood of belonging to a pension scheme and building up a pension entitlement is reduced. Attitudes to employment have changed little over the period covered by this survey though there have been some year-to-year changes largely in response to cyclical factors. Although an increasing number consider that inequalities in income have become *too large*, the number who also consider that their own incomes were *reasonable* has changed little. However, expectations regarding pay increases have been depressed, with increasing numbers not expecting any increase in pay in the coming year if they remained in the same job.

3.7 Shift from DB to DC money purchase schemes

344 Until the 1986 Social Security Act, occupational pension schemes contracted out of SERPS had to be of the DB (or salary-related) type. By 1991, of the 10.7 million employees covered by occupational schemes¹², some 900,000 were covered by DC schemes (GAD, 1994a, p.40). Further data on coverage found that over 90% of DC schemes were established after 1978 (DSS, 1994b). In their 1996 Annual Survey, the NAPF (1997b) observed that there had been a small increase in DC schemes reported in their survey, especially for smaller companies.

345 From the employer's viewpoint DC schemes have tended to enjoy a cost advantage over DB schemes, (especially for smaller schemes) although for large employers there is little cost advantage for DC schemes over DB ones. Evidence from the United States tends to confirm this, notably for those with more than 10,000 scheme members (Hay Group, 1996). However, in most DB schemes the risk of poor investment returns, along with the costs of fund management, falls on the employer. A survey of employers showed a marked preference for DC when setting up a new scheme (CBI, 1994). Other factors favouring DC schemes are the increasing number of small firms and a move towards short or fixed-term contracts, which are unsuited to DB schemes. Moreover, some employers may feel less need for the incentives for the recruitment and retention of staff inherent in DB schemes. Changes now being implemented following the Pensions Act 1995 are likely to tilt the balance further in favour of DC schemes: these include the more onerous duties of trustees, the increased requirement to take professional advice and the new minimum funding requirement (DSS, 1996d).

¹² Private and public sector.

3.8 Tax treatment

346 It is possible to tax any or all of three elements of a funded pension:

- a contributions by employers and employees to the fund;
- b investment income accruing on the fund; and
- c pension benefits paid to retired members.

In the United Kingdom, tax relief is given on qualifying contributions. Following the Budget Statement on 2 July, investment income accruing on the fund is taxed at the lower rate for Income Tax, currently 20%. Taxation of the pension when paid is as earned income (a proportion may be taken as a tax-free lump sum).

347 Chapter 5, Table 5.1 shows that countries such as Canada, the Netherlands, the Republic of Ireland and the United States have similar tax treatment of personal pension plans. Australia taxes all three elements, Denmark levies taxes on the pension fund and pension benefits paid, while Singapore does not tax at any of the three points.

348 This raises the question of the rationale for having tax incentives for pension schemes. There are probably three main reasons. First, the tax system might otherwise penalise savings and encourage immediate consumption. Thus tax relief for savers offsets this penalty. Second, to overcome short-sightedness, tax incentives should help individuals to overcome what appears to be inadequate planning for retirement. Finally, high savings, brought about by greater pension savings, may lead to higher investment and thus may boost economic growth. However, other methods of boosting pension savings may be used with this reason in mind (for example, compulsion, see Chapter 5).

349 In the United Kingdom, controls on tax relief on contributions differ between the different types of pension schemes. It is an essential principle that an individual cannot claim relief on both a personal and an occupational pension.

3.8.1 *Occupational DB final salary schemes*

The main limit on occupational DB schemes is the ultimate size of the pension benefit (a maximum of two-thirds of final pay). If part of the benefit is taken as a tax-free lump sum, this is also subject to limits (a maximum of 1.5 times final annual pay, subject to a maximum monetary ceiling). There is no fixed limit to an employer's contributions, but employee contributions cannot exceed 15% of salary each year, subject to a monetary pay ceiling (£84,000 pa for 1997—98).

3.8.2 *Occupational DC money purchase schemes*

Total contributions from both the employer and employee must not exceed 17.5% of employee's earnings, subject to the above monetary ceiling, with the employee's contributions not exceeding 15%. There is no limit on total benefits, although the tax-free lump sum is subject to limits (25% of the total fund excluding the value of protected rights).

3.8.3 *Personal pensions*

Again, there is no limit on total benefits, although the tax-free lump sum is subject to limits (25% of the total fund excluding the value of protected rights). However, total contributions cannot exceed a fixed percentage of employee's earnings in any year, rising from 17.5% at age under 35 to 40% at age over 60.

3.9 Other sources of retirement income

350 In section 3.5 we identified sources of income which top up formal pensions. It is convenient to divide such sources into two main types, asset-based and income-based.

3.9.1 *Asset-based sources*

351 These are savings and investment sources available to individuals throughout their working lives. Some sources, like Personal Equity Plans (PEPs) and Tax Exempt Special Savings Accounts (TESSAs), are subject to favourable tax treatments — others are not. Like building up a pension, the main constraint for many individuals is having sufficient income from which to contribute or save. PEPs are available for investors up to a maximum of £6,000 per year and on an additional individual company basis (£3,000 per year maximum) with no limit on the overall holding. TESSAs can be built up to a total of only £9,000 over five years, on current limits.

352 Furthermore, many forms of National Savings are available. A number of these embody tax concessions extending either to the standard rate of tax alone or to all forms of income and Capital Gains Tax. Life assurance enables a retirement fund to be built up through a form of indirect investment in company shares and other securities over a period, usually on an ongoing regular premium basis. It may also be possible to realise part of the equity in a house upon retirement, by moving to a smaller property or to one in a cheaper area.

353 A further source of retirement provision, either during the working life of the individual or after retirement, may come as a windfall capital sum. An inheritance is perhaps the most obvious of these but other examples include injury compensation payments and redundancy settlements.

354 One route often open to the self-employed is to sell their business at retirement, thus providing a ready-made retirement fund. Clearly this option is predicated on the value of

the business being maintained as the intended retirement date approaches and assumes that the business does not fail.

355 Some assets can readily be used to accumulate an income stream chiefly in the form of interest or dividends. Others need to be used to purchase an income-generating asset or an annuity with the retirement fund accrued. The advantage with the first course is clearly that the original assets are preserved (with or without their value being maintained intact against inflation) and are thus available for alternative uses, such as to purchase other investments or to leave in a will.

3.9.2 *Income-based sources*

356 Aside from the income generated by the asset-based approach described above, there are a number of ways in which retirement income can be further enhanced.

357 Part-time employment is open to some and, where formal employment is not available other retirees may resort to casual work.

358 Support may be available from the extended family — for example parents may live with their children. However, arrangements may be dependent on family size and the cohesiveness of the social structure. Projections of household size point to greater numbers of the elderly living alone (RII, 1996a).

359 Where formal state pensions are not forthcoming — usually through an inadequate National Insurance contribution record — then people beyond retirement age without other provision may resort to means-tested Social Security benefits. Although the level of benefits does not make it an attractive option for most people, it does provide limited protection against some of the risks inherent in pension provision.

Chapter 4: THE CONSUMER PROBLEMS WE IDENTIFIED

4.1 Introduction

401 One of the main reasons for a low level of income in retirement is a low level of income during the working life, a factor which is outside the scope of this report. Two other factors are: (1) the level of contributions and the period over which they are made; and (2) the value of the pension which those contributions generate. In this chapter we outline in four main sections the consumer problems we have identified.

4.2 Consumer problems inherent in Defined Benefit pensions

4.3 Consumer problems with Defined Contribution pensions

4.4 Complexity and inflexibility in pensions

4.5 Problems affecting particular groups in the community.

4.2 Consumer problems inherent in Defined Benefit pensions

402 DB occupational schemes provide a comprehensive range of benefits which for the most part meet the needs of consumers. In those occupations where they are offered take-up has generally been high. The latest NAPF survey (NAPF, 1997b and 1997c) indicates that, where an employer had a pension scheme, just less than two-thirds of employees were members. Usually, benefits are defined by reference to final salary and years of service. Our survey suggests that this element is reasonably well understood by scheme members. Often, the full pension entitlement is defined in terms of 40/60, that is, two-thirds of the employee's pensionable pay at the time of leaving the employment to which the scheme relates¹³. Definitions of *pensionable pay* vary considerably between schemes. Some schemes seek to top up the basic state pension and base contributions on pay above the lower earnings limit (termed *integrated* schemes) whereas others effectively ignore

¹³ The maximum permitted under Inland Revenue rules.

the existence of the basic state pension (termed *non-integrated* schemes). About one-quarter of private sector schemes surveyed by NAPF were reported as *integrated* (NAPF, 1997c; also UPS, 1996). It was beyond the scope of our survey to enquire into the definition of pensionable pay and how well it was understood but the possibility of confusion is evident.

403 In Chapter 3 we noted that there was a slow but steady increase in DC occupational schemes. The relative merits of DB and DC schemes, assuming comparable coverage in benefits, was considered at some length by the *Retirement Income Inquiry* (RII — Johnson *et al.*, 1996, Chapter 7). RII concluded that final salary schemes were incompatible with giving a risk free return to early leavers comparable to a DC plan. They found that about half the members of DB pension schemes would be better off in DC occupational schemes. RII went on to consider the possibility of defining benefits on the basis of a full revaluation of earnings. The rationale for such a move would be an insurance motive in that employees would obtain certainty of retirement income from a given level of lifetime contributions. On their part, employers would forfeit the ability to back-load pay and so penalise early leavers.¹⁴ Viewed from a consumer standpoint, it is not immediately obvious that DB schemes are, as is sometimes supposed, inherently superior to DC schemes, particularly when, as we will show in the next section, many of the problems with existing DC schemes are in fact capable of being addressed.

404 As we showed in Chapter 3, continuous employment in the same job is the exception. As few as 4.6% of men and 1.1% of women of the working population spend more than 30 years with the same employer (Burgess and Rees, 1994). At the time of the 1988 inquiry into retirement incomes and plans, a typical retired male worker reported having contributed to 3.6 schemes and was drawing a pension from just 1.2 schemes. Today that position would be considerably improved in that job changes which have taken place since 1988 should be on substantially better terms than hitherto. These changes were *not* retrospective so the legacy of poor or non-existent value from the membership of earlier pension schemes will remain for many years. Moreover, the rules which have operated

¹⁴ For a discussion of the rationale of back-loading, see Appendix E.

since 1988 still result in significant losses when employees leave a pension scheme. In the remainder of this section we report on some research work we commissioned to investigate the extent of this loss under present-day legislation.

4.2.1 *Transfer values*

405 David Blake and Michael Orszag of the Pensions Institute at Birkbeck College, University of London, were commissioned to look at *Portability and Preservation of Pension Rights in the United Kingdom*¹⁵.

406 A major concern was that early leavers from DB occupational pension schemes are disadvantaged in four ways:

- a Pension rights are based on final salary in each job, rather than at retirement. This may lead to lower benefits if there is real earnings growth over the life cycle.
- b Only the contracted-out elements of a scheme vest immediately. Otherwise, if employees leave a scheme during the vesting period, they will lose their pension rights. (This also applies to many occupational DC schemes.)
- c If preserved (deferred) rights are not indexed to real earnings growth or to the real return on securities, then early leavers will be penalised relative to the stayers.
- d Except where transfer clubs operate, there are penalties and variations associated with the calculation of transfer values to other pension schemes (including DC schemes), or welfare costs of remaining in a DB scheme when individual circumstances have changed. (Again, this also applies to many occupational DC schemes.)

¹⁵ See Appendix E, Volume 3 for the full report.

These were identified in Johnson *et al.*, 1996 and form the terms of reference for the report at Appendix E.

407 Successive legislation has improved DB transfer values. Prior to 1975, early leavers had no legal rights to transfer their accrued pension rights to a new scheme or to have a deferred pension from their old scheme. However, some schemes did provide a frozen, deferred pension. Thus, early leavers were penalised compared with the stayers. First, the pension rights accrued prior to the individual leaving the scheme did not benefit from subsequent career progression. This is due to real salaries at retirement being typically higher than real salaries earlier in the career, meaning that early leavers do not benefit from productivity growth. Second, the leaving salary was fixed in nominal terms, so that the real value fell with time, with an increase in retail prices. The effects on a frozen pension of different inflation rates between the leaving and retirement age are shown in Table 4.1.

Table 4.1 : EARLY LEAVER PENALTIES WITH A FROZEN PENSION

<i>Years to retirement</i>	<i>Inflation rate</i>	<i>% of full service pension</i>
40	5%	6.43%
30	5%	12.77%
20	5%	25.36%
10	5%	50.36%
40	6.74%	3.33%
30	6.74%	7.80%
20	6.74%	18.26%
10	6.74%	42.73%
40	10%	1.00%
30	10%	3.16%
20	10%	10.00%
10	10%	31.63%
40	13.67%	0.27%
30	13.67%	1.18%
20	13.67%	5.19%
10	13.67%	22.78%

Source: Appendix E, Table 3.1, p. 24

408 In 1975, the Social Security Act 1973 was implemented and required pensions to be vested after a period of five years for those over the age of 26, although deferred pensions were still not uprated. Guaranteed Minimum Pensions (GMPs) in contracted-out DB schemes, accounting for some 90% of membership and around 50% of total benefits accrued in DB schemes, have been fully protected against increases in national average earnings since 1978. Successive legislation in the Social Security Acts of 1985, 1986 and 1990 did further improve the position of early leavers' transfer values. Deferred pensions were uprated for consumer prices up to a maximum of 5% per year compounded from April 1978 for those leaving DB schemes after January 1991. The 1985 Act also allowed those leaving one scheme to transfer the value of their accrued pension rights to another scheme or to a particular type of insurance policy. Furthermore, the vesting period was reduced to two years by the Social Security Act of 1986. Table 4.2 shows the early leaver penalties at different wage growth and inflation rates.

Table 4.2 : EARLY LEAVER PENALTIES WITH LIMITED REVALUATION

<i>Years to retirement</i>	<i>Inflation</i>	<i>Real wage growth</i>	<i>% of full service pension</i>
40	6.74%	2.0%	23.47%
30	6.74%	2.0%	33.72%
20	6.74%	2.0%	48.44%
10	6.74%	2.0%	69.60%
40	4.0%	2.0%	45.29%
30	4.0%	2.0%	55.21%
20	4.0%	2.0%	67.30%
10	4.0%	2.0%	82.03%
40	4.0%	3.0%	30.66%
30	4.0%	3.0%	41.20%
20	4.0%	3.0%	55.37%
10	4.0%	3.0%	74.41%

Note: Applies only to benefits in excess of the Guaranteed Minimum Pension — GMP.

Source: Appendix E, 1997, Table 3.2, p. 26.

409 After the Pensions Act of 1995 came into effect on 6 April 1997, the cash equivalent had to be applied in one of the following ways:

- a as a refund of an early leaver's contributions if they have been a member of the scheme for less than two years;
- b used to provide a deferred pension (a short service benefit) at normal retirement age;
- c used to provide a transfer credit (for example, added years or a fixed benefit) to a new employer's occupational scheme that is willing to accept a transfer;
- d used to provide pension rights in a personal pension scheme;

e used to provide pension rights in an insurance policy or deferred annuity contract.

410 The legislation on transfer values and preservation of pension rights is implemented by the actuarial profession on the basis of Guidance Notes published by the Institute and Faculty of Actuaries. The ones relevant to transfer values are:

- a Guidance Note 11: Retirement Benefit Schemes — Transfer Values;
- b Guidance Note 16: Retirement Benefit Schemes — Bulk Transfers;
- c Guidance Note 26: Pension Fund Terminology;
- d Guidance Note 27: Retirement Benefit Schemes — Minimum Funding Requirement.

A new version of GN11 has been released to satisfy the requirements of the Pensions Act 1995. GN11 applies only to individual transfer values where a cash equivalent under the Pension Scheme Act 1993 applies and to the valuation of director's pensions in a company's annual report. The new version of GN11 now includes the treatment of the effects of the Minimum Funding Requirement¹⁶ (MFR) for contracted-out schemes and has more stringent rules and less discretion on the computation of Minimum Cash Equivalents (MCE) than other pension liabilities. The key principle for calculating transfer values is that they should be equal to the actuarial value of preserved benefits (Institute and Faculty of Actuaries, 1997a):

It is a fundamental requirement, stemming from legislation, that a cash equivalent should represent the actuarial value of the benefits which would otherwise have been preserved...

¹⁶ The requirement under the Pensions Act of 1995 that, if the value of scheme's assets is less than its liabilities, additional contributions must be paid by the employer to restore the funding level. The calculation of the assets and liabilities is determined by the scheme actuary on a prescribed basis. See also Regulation 7(3)(iv) of the Occupational Pensions Schemes (Transfer Values) Regulations 1996 (SI 1996 No.1847).

411 Appendix E quantifies the portability losses based on current legislation (that is, after 7 April 1997) and current actuarial guidance in the United Kingdom. Obviously these results are based on the particular set of assumptions. Two types of portability loss are identified:

- a **cash equivalent loss** where the worker switching jobs suffers a portability loss in the value of their accrued pension benefits because future real wage growth is disregarded;
- b **back-loading** loss in which the worker switching jobs may suffer additional portability loss because contributions are back-loaded in one scheme and not another.

412 The average worker in the United Kingdom changes job at least five times (Booth *et al.*, 1996), with the majority of these changes occurring early in the career. Only a small proportion will hold the same job at retirement as when they began pensionable service: 4.6% of men and 1.1% of women have more than 30 years' service in a single company (Burgess and Rees, 1994). The report considers the costs for changing jobs in a stylised world in which the MFR norms are satisfied. It isolates the impact of changing pension schemes and assumes that life-time earnings are the same. The results suggest that for someone changing from one defined benefit scheme to another:

- a where a worker changed job seven times, the final pension might be 71% of the full service pension;
- b where a worker changed five times, the final pension might be 75%;
- c where a worker changed just once in mid-career, the final pension might be 84%.

If a worker had switched, mid-career, into a personal pension scheme, the high charges of such schemes would have reduced the pension fund to either 61% or 37% of the full service pension, depending on whether the new employer contributed to the personal

pension. These results are based on the actuary's forecasts about price inflation and returns on investments being fully realised that is, identical pensions are obtained if pension rights are transferred or deferred.

- 413 How portability losses affect different types of United Kingdom workers is set out in Appendix E. Table 4.3 summarises these results:

Table 4.3 : SUMMARY OF PORTABILITY LOSSES (PERCENTAGE OF FULL SERVICE PENSION RECEIVED AT RETIREMENT)

<i>Worker</i>	<i>Type</i>	<i>Transfer value</i>	<i>Deferred pension</i>	<i>DC</i>	<i>Personal pension (employer contributes)</i>	<i>Personal pension</i>
MFR	A	75%	75%			
	B	71%	71%			
	C	84%	84%	71%	61%	37%
Average manual	A	75%	88%			
	B	71%	86%			
	C	84%	96%	78%	66%	45%
Average non-manual	A	75%	86%			
	B	71%	83%			
	C	84%	94%	79%	68%	44%
Mr high	A	75%	80%			
	B	71%	76%			
	C	84%	88%	74%	64%	40%
Ms high	A	75%	85%			
	B	71%	82%			
	C	84%	94%	79%	67%	44%
Mr low	A	75%	78%			
	B	71%	74%			
	C	84%	86%	73%	63%	39%

Job separation assumptions: A: separates at ages 28, 29, 30, 40 and 57. B: separates at 26, 27, 30, 31, 38, 44 and 55; C: separates at 45.

Source: Appendix E, Table 5.8, p. 74

A striking result is that, in the cases examined here, keeping deferred pensions rather than accepting transfer values appears to be better value for consumers but imposes costs on pension schemes in terms of administering deferred benefits.

414 Appendix E also reviews the discretion available to actuaries in making their calculations of cash equivalents. Elasticities of actuarial discretion were computed which measure the ratio of the percentage change in the computed pension to the percentage change in the actuarial assumption. At the MFR norms, the report found that small changes in the actuarial assumptions could have relatively large effects on the value of the pension in payment. The report found that the impact of changes in the discount rates, inflation rates, and wage growth rates depends on the time to retirement. The actuary also has discretion over a number of other areas, although these were not commented on in the report as the standard procedures used are not publicly available. The report accepts that individual circumstances can vary and recognises that either actuarial discretion or more complex rules (beyond the MFR assumptions) may be needed.

415 It is clear that for many employees, moving jobs continues to entail significant loss of occupational DB pension rights. Those who are moving to improve their salaries by more than the average increase in earnings allowed for in the analysis may offset some of this but the loss remains. Those who do not improve their salaries may be less fortunate.

416 The report also examines pensions portability in other countries: the eight countries analysed in Chapter 5 and Appendix D. For those countries that are predominantly DC such as Chile and Singapore, this is not an issue. However, for those countries which have DB schemes, the Netherlands offers the highest degree of pensions portability with the US the least. The United Kingdom comes somewhere between the two.

4.3 Consumer problems with Defined Contribution pensions

4.3.1 *Introduction*

417 In the course of this inquiry we have identified a range of problems facing consumers. These problems fall into a number of distinct groups:

- a the level and variability of investment returns;
- b the level and incidence of expenses;
- c the cost of purchasing the annuity;
- d the level of contributions that are sustainable, including the contribution that can be expected from employers in the current regulatory framework; and
- e continuity and rate of growth in earnings.

4.3.2 Investment risk

418 Risk as such is not a consumer detriment. It is a feature of efficient capital markets that risk is rewarded: the higher the risk, the higher the return.¹⁷ The consumer is therefore indifferent to risk provided the level is both:

- a appropriate, that is, understood and not excessive in relation to the worst outcome; and
- b optimal, in the sense that the highest possible return is achieved for a particular level of risk accepted.

419 Investment performance is often reviewed without reference to the risks involved. In its October 1996 survey of personal pensions, *Money Management* drew attention to the very wide range of investment performance of maturing contracts. Because personal pensions have been established only since 1988, most of this analysis was based on earlier s226 pension contracts. In the case of with-profits policies, open market option fund values for an investment of £200 per month over 20 years averaged £278,000 with a range of £203,000 to £367,000. Plans of shorter duration and for other types of

¹⁷ This applies, however, only to systematic or non-diversifiable risk. See Appendix C for details.

investment showed broadly similar variation. From the consumer view-point it is important to recall that, although the survey identified the best performing providers for policies maturing at that time, with a very few notable exceptions performance across successive surveys was not consistent (*Money Management*, 1997d). The result is therefore that consumers are unable to identify the best performers in advance. Selecting a fund is thus something of a lottery.

420 The existence of this wide range of differently performing products might suggest taking independent financial advice. However another article in *Money Management* (1997a), commenting on the very wide range of fund performance, questioned whether independent financial advisers were making product selections on bases which benefitted consumers. To realise *any* of the benefits of active fund management, the consumer or their adviser would have to be able to select *at the outset* the better performing funds and ensure that their performance was maintained over the life of the plan. However, as explained in Appendix F, there is little evidence that active fund management can deliver superior investment returns for the consumer.

421 The equity premium is the reward for accepting the systematic or market investment risk. Historically this premium has been around 5% in real terms. Other non-systematic or firm-specific risk can be diversified away by investing in a portfolio of shares and carries no reward. The so-called risk-free real rate of return, such as may be earned by investing in index-linked gilts, is no more than about 3.5%. Consumers therefore face a trade-off between almost complete certainty with an expected real return of only 3.5% and an increased exposure to equities with the prospect of bigger returns. Holding an investment for a number of years does, however, reduce the uncertainty in its average return and hence in the amount to which it will accumulate. There is an optimal risk profile for a consumer willing to accept a particular degree of investment risk with his pension. Much hangs on the extent to which consumers will be dependent on the value of the investment and their ability to accommodate variations in its projected value at retirement. Consumers may be asked about their attitude to risk when being sold a personal pension and will be advised according to their sensitivity to risk of the type of fund which best meets their needs. Many products now incorporate a switching of the

investor's funds from equities as the planned retirement date approaches, that is, age phasing, although such products do not currently optimise the trade-off between a lower risk and a higher return.

422 Where existing products do enable risk exposure to be modified, this is generally achieved by altering the constituents of the fund in which the consumer has invested or by switching their investment from one fund to another or into risk-free or low-risk investments. Switching between funds is, however, expensive and the extent to which it modifies risks may be uncertain. A move to low-risk investments as retirement approaches is generally undertaken in annual steps in the final ten years before retirement, but a more systematic approach over the entire period of the pension plan may, as argued in Appendix C, provide a better return for the same level of risk.

423 The marketing of most existing products focuses more on investment performance than on the level of expenses. While a consumer is required to make a decision based on two variables, level of expenses and prospective investment performance, the advice is frequently to concentrate on the latter on the grounds that it will have a far larger effect on the final pension. This is an unsatisfactory situation. Markets which require the consumer to make decisions on the basis of price alone tend to work better than markets where other, less objective product characteristics are important. In pensions, the level of expenses is the price of the product. Where quality differs in a market it is, of course, important that consumers take that into account but the characteristic on which the consumer is asked to rely here is, in our view, insubstantial and illusory. In Appendix F, the case for passive fund management and, in particular, the employment of tracker funds is set out. It is a strong one. There is little or no evidence that fund managers can deliver above average performance and every reason to believe that the average consumer would be better off with a passively managed fund. Further, this would enable the consumer to make a choice on the basis of an objective criterion: the level of expenses charged.

4.3.3 Charges

424 Charges reflect the costs of setting up and continuing to run a pension plan and cover:

- a commission to the salesman;
- b documentation;
- c fund management;
- d pension administration;
- e profit for the supplier.

There may, however, also be hidden costs for the consumer not reflected in the expenses charged. These include transactions costs and management fees within unitised investments such as audit fees, stockbroker commissions, market spreads, custody fees, trustee fees and stamp duty. Bacon & Woodrow (B&W) (1996b) estimate that these hidden charges might add 0.15% per year to the disclosed value of charges in the case of larger funds to as much as 0.5% for smaller funds.

425 B&W (1996b) found also a considerable divergence of charging structures, even within a restricted number of funds selected on the basis of investment performance, and emphasised the value of analysing charging *structures* as well as levels. This is a very important finding for anyone setting out to compare products. Charging information must be available in a form which makes it possible to take account of factors such as those listed above.

426 The *Money Management* survey (1996b) sought projections of future values of invested premiums based on standardised rates of growth. With the same premium of £200 per month, based on the provider's own charges over 25 years, the lowest (commission-free) charges reduced the projected value by only 8% while the highest charges reduced the projected value by no less than 29%.

427 Moreover, on top of these variations in pension fund performance and charges, consumers may be subject to varying performance by annuity providers. The

combination results in some very wide ranges in pensioners' ultimate retirement incomes.

428 The impact of charges was also examined in the *Money Management* survey (1996b).

Table 4.4: PERCENTAGE OF THE FUND VALUE REPRESENTED BY CHARGES

	<i>5 years</i>	<i>10 years</i>	<i>15 years</i>	<i>20 years</i>	<i>25 years</i>
£200/month					
Best commission free fund	4.1	5.0	6.0	6.9	8.0
Best commission loaded fund	5.6	7.7	9.2	10.8	12.6
Industry average	12.2	12.3	15.6	17.9	20.1
Worst fund	21.9	22.6	25.4	29.5	29.0
£10,000 single premium					
Best commission-free fund	4.5	8.6	11.8	14.2	16.2
Best commission-loaded fund	6.4	8.7	11.0	13.2	15.2
Industry average	10.3	13.8	17.0	19.7	22.6
Worst fund	17.4	18.5	23.1	27.8	32.2

Source: Money Management (1996b).

429 PIA, in their survey on the impact of disclosure (PIA, 1997a), asked providers to give estimates of the commission and remuneration levied over the first five years of a 25-year pension plan with a premium of £60 per month. The results are summarised in Table 4.5, according to the type of retail channel involved.

Table 4.5: 25-YEAR PERSONAL PENSION PLANS: COMMISSION OR REMUNERATION OVER THE FIRST 5 YEARS (£)

	<i>Unit linked</i>			<i>With profits</i>		
	<i>IFA</i>	<i>AR</i>	<i>CR</i>	<i>IFA</i>	<i>AR</i>	<i>CR</i>
Lowest	0	380	165	406	384	180

Average	502	688	675	526	688	697
Highest	578	1173	1329	572	877	1084

Source: PIA (1997a).

IFA — independent financial adviser; *AR* — appointed representative; *CR* — company representative.

Thus there is evidence of a wide variation in the level of charges. As, however, investment passively managed in a tracker PEP might cost only 0.5% per year in expenses, this suggests that even the cheapest funds are expensive.

Impact of charges on low contribution pension plans

430 Charges may bear particularly heavily on policies with lower levels of contributions. The structure of charges tends to reflect the underlying costs to suppliers of setting up and continuing to administer pensions contracts and reflects elements which do not vary with the amount invested. DSS estimate that in 1994—95 the median reckonable earnings for Approved Personal Pension plan members were £10,050 for males and £6,100 for females. These plans would be receiving as premiums only the employer's and employee's NI rebate for contracting out of SERPS. At the NI rates then applying, the contributions would be £450 and £200 per year respectively. It is noteworthy that for several recently introduced pension plans minimum contributions are £50 per month. A *Money Management* article (1997c) observes that charges would have a severe impact on the funds then invested (see Section 4.3.2). Whether it is worthwhile to opt out of SERPS into a rebate-only plan can depend critically on the level of contributions, the age at which contributions start and the performance of the fund in terms of both investment and charges. Contributions which may well have been difficult to sustain out of limited income may produce very little retirement income. Information on the level of contributions is set out in Chapter 3.

Impact of disclosure

431 The disclosure regime for charges introduced in January 1995 has had some effect in eliminating high charging products, though, as noted elsewhere in this chapter, a number

of products of doubtful value remain on the market. Disclosure has highlighted flat rate charges which contribute to the very poor returns on both low contribution products and on regular premium products where the contract lapses. In the section on product flexibility, below, we report the results of a SIB survey which indicated that the majority of providers who still had flat rate charges were either planning to eliminate them or were at least reviewing their impact.

- 432 PIA's report *Life Assurance Disclosure: Two Years On* (PIA, 1997a) relates the result of their own survey of suppliers alongside the results of successive *Money Management* surveys of personal pensions. PIA asked providers to give for a 25-year pension plan¹⁸ the reduction in yield due to charges of running to maturity and the effect of deductions for a plan over five years. The results showed little change from the previous year's figures. Average remuneration was lower for IFAs and covered a smaller range. Most providers have the same remuneration for all distribution channels, although there are a few which charge purchasers more for sales through ARs or CRs than through IFAs. While there are some notable exceptions, plans *not* sold through IFAs tended to have higher levels of remuneration than plans sold through all types of outlet, again reflecting the comparative lack of competitive pressure. If, as seems to be the case, consumers do not shop around, then they will have little basis for any comparison of charges between providers. PIA concludes, very tentatively, that competition may be sharpening up the market.

The absence of product flexibility

- 433 With a high probability of changing their employment over the period of a plan, most consumers may be required to suspend, vary or terminate the plan at some point before their retirement. Flexibility is therefore a key element in the suitability of any pension plan. Yet in their January 1997 review of personal pensions, the Consumers' Association identified a lack of flexibility as one of the key factors delineating products which they

¹⁸ 25-year plan for male non-smoker aged 40 contributing £65 per month.

considered to be poor value. *Which?* concluded that, taking into account high and front-loaded charges, many consumers would be better advised to consider a PEP rather than a personal pension plan. Another element inhibiting flexibility is the tax treatment of pension plans — see section 4.4.

434 PIA, in their survey of persistency of regular premium personal pensions taken out in 1993 and 1994, found that 16 % of pensions sold by company representatives were terminated after one year compared to only 8 % for those sold through IFAs. After two years the equivalent rates for 1993 were 28 and 16 % respectively. At the time of the PIA's survey, there were insufficient plans sold by direct advertising to give meaningful results, though in those markets where sufficient data existed persistency was found to be higher than for sales by company representatives but lower than for IFAs. For single premium policies, the numbers lapsing were found to be very much lower at between 1 and 2% after two years.

435 Disclosure requirements expressing charges as reductions in yield (RIY) relate only to plans running to term. Information on how charges may be affected if contributions are varied need not be provided. However, the consequences for RIY of discontinuing contributions can be extreme. Charterhouse IFA asked providers for fund value projections at age 60 for a male aged 26 who contributed £200 per month for just two years. The results ranged from £55,000 to under £6,000 (*Money Marketing*, 1996a).

436 Surveys of consumers who terminate any personal investment products early (not just pensions) commonly cite reasons triggered by one or more of the life cycle or labour market risks. **We must question whether, in view of the likely employment profiles of most of the working population, it is ever justified to sell a pension plan on the basis of continuous employment.** Kit Jebens, former chief executive of LAUTRO, has commented that

Unless investors are 80 — 90% certain that they will last the full term to retirement, they shouldn't be sold pensions on a regular premium basis. (*Money Management*, 1996a)

This judgment would presumably not apply to pensions plans with charges which were level (that is, without front loading), and without a fixed element. Moreover, relying on single premium policies runs a counter risk of not making regular contributions or of not maintaining or increasing the value of contributions, a problem faced by many self-employed contributors.

4.3.4 Annuities

437 For DC occupational schemes and personal pension plans, the accumulated fund at retirement must be used to purchase a pension annuity (although 25% of the pension fund can be taken as a tax-free lump sum). This is known as a compulsory purchase annuity. For DC occupational pension schemes this can be done by the trustees on the member's behalf. However, for other DC schemes, including personal pensions, this choice is left to the consumer.

438 Annuities are based on three principles:

- a the life expectancy of the annuitant¹⁹;
- b the current rate of return on the investments in the annuity fund; and
- c the company's expenses (or charges).

Annuities do have the advantage that they are secure, offer a guaranteed income and are relatively cheap to purchase.

439 Table 4.6 illustrates the three choices facing consumers and the possible permutations.

TABLE 4.6 : TYPES OF ANNUITY PENSIONS

¹⁹ Women tend to live longer than men so, for a given sum of money, a woman will receive a lower income than a man of the equivalent age.

<i>First choice: the duration or term of the annuity</i>	
Single-life annuity or immediate annuity	This ceases on death of the annuitant
Single-life annuity with minimum guarantee or temporary annuity ²⁰	These provide payments for a specific period (such as five or 10 years)
Joint-life annuity	This continues until the death of nominated beneficiary
<i>Second choice: The type of annuity²¹</i>	
Escalating annuity	This increases annually at a fixed rate and starts at a lower rate than level annuities
Unit-linked annuity	This either fluctuates in line with unit prices or is assumed to grow at a constant rate
With-profits annuity	This is based on an assumed annual bonus rate usually between 3.5% and 6.5%
Index-linked annuity	This increases each year in line with the retail price index
<i>Third choice: Frequency and timing of the annuity</i>	
Frequency	Monthly, quarterly, semi-annually, annually
Timing	Payment in advance, payment in arrears

Source: Blake (1995, pp.192—193)

This represents a substantial range of choices facing the consumer at retirement

440 Currently, consumers annuitising their pension fund savings can take advantage of any *open market option* to purchase an annuity from a source other than the pension provider insurer. There is sometimes a small penalty for this, although the benefits of changing the annuity provider are likely to offset this (*Pensions World*, 1997). Ensuring that consumers are free to shop around without incurring such a penalty would encourage them to search for the best annuity to suit their needs.

²⁰ A variant of this is the *Minimum Guarantee with Overlap Annuity*.

²¹ All these choices come with following variations: *Contingent Benefits, Minimum Guarantee and Capital Protection*.

- 441 Since the Finance Act 1995, consumers have also had the choice of when they purchase the annuity, thus removing some of the risk in the fluctuations of long-term interest rates. Within prescribed limits consumers also have the right to take retirement income from the pension fund (referred to as *income drawdown*) while deferring the actual purchase of an annuity. Income withdrawal is mainly of benefit to higher income consumers.
- 442 One element which is a source of continued discontent is the lower annuity rates offered to women retiring at the same age as men. At the present time, the expectation of life at age 65 is higher at 17 years for women than for men at 13 years and this is reflected in the mortality tables used to calculate annuities (OPCS, 1987). However, these differences are becoming less as the occupations and life styles followed by men and women converge. We understand that in the United States, for example, male and female mortality rates are expected to equalise in 5 — 7 years' time.
- 443 Women enjoy the same pensions as men both from the state and from salary-related schemes.²² Discrimination in terms of eligibility to join occupational pension schemes has been successfully challenged in Europe (Barber [1990] ECR 1989). Also in the United States, the Supreme Court has held that occupational pensions are a part of remuneration and must offer the same rates to men and women, rejecting the argument about life expectancy. However, where a pension requires an annuity to be purchased women will nearly always be quoted a lower rate. For example, an investment of £100,000 might secure single life annuity rates at age 65 of perhaps £11,000 for men compared to £10,000 for women (*Investors Chronicle*, 1 November 1996). Where a private pension is expected to replace a state or occupational pension, then women will be placed at a disadvantage by comparison with the existing arrangement. It is interesting to note that in the proposed *Basic Pension Plus*, equal annuity rates would have applied to men and women (DSS, 1997).

²² State pensions are, however, unequal in accrual terms. In the United Kingdom women need fewer years of eligible NI contributions to get a full basic pension and it can be paid at 60 rather than at 65 for men. This situation will change with the equalisation of the state pension age. Apart from the payment date, SERPS is equal in calculation, though men can accrue it over a longer period.

4.3.5 Contributions and earnings

444 As we show in Chapter 5, in many countries, one of the main concerns about pensions centres around ensuring an adequate level of contributions. Consumers are seen as being myopic both about the pension they might need and the contributions needed to achieve it.

How much pension?

445 Inland Revenue rules for tax relief on DB schemes are aimed at a maximum pension of two-thirds final salary (including the equivalent as a lump sum). Although many occupational schemes are geared to provide pensions up to this level, generally over 40 years service, few members qualify for the maximum entitlement in practice (see section 4.2). Occupational pension schemes frequently provide additional benefits including pensions for dependants and provision for retirement in the event of permanent ill-health. Many schemes also provide for pensions in payment to be uprated to a greater extent than is required for contracting out of SERPS²³. Finally the definition of *pensionable pay* on which scheme entitlements are based may vary considerably from that of gross income (UPS, 1996; NAPF, 1997b, 1997c).

446 An alternative approach is to consider existing spending commitments and how they may change upon retirement, in terms of present-day prices. Some existing commitments may cease — the needs of dependent children may no longer be considered and credit commitments, notably a mortgage, may have been paid off but new commitments may arise, for example out of infirmity or disability. Estimating such commitments perhaps 30 or 40 years hence will never be a precise business. Moreover, account will need to be taken of other sources of income including the basic state pension and any deferred pension from membership of an earlier scheme.

²³ The Guaranteed Minimum Pension.

447 However the target level of retirement income is determined, the consumer with a DC pension will also need to consider the type of annuity which may be required to provide that income. On recent annuity rates, £100,000 would buy a level income of over £11,000 for a single male but only £6,500 index-linked for a joint-life, half payment for surviving spouse annuity (*Investors Chronicle*, 1996). Put another way, the lump sum necessary to generate the same starting income could differ by nearly 70%.

How much to contribute?

448 Those who are covered by an occupational scheme normally have very little choice about their level of contribution, save for the facility to make AVCs or FSAVCs within Inland Revenue contribution limits, which apply on an annual basis²⁴. Those covered by personal pensions have a much wider discretion to contribute, or not. Critically the necessary level of contributions is affected by the time from starting a pension plan to retirement. Inertia is a real risk. This applies not only to the initial decision to take out a personal pension but also to maintaining the real-terms level of contributions where these are initially defined as £x per month rather than as a percentage of income. Those with irregular incomes need to review their contributions at least annually.

449 The level of contributions to many pension schemes is set on the basis of continuous membership of the same pension scheme or plan up to retirement at a predetermined date. Yet, as we showed in Chapter 3, changes of job and pension scheme are the norm not the exception. If planned contributions are interrupted, the amount invested will be reduced and in some personal pension plans higher charges will be triggered, eating into the reduced investment. This should be factored into initial contributions, with automatic review to ensure that contributions continue to be appropriate.

Consumer attitudes

²⁴ The self-employed are allowed to carry forward unused reliefs to take account of fluctuating income.

- 450 DSS (1995e) asked a sample of consumers how much thought they had given to their retirement income. Overall, 86% had given some thought but only 28% had given it a lot of thought. Those giving a lot of thought to retirement income were more likely to have been aged 35 to 64 and to be men rather than women.
- 451 In our survey (see Appendix A), we asked consumers about the characteristics they wanted from their pension. The most frequently mentioned were ability to transfer, employer contributions, and the ability to vary contributions, invest extra amounts and take a career break. They were also asked if they considered their pension arrangements to be well designed for their needs. Nearly half of non-pensioners thought that they were, a response which is arguably not entirely consistent with the responses to the previous question and the nature of many of the pension products available.
- 452 In a survey by BMRB reported by Mintel (1996b), 26% considered their arrangements satisfactory, 25% said they could not afford to make proper provision and 17% would have liked to increase their provision but were unable to do so.

4.3.6 *Selling personal pensions*

How personal pensions are purchased

- 453 In our survey we asked about the sources of advice which consumers had used in relation to pensions. Of the non-pensioners, about one-third had taken independent advice. Another third had consulted a company representative and just under a fifth banks and building societies, of which nearly all would have been advising only about their own products or those for which they were tied agents. It seems reasonable to conclude that the majority obtained advice from someone who was advising on a single product range. Moreover, 85% of those who had obtained advice had used only one source.
- 454 The PIA Consumer Panel (PIA, 1996a) found that nine out of ten purchases covered by their survey (which extended wider than personal pensions) were made with advice. However, just under two-thirds contacted only one source of advice. One-fifth contacted two sources. Consumers contacted in this survey expressed some concerns about the quality of that advice, notably the possibility of bias towards companies or products paying the highest commissions. The panel concluded that the greatest threat was probably product bias, though there was also a concern about how some of the larger IFAs and networks put together best advice product panels. Spoken information was seen as important, given that only 20% of consumers have much interest in financial matters. Around one in six found that the long-term nature of their commitment was not well explained. Twice that number were unhappy with explanations of charges and commissions.
- 455 Given that many consumers do not shop around, advertising by product providers and intermediaries is presumably an important influence in the final product choice as well as in the initial decision to take some action towards pension provision.

Influence of product advertising

- 456 Brand image is clearly an important feature of a number of the better selling personal pensions products. A number of recent entries to the personal pensions market have made effective use of a brand image built up with other financial services or even elsewhere. No one with a strong brand lightly commits it to new products if there is a risk that it might become discredited by association. A number of recent entrants have sought to impress on us that they intended to market products which they felt would establish new standards of excellence, for example in terms of investment performance, levels of charges and flexibility to the labour market risks. A number of brands firmly established in financial services markets (banks, building societies and life companies) evidently have a strong appeal to purchasers of personal pensions. Pensions are one product where the consumer may not find out for many years whether he or she is really satisfied with the purchase.
- 457 SIB's Financial Services (Conduct of Business) Rules Part 7 provide one example of how the advertising of pensions and other financial services products is controlled by the various regulators. Firms which are *authorised* by a regulator are in turn responsible for authorising the advertising of their products, that authorisation extending to advertisements of their products by third parties if these advertisements are likely to be seen by investors in the United Kingdom. Each firm must have an appointed person responsible for compliance, to give approval prior to publication.
- 458 The rules require that an advertisement be always distinguishable from other matter and disclose the advertiser's capacity and authorisation. The advertising should be clear and not misleading *in the form or context in which it appears*. Any synopsis of the product must give a fair view of the nature of the investment. The rules also cover the use of commendations and comparisons with other investments. The use of commendation must have the consent of the person concerned, fairly represent the comment made and must not be out of date. Any comparison with other investments must be fair in terms of what is *both* stated *and* unstated. Any reference to cancellation rights must be clearly stated.

459 References to past performance must be relevant to the subject of the advertisement, state the source of the information and, in the case of a higher volatility investment, cover a period of five years up to the date of the advertisement (or the full period of the fund's existence if shorter). Except in the case of short form or image advertisements, warnings of the risks involved in an investment must be given. Hence the use of phrases like *You may not get back what you invested* and *The value of your investment may go down as well as up*. Though the precise form of words is not specified, the circumstances which require them to be given is. For example, where charges and expenses are not deducted uniformly throughout the life of the investment but are loaded disproportionately onto the earlier years the advertisement shall draw attention to the fact and that, accordingly, if the investor withdraws from the investment in the early years, *he may not get back the amount he has invested* (our emphasis). We need to understand better the role and influence of advertising and other promotional material for the 60% of consumers who do not seek independent advice (Mintel, 1996).

Direct marketing of pensions

460 Latest available data on sales routes have indicated that direct marketing contributes less than 5% of new pensions business, but this figure does not take account of recent product launches. Direct marketing has been successful in a number of other areas in financial services, notably in retail banking and in motor and household insurance. But what is direct marketing and how is it different from sales involving, say, a company representative? In the case of pensions, direct marketing *may* mean dealing on an execution-only basis, but where advice is given then the standard procedures are observed. Moreover, since it is often the practice to record telephone calls, compliance with regulations is in some ways easier to monitor. It appears that, in practice, telephone selling is no different from other forms of marketing not involving IFAs. There are other clear advantages over visits by salesmen including lower cost; the consumer may find the situation less intimidating; and can terminate the call to avoid high-pressure selling; and it may well be easier to shop around if visits by or to salesmen do not have to be arranged. From a regulator's viewpoint, PIA's main concern centres around whether the consumer is clear about the distinction between sales with advice and sales on an

execution-only basis. (Colette Bowe, Chief Executive, PIA, speaking at *Pensions 1997*, a one-day conference held on 20 February 1997).

Role and competency of intermediaries

461 The mis-selling of pension products and the resulting inquiry by the PIA and SIB highlighted problems of the competency of, in particular, intermediaries in the late 1980s and early 1990s. Standards have been improved through the introduction of the Financial Planning Certificate (FPC).

462 Most direct-selling, financial services providers are today providing products which are essentially easy to understand and also to sell, without using traditional distribution techniques. In contrast, many traditional providers are offering pension products which are more complex, and thus required additional training for intermediaries. Under PIA guidelines certain stages of attainment are needed before the intermediary is fully qualified to sell the full range of financial services products. Core competency of pension advisers in the United Kingdom is built fundamentally around the FPC, in which pensions form only a small part. The Advanced Financial Planning Certificate (AFPC), which is optional for intermediaries, provides a greater depth of detail.

463 The setting of competency standards at levels higher than necessary to protect consumers could adversely affect competition and act as a barrier to entry for intermediaries. Moreover there may be a case for giving two levels of authorisation which reflect the intermediary's training and competency in life and non-life products, respectively. The level of qualifications needed will affect the availability of advice to consumers. So this arrangement could allow non-IFAs to advise on certain pension areas and issues, for example employers and trade unions advising their employees or members on matters surrounding the transfer from occupational to personal pensions schemes.

4.4 Complexity and inflexibility in pensions

4.4.1 *Level of consumer understanding*

464 As part of our survey of consumers, we asked a number of questions relating to knowledge of pension matters. Pensions tend not to be an everyday topic of consumer interest so it would be unreasonable to expect consumers to have detailed facts at their finger tips. Rather we sought to find out if consumers had a basic awareness, which might trigger a search for fuller information.

465 About one-third of those sampled were able to give the amount of the basic single person's pension within £5 of the true figure, but for the married couple's pension this number fell to one-quarter. Over three-quarters of those surveyed thought that everyone qualified for a full state pension simply by reason of age rather than on contribution record. However, around half of those surveyed thought correctly that the value of pensions was linked to prices.

466 Of those who had not yet retired, 25% expected that the basic state pension would provide the majority of their post-retirement income. For those who had retired, some 50% were actually dependent on the basic state pension for the majority of their retirement income. More detailed investigation would be needed to find out if this difference, between the expectations of the employed and the actual situation revealed for those who had retired, reflected over-optimism on the part of the former about other sources of income available in their retirement.

467 When asked about the meaning of *SERPS*, 57% of non-pensioners and 62% of pensioners did not know what the letters stood for. Even when the letters had been explained, more than one-third of those surveyed did not know if they were contracted out.

468 The over 90% of consumers professed themselves to have encountered no problems with their pension arrangements. Yet the responses to individual questions revealed a good

deal of confusion about the arrangements which were in place and a degree of optimism about the future which appeared unfounded. The survey is reported in full at Appendix A.

4.4.2 *Tax treatment*

469 A number of providers have suggested that the rules governing tax are inhibiting consumers from making sufficient provision. For example, the Simplifying Pensions Group (SPG) considers that the current tax rules:

are enormously and unnecessarily complex, with requirements subtly differing between different types of pension arrangements. This is costly and off-putting for potential participants. It materially affects the current substantial under-provision across a broad spectrum of those of working age (SPG, 1996, p5).

They suggest that the solution would be to break the links with earnings and remove tax limits on contributions. They argue that this would allow simpler products and a reduction of past complexities.

470 Contribution rates (see Chapter 3) for all types of pension schemes are significantly below the tax breaks outlined above. Furthermore, a survey by Mintel (1996b) found that, of those adults who were contributing to a personal pension plan, about 75% either contributed less than two-thirds of the maximum permissible by age or did not know the level. Further data from a survey carried out by Mintel for Flemings (1997) found that,

for those earning greater than £37,856, only 0.6% would have a difficult²⁵ retirement. Indeed, 80% would have a comfortable²⁶ or ideal retirement²⁷.

471 The main problems arise from the essentially different tax treatment of DB occupational schemes as opposed to DC personal pensions and the difficulties encountered in moving from an occupational scheme to a personal scheme. In the interests of increasing flexibility in pension arrangements, we consider it desirable that such rigidities should be eliminated. We were encouraged to learn that those with existing personal pensions would be able to transfer them into FSAVCs. This would avoid a consumer holding a multiplicity of pension plans and incurring higher costs as a result. We take the view that the tax system could be used to encourage desirable developments, such as increased employers' contributions to occupational DC schemes and group personal pensions (GPPs). As shown in Chapter 3, contributions from employers tend to be significantly lower (or even zero) for these types of schemes than for occupational DB schemes.

4.4.3 *Consumer redress*

472 All United Kingdom pension dispute resolution schemes identified rely on the consumers concerned having previously lodged a complaint with their pension provider and thus in the first instance the provider is given the potential to resolve the complaint. For a complaint involving an occupational scheme, the Occupational Pensions Advisory Service (OPAS) provides a valuable mechanism for not only seeking to resolve complaints but also as a mechanism for distributing information on pension provisions in the United Kingdom, (OPAS, 1996a). The organisation has a staff of only 12 people,

²⁵ Those people who will only be able to expect their income in retirement to be equivalent to between 25% and 40% of their final earnings.

²⁶ People whose current level of provision should provide an income in retirement of something between half and two-thirds of final salary.

²⁷ People who can expect a retirement income equivalent to two-thirds of more of their final earnings.

but with 520 volunteer advisers scattered throughout the United Kingdom. These advisers are usually drawn from industry, which provides a free service to OPAS. Funding is provided for OPAS by grants from the DSS via levies being placed on occupational schemes. OPAS highlight that Citizens' Advice Bureaux provide excellent points of contact for consumers in finding out details of the OPAS service.

473 The Pensions Ombudsman (PO) Scheme is a more formal disputes resolution arrangement which has the ability to take legal action to defend its decisions in the High Court. Funding is again provided from the DSS through levies imposed on occupational schemes. Legislation which covers the establishment and appeal provisions of the PO is the Pension Scheme Act 1993. The PO is often forced to defend his decisions against actions which would otherwise erode his powers and authority in industry (OPAS, 1996a, p.1).

474 Both OPAS and the PO have recorded significant increases in the level of complaints received about occupational pensions. It is anticipated that the newly formed Occupational Pensions Regulatory Authority (OPRA) will play a role in relation to easing the current work-loads experienced by the PO whose purpose is to *investigate in a cost-effective and user-friendly way, complaints and disputes concerning pension schemes, so as to determine them efficiently, fairly and lawfully* (PO, 1996, p.7). Consumers do not have to pay a fee for the service provided by the PO, as industry, through the DSS, covers the associated costs of the operation.

475 The Personal Investment Authority Ombudsman (PIAO) investigates complaints associated with investments sold by member firms of the Personal Investment Authority (PIA). Access to the scheme is free, but associated costs of professional advice are borne by the consumer. Like those complaint mechanisms which serve the occupational pensions system, the PIAO can deal only with complaints after the consumer has first approached the supplier. Ultimately the independence of the PIA Ombudsman is ensured via the Personal Investment Authority Ombudsman Council, which monitors and maintains the independence of the scheme. In most cases, the maximum award is

£50,000; in others, the limit is £100,000. In cases concerned with permanent health insurance, the ceiling is £20,000 per year.

476 Our survey (Appendix A) indicated that both pensioners and others had little knowledge of which dispute resolution scheme could help them with their complaints about pensions. 2,914 non-pensioner and 925 pensioner respondents were asked who they would go to to get the matter resolved if they became very unhappy with any aspect of their pension arrangements. The most frequently mentioned sources of advice were the Citizens Advice Bureaux (CABx), employers or an independent financial adviser. 7% and 3% of these respondent groups identified the PO as a means for assisting them with their inquiries and 2% and 1% respectively identified OPAS and the PIAO.

477 This plethora of dispute-handling arrangements can be both confusing and time-consuming. Anecdotal evidence from some pension providers suggests that they are actually directing consumers to the correct scheme for their particular problem. Support for a *one-stop shop* is given in the Personal Investment Authority's Consumer Panel 1995 Report (PIA, 1995).

478 Much discussion recently has centred on the delays experienced by those consumers who are seeking redress from being mis-sold personal pensions in the 1980s. In October 1994, the SIB highlighted the consumer problems which had been encountered and issued guidance on how redress for mis-selling of personal pensions should be provided. The SIB anticipated that this process would be largely complete by December 1996. In March 1997 only 1% of cases identified by the PIA had been resolved. A serious concern is that some 18,000 consumers between 1988 and the present had died while waiting for their concerns to be addressed.

479 Table 4.7 summarises progress on the review.

Table 4.7 : PENSIONS REVIEW PROGRESS STATISTICS: PERIOD ENDING 31/03/97

	<i>Total</i>	<i>Product Providers</i>	<i>Bancassurers</i>	<i>Networks</i>	<i>Large IFAs</i>	<i>Other IFAs</i>
Total cases identified	570,129	420,913	83,849	3,847	33,613	27,907
Priority cases identified	499,496	373,495	75,322	2,604	30,216	17,859
Number of assessments completed	50,303	35,642	7,501	452	1,057	5,651
Number of cases where no redress has been offered	30,273	20,862	2,747	446	684	5,534
Cases where redress offer has been offered	20,030	14,780	4,754	6	373	117
Cases where redress offer has been accepted	12,650	9,858	2,409	5	271	107
Ratio of redress accepted to priority cases (%)	2.5%	2.6%	3.2%	0.2%	0.9%	0.6%
Amount of redress offered (£)	£135.6m	£99.6m	£31.2m	£23k	£2.6m	£1.2m
Amount of redress accepted (£)	£102.2m	£81.1m	£18.1m	£23k	£2.0m	£0.9m

Source: PIA, 1997c.

4.4.4 Regulation: costs and benefits

480 The current regulatory system for pensions in the United Kingdom is divided between occupational and personal pensions. For personal pensions, the PIA is the principal regulator since it is its members who provide the products and the intermediaries who actually advise consumers on the purchase of these products. The Occupational Pensions Regulatory Authority (OPRA) assumes responsibility for occupational pensions from April 1997. For an estimate of the costs of regulation see Klumpes (forthcoming).

481 We were aware of concerns that the level of regulation in the pensions industry was not cost-effective. However, little concrete evidence was presented to us. The PIA's Evolution Project could have implications for the level of regulation of pensions providers.

482 The costs of regulation need to be fully assessed and balanced with the benefits regulation is providing to consumers. Regulation is needed in the market to provide consistency and discipline in the way products are sold. However, in the past the overall regulatory framework has failed to protect consumers, as exemplified by the Maxwell affair and pensions mis-selling. Further research is obviously needed to identify which elements of regulation provide benefits, the objective being to minimise unnecessary regulatory costs which will be passed on eventually to consumers of pension products. We note that this view is shared by the Consumers' Association (Consumers' Association, 1996).

4.4.5 *Public educational campaign*

483 Everyone we have spoken to in this inquiry has responded positively to the need for more coordinated public education and a greater level of such education. The DSS provides a wide variety of explanatory material on the whole range of benefits which it administers through the Benefits Agency. In the past the DSS has adopted an active stance in encouraging people to leave SERPS and to transfer into other pension arrangements and has highlighted the need for personal retirement planning. At that time (1988), the government's objective was to reduce the future costs of unfunded pension liabilities by encouraging the maximum level of opt-out from SERPS.

484 The DSS has undertaken educational campaigns to provide information and increase the awareness of consumers in planning for their retirement. There is a need to target the 18—35 year-old age group, who generally have little or no pensions provision. We would neither underestimate the difficulty of the task nor the need for it to be attempted. Nearly half (48%) of respondents to our consumer survey indicated that they agreed or strongly agreed with the statement that *I have found all the information I have seen, and advice*

I have received, on pensions very confusing. This figure was only slightly lower (43%) for people with degree-level education.

485 A more unified approach may be needed by government agencies and industry associations in the messages and the methods used to educate the public. It is crucial that the relatively complex series of product features and the legislation which surrounds pension products are translated into an effective message which consumers can understand. Other countries such as Australia have spent considerable amounts of public revenue on a comprehensive public education campaign targeting all households. More efficient distribution mechanisms need to be explored by relevant government departments. Use of intermediary and industry associations in this area, while not a preferred strategy, does afford excellent communication channels to distribute public education material. As an example, the Department of Labor in the United States has been successful in forging arrangements with these types of groups, which provide effective distribution channels and free telephone advice lines on retirement issues.

4.5 Pension problems faced by particular groups in the population

486 So far in this chapter we have looked at consumer problems relating to pensions in general terms. We now examine the pension problems faced by particular sections of the population.

4.5.1 Women

487 In *Averting the Old Age Crisis*, the World Bank (1994) indicated that, world-wide, women faced particular problems regarding pensions provision, in that they generally lived longer than men, were paid on average a lower wage compared with men and on the whole relied heavily on their spouse's pension in retirement to provide a suitable standard of living. In conducting our investigations, we noted that many of the pension products that are provided, on both occupational and personal, have made an inherent assumption that contributions will be provided continuously over a 30- to 40-year period

to generate the necessary income for retirement. The design of many DB schemes pays little consideration to women's career breaks through bearing and raising children.

488 Research on women's pension entitlements reveals two fundamental problems which shape their final pension in retirement. First, they are generally paid less than their male counterparts, despite legislation to counter discrimination. Additionally their working patterns become more spasmodic and uneven in later life, as women rejoin the workforce after raising children and in some cases can gain only lower-skilled, part-time or contract employment (Joshi *et al.*, 1996). Males spend fewer periods out of work and typically have held more jobs than females. In section 4.2 we showed how the number of transfers between pension schemes affected final-salary-based pension entitlements. Women were more likely than men to have left an occupational scheme without any entitlement to a deferred pension. As a result of career breaks, women have experienced a significant erosion of their pension entitlements (Johnson *et al.*, 1996).

489 In the United Kingdom the basic state pension recognises the problem of interrupted employment by giving some pension protection during periods of caring in the home, through Home Responsibilities Protection (HRP). Initially SERPS gave women more favourable treatment through the use of the best 25 years of earnings as the basis for this second-tier pension. These advantages have been eroded. The indexing of the basic state pension to retail prices is reducing the value of HRP credits. Successive changes to SERPS will reduce the pensions payable to those with shorter periods of employment.

490 Second, a substantial number of women rely heavily on the benefits provided by their husband or partner in retirement. Legislation introduced under the Pensions Act 1995 for the treatment of pension rights on divorce will allow courts to order a divorcing spouse to share his or her pension rights. A more comprehensive approach to the issue of divorce is anticipated in the future by the government.

491 Statistics gathered in *Women and Pensions* (DSS, 1996i) suggest that the level of women's provision for retirement is a cause for concern. Half of the women interviewed in the DSS survey had never been in an occupational pension scheme. Fewer than four

in 10 women expected to receive, or were being provided with, their own occupational pension and of these women only one in five considered that the pension, on its own, provided sufficient income for them to sustain themselves in the future. The Equal Opportunities Commission in response to the DSS's Green Paper on the treatment of pension rights on divorce (EOC, 1996a) highlighted that 30% of women in part-time employment worked for an employer with no occupational pension scheme compared to 22% of full timers. EOC also told us of anecdotal evidence that part time work was divided into separate jobs in order to avoid paying NICs, thus prejudicing entitlement to the basic state pension.

492 In our own survey (Appendix A) we found that women were a little more likely than men to agree with the statement about information and advice being confusing. Further, they were less likely to agree that pension schemes were designed for people like them.

493 Women are less well placed than men to benefit from the increased reliance for retirement income on occupational and personal pensions, as opposed to the basic state pension and SERPS. The value of the basic state pension is not rising in real terms and is projected to replace a falling proportion of the average wage, declining from 15% in 1995 to an estimated 9% in 2030 (see Chapter 3). Women will be disadvantaged by changes in the way SERPS is calculated. Women will also be disadvantaged by any moves which result in their pensions being paid out of individually purchased annuities which are likely to be gender specific (see section 4.3.5). It is noteworthy that under the proposed *Basic Pension Plus*, designed to replace the basic state pension with a personal pension, annuity providers were to be required not to discriminate (DSS, 1997).

4.5.2 *Ethnic minorities*

494 Ethnic minorities are particularly exposed to low retirement income. Many ethnic subgroups, for example, have significantly higher unemployment rates than those of the majority of the population. Additionally, larger proportions of ethnic men are identifying themselves as retired, effectively long-term unemployed, even though they are under retirement age.

Larger proportions of men under retirement age report themselves retired in black-African, Pakistani, Bangladeshi and Chinese groups than in others. The factor that most minority ethnic groups have in common is the large proportion of men who are unemployed or otherwise economically inactive. Working-age women in all ethnic groups are relatively unlikely to be working full-time and more likely to be economically inactive (Hancock et al., 1995, p.45).

495 Some ethnic groups tend to see their individual pensioners living with family members. This extended family model is suggested, anecdotally, as being under great strain as traditional cultural values are eroded by more Western-style influences (Hancock et al., 1995, p.45). Our research suggests that this trend is found also in Singapore.

496 Data from the General Household Survey indicates that, amongst ethnic minorities, those who are in employment are at least likely as whites to participate in occupational pension schemes. Research for the Retirement Income Inquiry found that smaller proportions of self-employed people from ethnic minority groups were paying into a private pension, compared with white self-employed people. However, most employed people from all of the ethnic groups, worked for employers who ran a pension scheme, and higher proportions than amongst the remainder of the population belonged to the scheme (Hancock et al., 1995. p.48).

4.5.3 *Self-employed*

497 As a group the self-employed do not participate fully in the current pensions system. In 1995, about 13% of those in work were self-employed (Labour Force Survey, 1996). Unlike employees, the self-employed are not required to make compulsory second-tier pension provision, and self-employment income does not give entitlement to SERPS. The self-employed pay different (and generally lower) National Insurance contributions. Our concern is that inadvertently the self-employed may be under-providing for their retirement. Our survey (Appendix A) indicated clearly that the self-employed's provisions for retirement were inadequate compared with full-time and part-time workers. 30% of self-employed contributed only up to £40 a month to personal pensions compared with 40% by full-time employed and 46% by part-time employed people. 34% of self-employed had no pension arrangements pre-retirement, compared with 22% for full-time workers. 18% of the self-employed surveyed considered that the current pension arrangements were not well designed for their needs compared with 14% of full-time and 15% of part-time employees.

498 The self-employed may well regard the value of their businesses as a *retirement nest egg*. This source may be less secure than a formal pension and subject to more cyclical influences. Department of Trade and Industry analyses of business failure indicate that, during the height of the recession in 1991, nearly 25,000 businesses in England and Wales became bankrupt or required deeds of arrangement to be initiated, contrasted with just over 13,000 business failures in 1995.

499 A recent report observed

The self employed are also in a precarious position... More worrying for the self employed, over 50% face financial hardship compared to only 21% of employees (Flemings, 1997).

4.5.4 *Unmarried partners*

4100 While nearly all occupational pension schemes provide for a widow's or widower's pension, but, unmarried partners are often left with no pension rights on the death of the partner. In many cases this involves both unmarried partners and gay and lesbian partners, whether or not their relationships have been built on long-term stability. In their 1996 survey of pension schemes, NAPF (1997 b, 1997c) found that only 8% of private sector schemes provided pensions to common-law partners as a matter of course, but a further 69% did so at the trustees' discretion. 18% of private sector schemes never paid pensions to common-law partners, compared to 79% of the public sector schemes sampled. In only 23% of private sector schemes and 8% of public sector schemes, surveyed was there any provision for same-sex relationships. In the private sector schemes 66% of those schemes which had such provisions exercised them at the trustees' discretion. In the public sector, the equivalent figure was 20%. Stonewall (1996) reported that 28% of private occupational schemes never provided a survivor's pension other than to a widow, widower or surviving children.

4101 We note that personal pension schemes are generally more flexible than employers' schemes in providing these benefits and are able to provide a lump sum death benefit and a survivor's pension to the person who has been nominated to receive it.

Chapter 5: ISSUES AND COMPARISONS WITH INTERNATIONAL PENSIONS SYSTEMS

5.1 Introduction

- 501 In examining the issues raised by this report, the OFT has sought to compare other international pensions models in Asia, Europe, North and South America. From this research, two common themes appear throughout the eight countries studied in detail. First, to varying degrees, all countries are dealing with part or all of the issues raised in this report. Recent reports by the World Bank (1994), the OECD (1996) and the IMF (1996) highlight the growing problems some countries may have in the financing of their pensions liabilities, in both the private and public sectors. Second, all countries have, or will have to face up to, the difficult realities of moulding a welfare system which sees its frontiers increasingly eroded by arguments for greater individual choice and the growing need to curtail public debt levels.
- 502 The transition in welfare and pension systems may be rapid, as was the experience of Australia, Chile and the United Kingdom in the 1980s or more gradual, as is occurring in Canada, Denmark and the Netherlands. Combined, the eight countries provide a useful focus for informed debate on the future pension needs of the United Kingdom. The details of each country's pension system are contained in *Appendix D: International Comparisons* of this report.
- 503 Eight countries (Australia, Canada, Chile, Denmark, the Netherlands, the Republic of Ireland, Singapore, United States) were used as the basis of an international comparison to discover whether the issues identified by the report were being encountered internationally and what remedies were being considered or implemented by industry and government. Four (Denmark, the Netherlands, the Republic of Ireland and the United States) were visited and the rest researched by other means. The basis of selection of these countries centred on their usefulness in highlighting similarities and comparisons

with the United Kingdom's pension system, different methods for dealing with the ageing population crisis, approaches towards compulsion and the existing issues of consumer detriment identified by the Pensions Inquiry.

5.2 Compulsion

504 An issue highlighted in the report is the concept of greater compulsion. Obvious advantages exist with compulsion. For government it provides an important method of increasing pensions savings and provision for retirement quickly. This was the experience with Australia, which began introducing its compulsory superannuation system in the mid-to-late 1980s as part of a centralised wage-fixing system. Through union support the then government quickly established the framework for compulsory co-contributions paid into private-sector (but state-approved) funds, which are now maintained at a level of 9% of gross income of the employee. This level is expected to continue increasing until 2002—2003 where an expected level of 12% will be achieved. Such contributions are made only on salary above a certain threshold.

505 Singapore has also adopted a comprehensive retirement incomes system which is heavily based on compulsion. Remarkably, levels of combined co-contributions are at 40% of gross income (although not all is used for pensions), with a combined salary and contribution ceiling. Chile incorporates compulsion into its pension system. Compulsory pension savings accounts were established in the early 1980s to receive a minimum of 10% of the employee's salary (with no employer contributions). Contributions can be increased up to a maximum of 20%, with this level being subject to a salary ceiling of US\$22,000 per annum, above which savings are not mandatory.

506 At the opposite end of the *compulsory spectrum* are Canada and the United States. These two countries are closely aligned, with tax incentives being provided to individuals and employers in providing or establishing retirement vehicles. In Canada, the first and second tier are essentially PAYG-based, with the Canada Pension Plan (CPP) receiving compulsory contributions from both the employee and the employer. In contrast, the third

tier sees individuals derive tax benefits by contributions to Retirement Pension Plans (RPP) and Registered Retirement Savings Plans (RRSP). Employers also receive tax benefits derived from RPP contributions on behalf of their employees. In the United States the pensions system is more heavily geared towards providing both employers and employees with tax incentives to establish pension plans. These retirement vehicles take the form of 401(k) and individual retirement account (IRA) plans, along with savings incentive match plans for employees (SIMPLE) for small businesses (and Keogh plans for the self-employed).

507 Ultimately, compulsion is seen to be a method of increasing the coverage of the workforce with retirement provision. In the United States and Ireland, only 50% and 52% respectively of the workforce is covered by pension schemes compared with Australia 81%, Chile 62% and Singapore 66%. However, even with these coverages, not all members contribute continuously. For example, in Chile, only 56% of members in 1995 were employed contributors. Further, countries such as Denmark and the Netherlands, with quasi-compulsory pension models, have achieved coverages of over 80%.

508 In summary, the attraction of compulsion for many countries is that it lifts the coverage of the pension system very quickly and that it harmonises certain minority groups and women, who often do not have the opportunity to participate in a voluntary scheme. However, compulsion is often politically unpalatable to introduce unless it is combined with centralised wage negotiation or the funds used to develop public infrastructure, as in the case of Singapore. Further, it represents an enormous shift in savings, diverting funds from other vehicles, with Australia encountering a progressive decline in ordinary savings in favour of a growth in superannuation assets. However, it can contribute to overall savings, with Singapore, for example, having the highest saving rate in the world.

5.3 Transfer values and vesting

- 509 The extent and scale of the perceived consumer detriment associated with transfer values and vesting in the various researched countries was not as great as in the United Kingdom, where research contained in (*Appendix E*) highlight this problem. Compulsory systems, such as those of Singapore and Chile, have no problem since these are completely DC. Similarly for Australia, which is predominately DC. Furthermore, Denmark has very few DB schemes, with the government encouraging its pension schemes to move from a DB to a DC basis. However, countries like Ireland, which have a similar pensions system to that of the United Kingdom, sees the treatment of early leavers varying considerably. The vesting period is up to five years, during which there is no entitlement to the employer's contributions on leaving service. However, the 1990 Pensions Act ensures that deferred benefits are increased in line with consumer prices up to a limit of 4% per year. Actuarial methods used to calculate transfer values are similar to the United Kingdom, although it appeared that there were no problems with these.
- 510 To counter the perceived consumer detriment of job changes in the Netherlands with respect to transfer values, *transfer circuits* operate within industries. This essentially means that employees are not penalised when changing jobs, with standardised actuarial assumptions used together with a clearing house for pension fund benefits. Deferred benefits in the Netherlands are generally indexed to inflation, although this is not mandatory, with the vesting period being one year.
- 511 Canada recently acknowledged the problem of transfer values, and the associated effects of employment changes on final retirement benefits, by seeking to provide rebates for those employees who change jobs frequently before retirement and thus have their overall retirement provision adversely affected through spasmodic employment patterns as they approach retirement. Currently, the indexation of deferred benefits in Canada is as uncommon as it is in the United States, although the vesting period of two years is shorter than in the United States, so-called *cliff vesting* is five years and *graded vesting* is between three and seven years. Furthermore, the United States simply does not allow

transfers between DB schemes, unless a reciprocity agreement is in place. Significantly, in relation to these two perceived issues, no other country has attached any great significance to these problems experienced in the United Kingdom.

5.4 Funding

512 As previously indicated, a common theme throughout this international research is how governments in all the countries examined are seeking to have their citizens play, to varying extents, greater roles in planning for their retirement. Simply put, most OECD countries are facing major changes in the age structure of their population, with the elderly becoming a significantly larger proportion. At the same time the working population is also shrinking, which is causing major fiscal concerns to several of the countries this report examined. For example, Australia identified in the late 1980s that its savings levels and retirement provisions would have to improve sharply to sustain the current lifestyle that most Australians enjoy. In the United States, the president appointed an advisory council on the social security system to identify the options that the country faces in the next century. Although opinion is sharply divided over the approach one should take towards reform of the first tier in the United States, common opinion suggests that by the 2020s the pension system, as currently projected, will become insolvent.

513 Even countries like Ireland, which will have an ageing population crisis that is likely to be offset by 30 years compared with other OECD nations, is concerned with the low level of pension coverage. The Pensions Board is currently conducting a review of the existing pensions arrangements and attempting to plot out the requirements of its pension system in the 21st century. Denmark and the Netherlands have populations that are ageing rapidly by OECD standards. Such a demographic feature is expected to place great pressure on both countries' fiscal positions in sustaining their comparatively generous first tier. In Denmark, some commentators suggested that there was growing resentment among the younger generation at the high levels of taxation maintained by the state. Thus,

the conclusion drawn by some commentators was that the current system's design was likely to alter in the future.

5.5 Consumer knowledge

514 Compounding the ageing population issue which faces many nations is that much of their population appear to suffer from a degree of myopia towards retirement planning. One way in which countries have addressed this issue is to increase the level of public education on pensions. Although some countries have experimented with such education, this method of *empowering consumers* seems to be used more commonly on a large scale in countries which have compulsion underlying their pension system. In Singapore, the Central Provident Fund (CPF) plays an active role in informing its members of the benefits of the scheme and of their related entitlements. This function is carried out through use of the media, including associated membership magazines and appointed staff of the CPF being designated to handle inquiries from members. Where more choice of scheme or investment manager exists, as in Chile and Australia, the relevant regulatory bodies have been active in the past in promoting the need for retirement planning and the overall features of the pensions system. In Australia the sole pensions regulator (Insurance & Superannuation Commission) spent in the first half of the 1990s some AUS\$11 million on an integrated and co-ordinated public education campaign, which targeted the whole population through television, radio and print media.

515 Informing consumers of the benefits that they are entitled to under a nation's pensions system appears to be increasingly seen as a role adopted by government, through its pensions regulator. In the United States, the Department of Labor has been actively working in partnership with industry bodies to promote understanding of the current United States pension system. Canada, Denmark, Ireland and the Netherlands have also been very active in developing co-ordinated public campaigns aimed at increasing the understanding and overall coverage of pensions schemes. Through discussions and comment in all the eight countries examined, the difficulty seen with mounting any public education campaign was who was the most effective to carry out this task, whether it

should be government or industry, or both. There was additionally the risk that these campaigns would be seen simply as stimulating business growth for pension providers.

5.6 Redress

516 A wide variety of approaches was noted about the way consumer redress was handled by the researched nations. Singapore, for example, has no formal redress mechanism, comparable with that in existence in the United Kingdom, whereas Australia has principally modelled its disputes resolution mechanism on English legal principles, in the form of the Superannuation Complaints Tribunal and the Life Insurance Complaints Service. In the Netherlands, the Pensions Ombudsman works closely with industry to resolve complaints. Interestingly, his office indicated that industry was always very willing to resolve the complaints highlighted to it by that office. Although no strong sanctions exist in the Dutch redress system, a culture of appropriate conduct in resolving consumer complaints was apparent.

517 Canada and the United States have a redress system that is significantly different from that of the United Kingdom. Canada's constitution sees its provincial governments playing a large role in the regulation of pension schemes within provinces. On this basis, regulatory bodies such as the Pensions Commission of Ontario (PCO) have a disputes resolution mechanism established to hear complaints levelled at pension schemes under its jurisdiction. Such consumer redress normally takes the form of a tribunal which hears evidence from both parties involved in the dispute.

518 Again, the constitution appears to have shaped the consumer redress mechanism of the United States for pensions. Certainly the first two tiers have recourse through the relevant federal government bodies: the Department of Labor and the Pension Benefits Guaranty Corporation (PBGC) for DB schemes. Additionally, industry associations play a role in handling some complaints relating to the third tier, but this function is carried out mainly by individual State Insurance Commissioners and consumer protection agencies in each

of the states, territories and the District of Columbia. Finally, Ireland’s approach is to leave consumer redress effectively to the regulator, the Pensions

5.7 Tax

519 Tax aspects, like consumer redress, are treated quite differently by the various countries examined. As discussed in section 3.7 of this report, pension schemes are capable of being taxed at one or more of three distinct points. Table 5.1 shows the different forms of tax treatment by the eight countries studied and the United Kingdom.

Table 5.1 : TAX TREATMENT OF PENSIONS

<i>Country</i>	<i>Contributions</i>	<i>Investment/ Income</i>	<i>Benefits</i>
Australia	T	T	T
Canada	E	E	T
Chile	E	E	T
Denmark	E	T	T
Ireland	E	E	T
Netherlands	E	E	T
Singapore	E	E	E
United Kingdom	E	T	T
United States	E	E	T

Notes: E: Exempt subject to regulations and limits. T: Taxed.

520 Some countries which have little compulsion evident in their pensions system rely heavily on tax incentives. For example, in the Netherlands, contributions are tax-deductible subject to regulations and limits. Returns are also tax-deductible, with pensions being fully taxed when received either as a lump sum or as an annuity. Denmark also provides some tax relief for consumers, with contributions being tax-deductible, but the real interest accruing on the pension fund is taxable within the fund. As in the Netherlands, pension benefits are fully taxed.

521 Australia clearly has a taxation approach which contrasts sharply with the other countries studied. Tax is levied on the consumer in essentially all aspects during the duration of the superannuation policy. Contributions are taxed, along with the investment income and the annuity or lump sum finally provided. To counter criticism of this approach, previous Australian governments have insisted that the general rate of 15% is lower than the associated marginal income tax rates which are associated with personal earnings. Interestingly, within Singapore's compulsory pensions system, the tax treatment is in stark contrast to that of Australia. The contributions, income earned and benefits derived are not taxed.

5.8 Women

522 Women in the various researched countries face similar problems to those experienced in the United Kingdom. A common problem for women in all countries examined was that they tend to have lower paid jobs than men, work in industries with traditionally low pension coverage, be more likely to work part-time and to have interrupted work patterns. Furthermore, as noted in the World Bank's (1994) *Averting the Old Age Crisis*, women tend to outlive their partners. In response to this, some countries, like the United States, Canada and Australia have been concentrating public education resources on trying to encourage women to increase their pension provision. Increasingly, the family's pension provision has tended to become its largest asset; thus on divorce women are often exposed to financial hardship as the spouse usually represents the major source of retirement income. A majority of the countries researched have put or are about to put in place, legislation which will see pension provision included as part of the divorce settlement. With divorce rates increasing in most OECD nations, one would expect this development to be further refined in the future.

523 As indicated in (*Appendix E*), early leavers from DB schemes suffer a significant amount of consumer detriment. In effect, those who either change jobs frequently or sustain career breaks tend to suffer the most detriment. Internationally, our research indicated that DB schemes provided little perceived benefit for women, with DC schemes

providing greater flexibility and accommodation of women's working patterns. In Europe, the pension systems have had to comply with a recent European Court of Justice (ECJ) ruling (the Barber judgment), which required that men and women be treated equally in pension schemes. Naturally, this decision has bolstered woman's pension coverage and the benefits they will derive from these systems. Furthermore, Denmark has introduced reforms of the supplementary pension scheme (the ATP) to acknowledge women's position in regard to maternity leave.

5.9 Minorities

524 No clear minority groups based on ethnicity could be identified from the international research as suffering detriment under existing pension systems. A further observation, however, was that ethnic or indigenous peoples in Australia and the United States who sustained spasmodic working patterns did not receive the same pension benefits as those groups who were in more continuous employment. The self-employed seemed a group who consistently made lower than average contributions for their retirement and had significantly lower coverage. Such an observation is consistent with industry comment that people involved in small business considered that their retirement would be supported by the continued performance or the sale of their business in due time. However, this ignores the high level of business failures within the sector.

5.10 Annuity rates

525 Recent legal and legislative initiatives have seen the distinction between the treatment of men and women based on the use of differential annuity rates increasingly challenged. In the United States, two Supreme Court rulings in the State of Arizona and the City of Los Angeles outlawed discrimination according to gender in employer-sponsored pension funds. The basis of this ruling was the constitutional amendment which forbids discrimination so based. It was argued that the benefits derived from these employer's plans were effectively compensation, and thus no sexual discrimination could be used in the setting of annuity rates. Thus, uni-sex annuity tables are now used in the United States

for employer-sponsored pension schemes for example, 401(k) plans. Otherwise, it is up to the insurance company concerned whether or not to use such rates.

526 There was a substantial debate in Canada in 1981 about the future of Canada's pension system, which resulted in calls for the adoption of uni-sex annuity tables in employer-sponsored schemes. Some provinces changed their legislation accordingly. In Europe, an ECJ ruling (the Barber judgment, referred to above) forbids any discrimination on this matter after 17 May 1990. Again, this judgment relates to pensions considered as *pay*, for the purposes of Article 119 of the Treaty of Rome regarding equal pay for equal work. So, this applies only to occupational schemes. Finally, in Australia changes to the Sex Discrimination Act 1984 (Cwlth) saw the general exemption removed which had allowed superannuation funds to discriminate on the basis of marital status and gender in the provision of superannuation benefits.

5.11 DB and DC

527 On the whole there is a significant shift taking place in most of the researched nations from DB to DC schemes. Irish commentators suggested that this was occurring in Ireland principally because industry was eager to curb costs and, by their very design, DB schemes had the potential to cost companies more than DC schemes. The suggestions from several of the researched countries was that regulatory costs were effectively pushing companies into DC schemes, as they were less costly to operate in response to the existing regulations. In addition to this anecdotal evidence, in the United States the Employee Benefit Retirement Institute (EBRI) had updated a study by the Hay Group (1996) for the Pension Research Council's 1996 conference. This found that overall pension administrative costs had continued to increase with the difference between DB and DC schemes, especially small ones, increasing too. For example, for the smallest DB schemes, the administrative costs were now 3.1% of payroll compared to 1.4% for DC schemes. Some countries like Chile, Denmark and Singapore had, for historical and legislative reasons, no or few DB schemes in operation. By changing their systems so that

the individual was more in control of their retirement plans, Australia and Chile had moved away from a collective approach towards individual pension arrangements.

5.12 Mis-selling

528 Various countries have experienced the inappropriate selling of pension products. Australia had notable examples of mis-selling and near collapses of superannuation funds in the late 1980s and early 1990s. In the United States, retirement annuities had been inappropriately sold by intermediaries who failed to disclose important aspects of the product. Ireland in the late 1980s witnessed some employer pension fund collapses, which caused detriment for the members of these schemes. A reaction to this was the government established an inquiry into the future of the pensions system in Ireland. This eventually led to the adoption of legislation in the form of the Pensions Act 1990 and the formation of the Pensions Board to monitor and supervise the operation of the Act.

5.13 Simplified products

529 None of the countries researched has a product with all of the desirable characteristics we have identified, although there are products available with some of these. In the United States, for example, simplified retirement plans (known as SIMPLE) for small employers have been introduced by the Small Business Job Protection Act of 1996. Obviously, the costs for small employers to sponsor retirement plans have been recognised by the United States Department of Labor, with this initiative being one way of reducing these. Clearly, as already indicated, those countries that are predominately DC for example, Australia, Chile, Denmark and Singapore, have addressed the job mobility problem inherent in DB schemes. All annuities in Chile are index-linked.

530 However, the products available in the countries researched can still lead to consumer detriment. Internationally, *lifestyle products* do exist, but are based on a crude form of regulating risk for example, a stepwise shift into gilts 10 years from retirement. Other products rely on the consumer to decide when to shift. Furthermore, economies of scale

appear not to have been captured, with administrative costs for private schemes for example, in Chile and the United States (at about 2% of per capita income of scheme members) being comparable to the most expensive government schemes (for example, the Zambia). This compares to the United States, first-tier state pensions cost of about 0.05%.

References for Chapter 5

Hay Group (1996), E.H. Husted, *Retirement Income Plan Administrative Expenses for 1996*, May (Washington: Employee Benefit Research Institute)

IMF (1996), S.K. Chand and A. Jaeger, *Aging Populations and Public Pension Schemes* (Washington)

OECD (1996), *Ageing in OECD Countries: A Critical Policy Challenge* Social Policy Studies Number 20 (Paris)

World Bank (1994), *Averting the Old Age Crisis* (Oxford: Oxford University Press)

Chapter 6: CONCLUSIONS AND RECOMMENDATIONS

6.1 Introduction

601 In Chapter 2 we set out briefly the history of pension provision in the United Kingdom and alluded to a number of proposals which have been made over the last year or so by the main political parties and by industry and consumer groups.

602 In Chapter 3 we outlined a number of trends in the pensions market, in particular the ageing of the population and the pressure on the *pay-as-you-go* financing of the basic state pension and SERPS. Although some of these proposals bring into question the continuation of the present basic state pension and SERPS, we assume that they will continue in broadly their current form, but the solutions put forward in this chapter are not necessarily incompatible with these proposals. We noted a tendency towards under-provision for retirement income as well as a gradual shift from defined benefit (DB) to defined contribution (DC) schemes.

603 In Chapter 4 we described various forms of consumer detriment associated with pensions and the extent to which certain groups in the population are particularly affected. In DB schemes, the principal problem is the losses incurred by early leavers. DC schemes are free from this form of detriment but they suffer from other, equally serious, problems. Price competition, that is, competition to supply a product with the lowest management fees, is subordinated to competition for distribution channels. These channels market the product to consumers by emphasising supposedly superior investment performance. In our view, this characteristic of a pension product is insubstantial and illusory as there is a finite premium to be secured for any level of risk assumed and, as Klumpes demonstrates in Appendix F, no convincing evidence that investment managers can consistently outperform this relationship.

604 In Chapter 5 and Appendix D, we reported on studies of the pension systems in eight countries: Australia, Canada, Chile, Denmark, the Netherlands, the Republic of Ireland, Singapore and the United States. They were selected in order to highlight similarities and contrast approaches with the United Kingdom's pension system and the steps taken to address the problems we have identified.

605 In this present chapter we bring forward conclusions and recommendations.

6.2 Problems with DB Pensions

606 DB occupational schemes have provided and will continue to provide a comprehensive range of benefits which meet many of the needs of consumers. For the most part these benefits are defined in terms of final salary and satisfy the needs of long-serving employees. This has the advantage to employers of reducing labour turnover, but the needs of the majority of employees who do not stay with a single employer throughout their life are less well met.

607 In Chapter 4 we identified the main consumer problem as being the loss of pension rights of early leavers. Someone who has had a series of jobs covered by different final salary schemes arrives at retirement with a significantly lower pension than someone with an identical salary progression in a single scheme. This consumer detriment continues, notwithstanding the considerable improvements which have been made since 1975 in the treatment of early leavers. These improvements arose from changes to the vesting of pension rights and the indexation of deferred benefits to inflation.

608 This conclusion is confirmed by the report we commissioned from Blake and Orszag at Appendix E. Notwithstanding a dramatic improvement in the position of early leavers over the last two decades, losses for early leavers persist. Furthermore, the transfer values that employees receive on leaving DB schemes are subject to a large degree of actuarial discretion that can dramatically reduce their size. The Pensions Act

1995 has had the perverse effect of reducing transfer value for early leavers though it has reduced the scope for variations.

609 We have considered a number of ways to solve this problem.

- a *Do nothing* — The consumer detriment for early leavers would remain. The option of taking out a personal pension normally involves the loss of the employer's contribution, which means that this option, envisaged by the Social Security Act 1986, is not available in practice.
- b *Improve the treatment of early leavers by giving them back a part of their accrued contributions* — It would involve employees receiving back some of their accrued contributions when they move jobs in addition to a fraction of their accrued service credits calculated using current actuarial methods. Blake and Orszag point out that it would not require substantial changes in legislation and that it could be a stop-gap measure or else one component in the transition to a fully portable defined contribution scheme.
- c *Give full service credits on transfer* — Early leavers are currently offered cash equivalents of their accrued pension benefits to buy service credits in their new employer's scheme, to keep a deferred pension in their leaving scheme or to buy into a personal pension. This proposal, also suggested by Blake and Orszag, would mean that early leavers would not be penalised for moving jobs, implying full portability, and would encourage employees to transfer their pension rights rather than to preserve them.
- d *Uprate deferred pensions in line with the growth rate of earnings or the real return on securities rather than movements in prices* — When pension rights are deferred, the minimum obligation is that the deferred pensions are uprated via limited price indexation (that is, in line with consumer prices up to a maximum of 5%). This penalises early leavers relative to stayers. The

proposal, again suggested by Blake and Orszag, would encourage employees to preserve their pension rights with a scheme run by their existing employer rather than to transfer them to a scheme run by a new employer.

- e *Redefine benefits in terms of life-time earnings* — The early leavers problem stems primarily from the definition of benefits in most DB schemes in terms of final salary. The result is that, relative to contributions, benefits are *back-loaded*. This is avoided if benefits are defined in terms of revalued life-time earnings, as, for example, in the NHS doctors' pension scheme and some pension schemes in the Netherlands. In practice, defining benefits in terms of life-time earnings would transform DB schemes into something very close to DC schemes.
- f *Wider use of transfer clubs/circuits* — These operate in parts of the public sector in the United Kingdom and in a number of other countries, for example, the Netherlands. The essential requirements for a pension scheme to be part of a transfer club is that the pension fund is indexed, the pension is based on final salary and standardised actuarial assumptions are used.

610 We do not favour any of these proposed solutions. Each would impose substantial costs on employers at a time when pressures on costs from implementing the Pensions Act 1995 are being felt and could accelerate the trend towards DC schemes, thereby exposing consumers to the shortcomings in existing DC schemes. We consider, however, that DC schemes are capable of considerable improvement, sufficient to make them a viable alternative to existing DB schemes. It is to these proposals which we now turn.

6.3 Problems with DC occupational and personal pensions and proposals for a designated personal pension (DPP)

611 Notwithstanding the woeful history of pensions mis-selling and the inadequacy of many products currently on offer, DC personal pensions, and their occupational counterparts, are also capable of meeting consumers' needs. Although the investment risk is borne by the consumer, not the employer, this does not, of itself, represent a consumer detriment. It is a feature of efficient capital markets that risk is rewarded: the higher the risk, the higher the return. The consumer is therefore indifferent to risk provided the level is both:

- a appropriate that is, understood and not excessive in relation to adverse outcomes; and
- b optimal, in the sense that the highest possible return is achieved for the particular level of risk accepted.

Only when considering what would be comparable employer contributions into DC and DB schemes might there be a need to take explicit account of the different attribution of investment risk in the two systems. Without any fundamental rationale for the particular figure, DB schemes typically assume an employer/employee contribution allocation of 2:1. It could be argued that comparable employer contributions into a DC scheme would require the employer's contribution to represent a higher proportion of the total. It is, however, notable that the 2:1 convention is also adopted in countries where DC pensions prevail, for example Denmark, but that in the United Kingdom most DC personal pensions enjoy no employer contribution.

612 In Chapter 4, and more formally in Appendix C, we identified five causes of consumer detriment in currently available DC pension products:

- a the level and variability of investment returns;
- b the level and incidence of expenses;
- c the cost of purchasing the annuity;
- d the level of contributions that are sustainable, including the contribution that can be expected from employers in the current regulatory framework;
- e continuity and rate of growth in earnings.

613 The resulting consumer detriment can be minimised, or even eliminated. This requires:

- a ***an underlying investment in a well-diversified portfolio of equity shares, the portfolio overall having average risk*** — in order to take advantage of the equity risk premium of around 5% per year, it is necessary to invest in equity shares;
- b ***passive fund management of the portfolio*** — the equity risk premium should, however, be secured at the lowest possible cost. All the evidence in Appendix F points to this being achieved by passive fund management and, more particularly, by the employment of tracker funds;
- c ***the use of gearing²⁸ to regulate the individual consumer's exposure to investment risk*** — passive fund management precludes altering the gearing of a portfolio to adjust the overall level of investment risk. Gearing is used to effect this;

²⁸ The ratio of borrowing to the market value of the equity portfolio less borrowing. In this definition, investment in risk-free securities corresponds to negative borrowing.

- d ***systematic reduction of gearing as the individual consumer approaches retirement so that the investment return on the fund is maximised in relation to the overall level of investment risk assumed*** — many DC personal pension plans allow the individual to switch into low-risk investments as retirement approaches to reduce exposure to market fluctuations. Some plans do this automatically, for example switching from a tracker fund to an index-linked gilts fund over the last 10 years before retirement. Our proposal is that positive gearing is permitted at the outset and is thereafter continuously reduced in a way that optimises the risk-return profile over the consumer's working life.²⁹
- e ***an annuity purchased on the open market*** — there are wide variations in the annuity rates available at any time. Significant savings can be achieved by shopping around, yet some providers seek to limit this option;
- f ***an annuity which is fully index-linked*** — limited indexation is a requirement for protected rights in contracted-out money purchase schemes. Full indexation provides a more effective elimination of consumer detriment;
- g ***equal annuity rates for men and for women*** — where pension schemes are linked to employment, any form of discrimination is already outlawed by a European Court of Justice ruling. Even if this requirement can be

²⁹ The relationship derived in Appendix C is:

$$\Phi_i = \frac{\sigma_p}{\sigma_e} \sqrt{n-i} - 1$$

where : Φ_i is the optimal gearing ratio at the start of year i ;
 σ_e is the anticipated standard deviation of the return in a single year on equity shares;
 σ_p is the accepted anticipated standard deviation on the return on the pension fund; and
 n is the number of years of the pension plan, that is the number of years to planned retirement.

The extent of any initial positive gearing could, however, be capped.

circumvented, there is a strong moral case that men and women should enjoy the same level of pension for the same contribution;

- h ***expenses fixed as a proportion of fund value with no hidden element*** — many existing personal pension products, including group personal pensions, have charging structures which are both high in relation to occupational schemes and heavily loaded towards the early years of the plan. This penalises anyone who does not maintain contributions over the whole period of the plan. A structure which provides a single equity fund for many members and corporate gearing which can be structured between members is required;
- i ***a structure which enables economies of scale to be exploited and gearing in respect of individual consumers to be aggregated*** — it is important that economies of scale are captured if costs are to be kept low (paras 615—617);
- j ***an entitlement for an employee, on becoming eligible to join an occupational scheme, to receive in lieu a contribution from the employer to a personal pension scheme with the characteristics listed above*** — the option of not joining an occupational scheme may be worthless if it means the loss of the employer's contribution. To make a personal pension a viable alternative, there needs to be an entitlement for at least some basic level of contribution from the employer. The level of such an entitlement is discussed in para 623;
- k ***unbiased and objective recommendations on the levels of contribution needed for consumers of different ages and with different levels of accumulated savings*** — we consider that consumers should have access to authoritative advice from an unbiased source on the retirement income they should be aiming for and the levels of contributions needed to achieve it. These recommendations should be based on a set of published economic and financial assumptions.

Appendix C contains a more detailed explanation of these requirements. A number of aspects are covered in more detail in the following pages.

- 614 If a personal pension satisfying these requirements were available and suitably regulated, it would represent not only a means of overcoming the consumer detriment in DC pensions, it would also provide, over time, a solution to the early-leaver problem inherent in DB schemes. We refer to such a product as a **Designated Personal Pension** or **DPP**.
- 615 The features we identify for a DPP are inter-related and mutually dependent. Many existing products have some of them but no currently available product has them all. DPPs are unlikely to emerge unless a suitable regulatory environment is made available for them. In particular, if gearing is to be used to regulate risk, and if economies of scale are to be captured, a differently structured product is needed from the free-standing portable pension developed by insurance companies and others for the United Kingdom market.
- 616 The necessary economies of scale could be secured as a by-product of compulsion. Given some tax incentives and recognition of a favoured status in respect of employers' contributions, it should not prove necessary to increase the level of compulsion (see section 6.4). A suitable regulatory and statutory framework for the product must, however, be created.
- 617 Existing personal pension products are sold by promoting more or less illusory investment performance. Competition is largely directed at securing distribution channels which meet the regulator's requirements over sales conduct and disclosure of information at the point of sale. Price competition, that is, competition to supply at the lowest level of expenses, is limited. In consequence, regulation is expensive, both in terms of the regulator's fees and the firm's compliance costs. DPPs are, however, a clearly specified product suitable for the widest possible range of consumers, for whom price competition should dominate. In these circumstances, regulation can be

largely directed to ensuring that the product complies with the regulator's specification. This approval would be similar to that envisaged in the United Kingdom for OEICs and in the USA for simplified retirement plans, known as Savings Incentive Match Plan for Employees (SIMPLE).

- 618 Some providers indicated to our inquiry that, because of the absence of economies of scale and the high cost of regulation, it had been unprofitable to service low-income clients with existing products. However, we are very clearly of the view that economies of scale and the resultant low cost would enable the DPP to be offered to a wide and comprehensive range of consumers. Provision of pensions to this socio-economic group would thus be made practicable.
- 619 Examination of practice in the United Kingdom and elsewhere in the world confirms that a number of ways of providing the DPP are possible and should be encouraged. Employers may choose to provide occupational DC schemes. Industry-based schemes, such as those adopted in Australia, Denmark and the Netherlands, might be offered. With its simplicity of form and regulation, the DPP should be attractive to existing suppliers with direct marketing operations.
- 620 We believe that the time has come to transform the United Kingdom pension scene providing benefits and options available nowhere else in the world. The Building Societies Act 1997 would enable building societies to provide DPPs. Increasingly, trade unions and friendly societies are looking to provide new and more dynamic services for their members. Evidence from overseas, for example from Australia, Denmark, and the Netherlands, suggests that trade unions are willing to diversify their services into pension provision in order to maintain and expand their membership. Financial services are increasingly being used as a method of adding value to being a member of a trade union or a friendly society. As trade unions provide a valuable affinity group for direct marketing operations, DPPs might well be offered as a joint venture with existing financial services providers.

- 621 One further group that may be interested in providing this product, on account of its low cost, would be employers operating small businesses wishing to provide some pensions for their employees. This sector of the economy is increasing rapidly and often pension provision is used as part of a competitive benefit package. By contributing to a sponsored DPP, the employer would be able to establish a more cost-effective arrangement than DB or DC schemes managed in more traditional ways. For the employee of a small business, perhaps anticipating a change of employment in a year or two, a more efficient retirement vehicle would be secured.
- 622 Whoever provides the product, the regulator should require a separately incorporated entity, empowered only to take contributions from employees and their employers, to own and manage a fund which tracks a broadly based equity index such as the FT All Share Index, and to borrow or invest in a limited range of risk-free investments, including index-linked gilts. Open Ended Investment Companies (OEICs), which require a separate authorised depository to hold investments and ensure that they have been invested in compliance with regulatory requirements, might be an ideal vehicle. Should investments by DPPs grow to become a significant proportion of the stock market, random stock selection could replace the use of tracker funds.
- 623 There would be no clear pressures, regulatory or otherwise, encouraging employers to contribute to DC pensions including the DPPs. A generally lower level of employers' contribution into existing DC schemes than into existing DB schemes can be observed. If labour markets were efficient so that these differences are compensated for in remuneration, this would not strictly represent a consumer detriment, but this is far from self-evident. Furthermore the labour market, especially for the weak and disadvantaged, is unlikely to be efficient. Moreover, those working for employers with occupational DB schemes have little prospect of persuading their employer to contribute to a personal pension of the employee's choice. Given the inadequacy of many existing personal pensions products, this acts as a sensible safeguard. The DPP would, however, avoid the shortcomings of existing products. We therefore

recommend that the DPP be made available as an alternative to occupational DB schemes by:

- a weighting the employer's tax allowance for wages and pensions contributions in favour of pensions or, *in extremis*, making the tax allowance for wages dependent on a minimum level of pension contribution by the employer³⁰; and
- b giving every employee, on becoming eligible to join an occupational pension scheme to which the employer contributes, an entitlement to receive in lieu a contribution into a DPP. The appropriate level of that contribution is discussed in Table 6.1.

624 Provided that appropriate assumptions are made about future investment returns, annuity rates and the rate of growth in earnings, the rate of contribution to a DPP to achieve a particular level of pension at a particular retirement date depends on only two factors: the consumer's age and the amount of any prior savings that can be transferred into the pension fund or accumulated separately towards the pension. It is recommended that the regulator should assume responsibility for publishing recommendations on the levels of contributions that should be made and the underlying assumptions. *These contributions relate only to a pension for the employee. Additional contributions would be needed to cover wider benefits such as surviving dependants.*

Table 6.1 illustrates one way in which such recommendations might be published.

³⁰ See Appendix C for an explanation of how tax incentives might operate.

Table 6.1: RECOMMENDED LEVELS OF COMBINED CONTRIBUTION BY EMPLOYER AND EMPLOYEE TO A DESIGNATED PERSONAL PENSION (% OF SALARY)

<i>Accumulated savings as a percentage of salary</i>	<i>Age on entry</i>				
	25	30	40	50	55
0	10.3	13.4	23.4	46.2	74.2
100	5.2	8.4	17.6	38.3	63.2
200	0.1	3.1	11.7	30.3	52.1
300	0.0	0.0	5.9	22.3	41.0
400	0.0	0.0	0.1	14.3	30.0

The above estimates are based on the following assumptions:

<i>Retirement age</i>	<i>65 years</i>
<i>Targeted pension as a proportion of final salary, say</i>	<i>66.7%</i>
<i>Ceilings on levels of contribution for tax purposes</i>	<i>none</i>
<i>Anticipated real rate of return on equities</i>	<i>7.9%</i>
<i>Anticipated standard deviation on annual rate of return on equities</i>	<i>22.3%</i>
<i>Real risk-free rate of return</i>	<i>3.5%</i>
<i>Expenses as a percentage reduction in the rate of return on funds managed, say</i>	<i>0.5%</i>
<i>Acceptable standard deviation of accumulated return on pension fund, say</i>	<i>5%</i>
<i>Annuity rate — gender blind rate, say</i>	<i>12.5</i>
<i>Real rate of growth in earnings</i>	<i>2%</i>
<i>Rate of tax on pension fund income</i>	<i>20%</i>

Sources: Anticipated real rate of return on equities and anticipated standard deviation on the annual rate of return on equities — BZW (1997). Real risk-free rate of return — return on indexed linked gilts. Real rate of growth in earnings — OECD (1997), from data between 1970 and 1995.

The corresponding set of assumptions employed by the regulator should also be published.

- 625 In view of the impracticability in identifying the employer's contribution relating to a specific employee, we are recommending that the re-directed contribution should equal two-thirds of the total recommended contribution into a DPP for a 25-year-old aiming to retire at 65. On the assumptions above, this would be approximately 6.9% (2/3 of 10.3% in table 6.1.). This level would provide the equivalent of a two-thirds final-salary pension for an older individual who had contributed to a scheme with equivalent benefits and who had avoided loss on leaving an occupational final salary scheme early. It therefore represents a fair level of contribution to the employee without penalising the employer or stimulating a mass exodus from occupational schemes.
- 626 Although we have referred to a *Designated Personal Pension* and to the activity of a *Regulator*, we have deliberately avoided suggesting which organisation might undertake this responsibility. Of course, any personal pension plan which receives National Insurance rebates on behalf of employees who have opted out of SERPS requires approval from the Department of Social Security that it is *appropriate*. Pension plans also require confirmation from the Inland Revenue that they qualify for the various tax concessions which are available.
- 627 PIA's Consultation Paper 23 (PIA, 1997b), paragraphs 73 to 78, rejects the suggestion that the PIA should become involved in designating *safe haven* or *kitemarked* products. But consumer representatives found merit in the idea and some pension providers, recognising that it would lighten their regulatory burden, also favoured it. Overall, however, the majority of consultees were against any involvement by the PIA.
- 628 The PIA was concerned that consumers might be induced to purchase products which were unsuitable to their circumstances or be given a false sense of security. They felt

there was a potential for bureaucracy and that arguments might arise between suppliers and the PIA. There could have been a potential restriction in competition and possibly a conflict with EU legislation. The PIA would have had to monitor that products continued to justify a kitemark and could have been criticised if a product subsequently went *sour*. They felt it would have been *inappropriate* to have a differing standard of regulation simply because a product was kitemarked.

629 We are not convinced that these objections would apply to the DPP proposed above. It would be an appropriate investment for the majority of consumers seeking to save for their pensions. Suppliers would continue to be able to provide other, more complex, products. With appropriate regulation directed to requiring suppliers to deliver the DPP as specified, consumers would have a good appreciation of the (relatively modest) level of risk to which they were exposed. Arguments between the regulator and the suppliers as to the nature of the DPP would be avoided as the product would be precisely specified. Competition would be more intense compared with existing products as it would take the form of price competition (that is level of expenses), not competition to secure channels of distribution. Monitoring of continued suitability should be within the capabilities of a competent regulator since, unlike the proposal for kitemarking which was of much wider application, the DPP would be a single product. It seems doubtful whether the PIA's concern about EU legislation would be a problem in practice.

6.4 Alternative solutions to personal pension problems

630 In making our recommendations for the DPP, we have considered not only a number of solutions adopted in other countries but also some alternative forms of providing for retirement income already available in the United Kingdom, or put forward by others as possible changes to the present arrangements.

631 In Chapter 4 we have referred to a number of recent developments in the personal pensions market, where new products have appeared incorporating some of the

elements of the DPP, notably passive funding, phased changes in gearing towards retirement and a charging structure which is both lower and flatter than many other products in that market. The DPP would be more suited to providing the flexibility which the lifestyles of the majority of consumers dictate. We are also aware of suggestions which have been made for various forms of retirement savings accounts. For example, the National Consumer Council in their report *Savings and Investments for Low-income Consumers* (NCC 1997) has advocated that the National Savings Organisation should examine how it could fill gaps emerging in the long-term savings market, through the provision of cheap and efficient pension schemes in order to avoid high front-loaded charges.

- 632 We wish to avoid adding to the existing patchwork of mutually incompatible products. Our recommended specification for the DPP is therefore tightly drawn, but only in terms of characteristics that are:
- a *indivisible* — for example, passive investment and optimal gearing can either be provided or not — there is no opportunity for half measures;
 - b *essential* — each characteristic is directed at eliminating a specific consumer detriment and nothing is specified that does not make a contribution in this direction; and
 - c *inter-related* — specifying a product which has some but not all of the characteristics we identify could increase consumer detriment, not reduce it. For example, a right for employees to transfer employers' contributions from occupational schemes into ordinary portable pensions would be disastrous as it could prompt another round of mis-selling.
- 633 The existing patchwork makes for complications when consumers or their advisers are searching the product market. It becomes extremely difficult to identify products which are appropriate to the needs of particular consumers and which meet those

needs in a cost-effective way. These complications increase the possibility of mis-selling and reduce the competitive pressures which price-conscious consumers are able to bring to bear in the market-place.

634 As we indicated in Chapter 4, the present state of pension provision in the United Kingdom falls far short of ensuring effective competition. Recent requirements for disclosure have resulted in no more than limited competition on price. Much competitive effort is still directed either at securing distribution channels or in making claims of superior product performance which are difficult to substantiate. The drive for product differentiation as a source of competitive advantage is in obvious conflict with the consumer's need to be able to choose the product which offers the best value for money. The consumer is forced to make difficult purchase decisions in the light of a matrix of information, much of which is specious and highly subjective. Furthermore, largely as a result of regulation, there are two incompatible systems running side by side: occupational DB pensions and DC pensions.

635 The DPP represents a way in which effective competition can be introduced and consumer detriment arising from the interaction between the two systems reduced and eventually eliminated. The absence of a suitable regulatory environment to allow such a product to emerge can itself be seen as a barrier to market entry. Once this barrier has been removed, a competitive market should flourish and suppliers from the United Kingdom and elsewhere in the EU can enter. There would be no other barriers to entry. We could therefore argue that the recommendations are pro-competitive.

6.5 Level of contributions: the case for greater compulsion

636 In the United Kingdom, contributions to the basic state pension and to SERPS are compulsory once certain income thresholds have been reached. However, as noted in Chapter 5, some other countries, notably Australia, Chile and Singapore, have a rather greater level of compulsion. These systems have minimum levels of contributions

from the employee and employer, although Chile has contributions from the employee only. For the governments concerned, it provides an important method of quickly increasing pensions savings and provision for retirement. Further, it harmonises the treatment of certain minority groups and of women, who often do not have the opportunity to participate in a voluntary scheme. Compulsion can contribute to overall savings, with Singapore, for example, having the highest saving rate in the world.

- 637 However, tax incentives are an alternative to compulsion. These can be provided to employers and to individuals to establish retirement vehicles; Canada and the United States have adopted this method. Ultimately, compulsion is seen as a method to increase the coverage of the workforce. In the United States only 50% of the workforce is covered, compared with Australia 81%, Chile 62% and Singapore 66%. However, greater compulsion does not *necessarily* lead to a very high level of penetration of pension schemes. For example, in Chile, only 56% of members in 1995 were employed contributors. Furthermore, countries such as Denmark and the Netherlands, with quasi-compulsory systems, have achieved coverages of over 80%.
- 638 If pension provision above some very basic level is left to individual choice, there may be a cost in creating the necessary tax incentives needed. On the other hand, it can be argued that it is inequitable and inefficient to tax income shifted to pension provision in retirement at more than one point and that no incentive or subsidy should be involved. But we make no recommendation about increasing the level of compulsory contributions in this report. However, we note a widespread concern that provision is inadequate. Although 24% of the workforce makes some form of contribution to a personal pension, doubts have been raised whether these contributions can be sufficient to generate an adequate pension and whether existing personal pensions products are cost-effective at lower levels of contribution, particularly in view of the level and structure of charges levied on many pension plans.

639 For many low-income consumers, it may be perfectly rational for them not to provide for a second-tier pension at all, considering what might be provided by the basic state pension. Consumers may be content after all to rely on the existence of means-tested benefits to make up any shortfall. Compulsory retirement saving may not solve this problem unless these savings are ringfenced and cannot be cashed in immediately on retirement, has been introduced in Australia. Moreover, compulsory contributions cannot solve problems which have their root in low levels of pre-retirement income. Indeed they may be seen as a tax on jobs, which could reduce employment in the formal economy, which is outside the scope of this report.

6.6 Non-core recommendations

640 In the remainder of this chapter we cover problems not addressed by the DPP.

6.6.1 *Rules governing the tax deductibility of pension contributions*

641 In section 4.4.2 on tax treatment we reported the views of a number of providers that the rules governing the deductibility of consumers' pension contributions for tax purposes were unnecessarily complicated and were inhibiting consumers from making adequate provision. We identified the main problem as the essentially different treatments of personal and occupational pensions.

642 We recommend that the differences between these treatments should, as far as practicable, be eliminated and the limits on the maximum levels of contributions deductible for tax purposes should apply to the total contributions to personal and occupational pensions and to DPPs.

6.6.2 *Regulation of other pension products*

643 In view of the fact that the majority of purchasers of annual premium pension policies do not seek independent advice, we think that greater attention should be paid to the

means by which this group selects products. This would involve examining the influences of advertising, defined widely so as to encompass all material which is not an illustration, and other forms of consumer information, to ensure that consumers are being given useful information. We should be concerned if the various health warnings which are given ostensibly to protect consumers were to serve more to protect suppliers. The same may be true of other compliance activity. We recommend that more attention is given to ensuring product advertising, extending to all non-client specific information, allows consumers to make rational choices between competing products.

644 Recommendations of product suitability *must* take into account the risks faced by most consumers, that they may need to vary or to terminate the pension contract early. In the case of a pension plan, this means before the earliest retirement date. We are concerned that, despite the widespread recognition of the need for product flexibility, inflexible products remain on the market and are still being recommended to consumers by company salesmen and intermediaries. We question whether, in view of the likely employment profiles of most of the working population, it is ever justified to sell a pension plan on the basis of continuous employment.

6.6.3 Redress

645 We are aware of confusion on the part of consumers as a result of the multiplicity of regulators involved in occupational and personal pensions. For consumers the most obvious concern is the lack of a single contact point for all pension problems other than the state pension. We recognise that, with different providers involved in occupational as distinct from personal pensions, it may be difficult to achieve a single regulator. Indeed were personal pension providers to become subject to a different regulator for their pensions business than for other financial services, there could be confusion of a different nature. We recommend provision of a single initial contact point for all pension problems other than those relating to the state pension.

6.6.4 Consumer information

646 Consumers need access to a source able to deliver unbiased information on *all types* of pension, in particular to enable them to make at least a preliminary assessment of the adequacy or otherwise of their own pension arrangements. To complement this, product providers should be required to provide consumers with an annual statement of the projected maturity value *expressed in current prices*. Where contributions are fixed in money terms, for example £100 per month as opposed to 10% of earnings, it will be necessary to assume that future contributions will be indexed to prices and to make clear to consumers the impact of the declining value of money. Although nearly one-quarter of the workforce makes some contribution to a personal pension, plan holders need to be kept informed as to whether their contributions are likely to generate a pension which will be adequate and in line with their expectations.

6.6.5 Annuities

646 No consumer of any personal pension product should be tied to their pension plan provider when it comes to purchasing an annuity. They all should be able to exercise the open market option *without penalty*.

6.6.6 Unmarried partners

647 Some occupational pension schemes provide for unmarried (including same sex) partners' benefits, but many schemes do not. We would like to see a wider use of trustees' discretion in this area, although it may be difficult to formulate precise scheme rules.

GLOSSARY OF TERMS

Abbreviations used

DSS	Department of Social Security
FA	Finance Act
FSA 86	Financial Services Act 1986
ICTA 88	Income and Corporation Taxes Act 1988
JOM	Joint Office Memorandum
OPB	Occupational Pensions Board
PSA 93	Pension Schemes Act 1993
PA 95	Pensions Act 1995
PSO	Pension Schemes Office
S	Section (of an Act)
SSA 73	Social Security Act 1973
SSA 86	Social Security Act 1986
SSA 90	Social Security Act 1990
SSAP 24	Statement of Standard Accounting Practice 24
SSPA 75	Social Security Pensions Act 1975

Definitions

ACCRUAL RATE: The rate at which pension benefit builds up as pensionable service is completed in a **defined benefit scheme**.

ACCRUED BENEFITS: The benefits for service up to a given point in time, whether **vested rights** or not. They may be calculated in relation to current earnings or projected earnings.

ACCRUED BENEFITS VALUATION METHOD: A **valuation method** in which the **actuarial liability** at the valuation date relates to:

- (a) the benefits for current and deferred pensioners and their dependants, allowing where appropriate for future increases, *and*
- (b) the **accrued benefits** for members in service on the valuation date.

A recommended contribution rate may allow for earnings and service projected to the end of a specified period (the control period). In that case, allowance may be made for replacing members assumed to leave during that period.

ACCRUED RIGHTS: A term sometimes used to describe **accrued benefits**.

The term is given specific definitions for the purposes of preservation, contracting-out and the Disclosure Regulations PSA 93 and PA 95.

ACTIVE MEMBER: A member of a pension scheme who is at present accruing benefits under that scheme in respect of current service.

ACTUARIAL ASSUMPTIONS: The set of assumptions as to rates of return, inflation, increase in earnings, mortality etc., used by the actuary in an actuarial valuation or other actuarial calculations.

ACTUARIAL BASIS: A term commonly used to mean valuation method and/or actuarial assumptions.

ACTUARIAL LIABILITY: The value placed on the liability of a pension fund for outgoings due after the **valuation date**.

*See **prospective benefits valuation method** and **accrued benefits valuation method**.*

ACTUARIAL VALUATION: An investigation by an actuary into the ability of a pension scheme to meet its liabilities. This is usually to assess the **funding level** and a recommended contribution rate based on comparing the **actuarial value of assets** and the **actuarial liability**.

ACTUARIAL VALUE OF ASSETS: The value placed on the assets by the actuary. This may be market value, **present value** of estimated income and proceeds of sales or redemption, or some other value.

ACTUARY: An adviser on financial questions involving probabilities relating to mortality and other contingencies.

For statutory purposes in the United Kingdom, the term automatically includes Fellows of the Institute of Actuaries and of the Faculty of Actuaries. Persons with other actuarial qualifications can be approved by the Secretary of State for a specific purpose of the legislation.

ADDED YEARS: The provision of extra pension benefit by reference to an additional period of pensionable service in a **defined benefit scheme**, arising from the receipt of a transfer payment, the paying of additional voluntary contributions or by way of **augmentation**.

ADDITIONAL PENSION: The earnings-related element of the state pension, over and above the basic pension.

ADDITIONAL VOLUNTARY CONTRIBUTIONS (AVCs): Contributions over and above a member's normal contributions, if any, which the member elects to pay to the scheme in order to secure additional benefits, either **added years** or **money purchase**. *See also free-standing additional voluntary contributions.*

ANNUITY: A series of payments, which may be subject to increases, made at stated intervals until a particular event occurs. This event is most commonly the end of a specified period or the death of the person receiving the annuity.

APPROPRIATE PERSONAL PENSION SCHEME (APPS): A personal pension scheme or free-standing AVC scheme granted an appropriate scheme certificate by the OPB, enabling its members to use it for the purpose of contracting-out.

APPROPRIATE SCHEME CERTIFICATE: The certificate issued by the OPB to a personal pension scheme or to a free-standing AVC scheme confirming that the scheme satisfies the conditions required for contracting-out.

APPROVED SCHEME: A retirement benefits scheme which is approved by the Inland Revenue under Chapter I of Part XIV of ICTA 88, including a free-standing AVC scheme. The term may also be used to describe a personal pension scheme approved under Chapter IV of that Part. *See also exempt approved scheme.*

ATTAINED AGE METHOD: A prospective benefit valuation method in which the **actuarial liability** makes allowance for projected earnings. The **standard contribution rate** is that necessary to cover the cost of all benefits which will accrue to existing members after the **valuation date** by reference to total earnings throughout their future working lifetime projected to the dates on which benefits become payable.

AUGMENTATION: The provision of additional benefits in respect of particular members, normally where the cost is borne by the pension scheme and/or employer.

AVERAGE REMAINING SERVICE LIFE: As defined by **SSAP 24**, a weighted average of the expected future service of the current members of the scheme up to their normal pension dates or expected dates of earlier withdrawal or death in service.

BASIC STATE PENSION: The single person's flat rate state pension paid to all who have

met the minimum National Insurance contribution requirements. A widow, widower or, in some cases, a married woman may also claim a basic state pension on the contribution record of his or her spouse.

BUY-OUT: The purchase by pension scheme trustees of an insurance policy or bond in the name of a member or other beneficiary, in lieu of entitlement to benefit from the scheme, following termination of the member's pensionable service.

CAREER AVERAGE SCHEME: A scheme where the benefit for each year of membership is related to the pensionable earnings for that year.

CASH EQUIVALENT: The amount which a member of a pension scheme may, under Part IV of PSA 93, require to be applied as a transfer payment to another permitted pension scheme or to a buy-out policy.

CLASS A MEMBERS: Members of schemes established on or after 14 March 1989 and all new members of earlier schemes joining on or after 1 June 1989.

COMPULSORY PURCHASE ANNUITY (CPA): An annuity which must be purchased at retirement for a member retiring from service.

CONTRACT-OUT: To use a statutory arrangement under which members of a pension scheme which meets certain conditions obtain rights under it in place of part of their earnings-related state scheme benefits. Contributions to the state scheme are reduced in respect of such employees or, in the case of a personal pension scheme or free-standing AVC scheme, partly repaid to the scheme.

CONTRACTED-OUT MONEY PURCHASE SCHEME (COMPS): A **money purchase scheme** which is contracted-out, usually by reference to the provision of **protected rights**.

A money purchase scheme can also be contracted-out by reference to the provision of a GMP, but would then be viewed by the OPB as a COSRS, not as a COMPS.

CONTRACTED-OUT PROTECTED RIGHTS PREMIUM (COPRP): A type of **state scheme premium** which may (until 5 April 1997) be paid by a money purchase scheme which is contracted-out by reference to the provision of **protected rights**, in order to purchase benefits under the state scheme for a member, if the scheme ceases to be contracted-out.

CONTRACTED-OUT REBATE: 1. The amount by which the employers' and employees' National Insurance contributions are reduced in respect of employees who are contracted-out by virtue of their membership of an occupational pension scheme.

2. The equivalent payment made by the DSS as **minimum contributions** to a personal pension scheme.

CONTRACTED-OUT SALARY RELATED SCHEME (COSRS): An occupational pension scheme which is contracted-out by reference to the provision of a **GMP**.

CONTRIBUTION HOLIDAY: A period during which employers' and/or members' contributions are temporarily suspended, normally when the fund is in surplus. The term is sometimes used loosely when contributions continue to be paid but at a reduced rate.

CONTRIBUTORY SCHEME: A scheme which requires contributions from active members unless such contributions are temporarily suspended during a **contribution holiday**.

CURRENT UNIT METHOD: An accrued benefits valuation in which the **actuarial**

liability is based on earnings at the valuation date. The standard contribution rate is that necessary to cover the cost of benefits which will accrue in the year following the valuation date by reference to earnings projected to the end of that year.

DEFERRED ANNUITY: An annuity which commences from a future date.

DEFERRED PENSIONER: A person entitled to **preserved benefits**. Sometimes referred to as a deferred member.

DEFINED BENEFIT SCHEME: A pension scheme in which the rules specify the benefits to be paid, and the scheme is financed accordingly.

DEFINED CONTRIBUTION SCHEME: An alternative term for a **money purchase scheme**.

DEPENDANT: A person who is financially dependent on a member or pensioner or was so at the time of death or retirement of the member or pensioner.

For PSO purposes, a spouse qualifies automatically as a dependant and a child of the member or pensioner may always be regarded as a dependant until attaining the age of 18 or ceasing to receive full-time educational or vocational training, if later.

DISCRETIONARY INCREASE: An increase in a pension in payment or in a preserved benefit arising other than from a system of indexation. Such an increase may be of a regular or an *ad hoc* nature.

EARLY LEAVER: A person who ceases to be an active member of a pension scheme, other than on death, without being granted an immediate retirement benefit.

EARLY RETIREMENT: The retirement of a member with immediate retirement benefit, before normal pension date.

*The benefit may be reduced because of early payment. See also **ill-health early retirement**.*

EARNINGS CAP: Limitation introduced by FA 1989 on the amount of remuneration on which benefits and contributions of a **class A member** may be based. This was set at £60,000 for tax year 1989/90, and is increased annually in line with prices (although no such increase was made for 1993/94). The same limitation applies to **net relevant earnings** for all members of personal pension schemes.

ENTRY AGE METHOD: A prospective benefits valuation method in which the new entrant contribution rate is taken as the standard contribution rate.

EQUAL ACCESS: Identical entry conditions for each sex. This is required by PA 95.

EXEMPT APPROVED SCHEME: An approved scheme other than a personal pension scheme which is established under irrevocable trusts (or exceptionally, subject to formal direction under S.592(1)(b) of ICTA 88) thus giving rise to tax reliefs specified in ICTA 88.

FINAL PENSIONABLE EARNINGS/PAY/SALARY: The pensionable earnings at or near retirement or leaving service, on which the pension is calculated in a **final salary scheme**. The earnings may be based on the average over a number of consecutive years prior to retirement.

FINAL SALARY SCHEME: A pension scheme where the benefit is calculated by reference to the member's pensionable earnings for a period ending at or before normal pension date or leaving service, usually also based on pensionable service.

FIXED REVALUATION RATE: The rate by which a contracted-out scheme may revalue **GMP** between termination of contracted-out employment and age 65 (male)/60 (female) as one of the alternatives to applying **Section 148 Orders** (previously Section 21 Orders).

FREE-STANDING AVC SCHEME: A scheme established by a **pension provider** to accept free-standing additional voluntary contributions.

FREE-STANDING ADDITIONAL VOLUNTARY CONTRIBUTIONS (FSAVCs):

Contributions to a pension contract separate from a company pension scheme effected by an active member of that scheme. Benefits are secured with a **pension provider** by contributions from the member only.

FUNDING LEVEL: The relationship at a specified date between the **actuarial value of assets** and the **actuarial liability**.

The funding level may be calculated separately in respect of different categories of liability, for example pensions in payment and AVCs.

GRADUATED PENSION SCHEME: The state earnings related scheme which commenced on 3 April 1961 and terminated on 5 April 1975.

GROUP PERSONAL PENSION SCHEME: An arrangement made for the employees of a particular employer to participate in a personal pension scheme on a grouped basis. This is not a separate scheme; merely a collecting arrangement.

GUARANTEED MINIMUM PENSION (GMP): The minimum pension which an occupational pension scheme must provide for contracted-out service before 6 April 1997 as one of the conditions of contracting-out (unless it is contracted-out through the provision of **protected rights**).

For an employee contracted-out under any occupational or personal pension scheme an amount equal to the GMP is deducted from his/her benefits under the state scheme.

ILL-HEALTH EARLY RETIREMENT: Retirement on medical grounds before normal pension date. The benefit may exceed that payable on early retirement in other circumstances.

IMMEDIATE ANNUITY: An annuity which commences immediately or shortly after its purchase.

INLAND REVENUE LIMITS RULE: A rule, which must be included in the rules of an approved occupational pension scheme, specifying the maximum approvable benefits for members.

INTEGRATION: The design of pension scheme benefits to take into account all or part of the state scheme benefits which the member is deemed to receive.

One form of integration involves a state pension disregard.

LATE RETIREMENT: The retirement of a member, with immediate retirement benefit, after **normal pension date**.

The benefit may be increased because of late payment.

LIMITED PRICE INDEXATION (LPI): The requirement to increase pensions, once in payment, by 5% per annum or RPI if less.

LIMITED REVALUATION PREMIUM (LRP): A type of **state scheme premium** which may (until 5 April 1997) be paid when a member of a scheme contracted-out by means of the **GMP** test ceases to be in contracted-out employment. In return for this premium any subsequent revaluation of **GMP** up to state pensionable age above a specified level (currently 5% per annum) would be provided by the state scheme instead of under the occupational scheme. This is one of the alternatives to applying **Section 148 Orders** (previously Section 21 Orders).

LOWER EARNINGS LIMIT (LEL): The minimum amount, approximately equivalent to the **basic pension**, which must be earned in any pay period before National Insurance contributions are payable.

MEMBER: A person who has been admitted to membership of a pension scheme and is entitled to benefit under the scheme. Sometimes narrowly used to refer only to an **active member**.

For some statutory purposes the term 'members' may include employees who are prospective members.

MINIMUM CASH EQUIVALENT: The liability which would be calculated in accordance with the actuarial guidance note which is concerned with the calculation of liabilities under the **minimum funding requirement**. The assumptions in this guidance note may be appropriately modified in any case where the cash equivalent calculation is made, as is usually the case, on an individual basis.

MINIMUM CONTRIBUTIONS: 1. Contributions payable to a personal pension scheme or to a free-standing AVC scheme by the DSS in respect of a member who has elected to contract out. The contributions consist of a partial rebate of National Insurance contributions, together with the incentive payments where applicable.

2. The term could also be used in respect of any minimum amount which a member is required to contribute in order to be a member of an occupational or personal pension scheme, or in order to make additional voluntary contributions.

MINIMUM CONTRIBUTIONS SCHEME: A rebate-only personal pension scheme or a contracted-out money purchase scheme to which only payments to the same level as the rebate are made. *See **rebate-only personal pension scheme**.*

MINIMUM FUNDING REQUIREMENT: The requirement under PA 95 that, if the value of a scheme's assets is less than its liabilities, additional contributions must be paid by the employer to restore the funding level. The calculation of the assets and liabilities is determined by the scheme actuary on a prescribed basis.

MINIMUM PAYMENTS: The minimum amount which an employer must pay into a money purchase scheme which is contracted out through the provision of **protected rights**. This amount corresponds to the reduction in National Insurance contributions which applies in respect of employees who are contracted-out.

MONEY PURCHASE: The determination of an individual member's benefits by reference to contributions paid into the scheme in respect of that member, usually increased by an amount based on the investment return on those contributions.

MONEY PURCHASE CONTRACTED-OUT SCHEME: The term used in PSA 93 to describe a **money purchase scheme** which is contracted out through the provision of **protected rights**.

MONEY PURCHASE SCHEME: A scheme where the benefits are determined on a **money purchase** basis.

MONEY PURCHASE UNDERPIN: A minimum benefit provided in a defined benefit scheme, calculated on a **money purchase** basis.

NET RELEVANT EARNINGS: Earnings from self-employment or non-pensionable employment after deducting losses and certain business charges on income, used in determining the maximum contributions to a retirement annuity or **personal pension scheme** which qualify for tax relief.

With effect from tax year 1989/90 net relevant earnings have been restricted by the **earnings cap**. The maximum contribution below the cap is currently 17.5% of net relevant earnings with higher percentage limits for persons aged over 35, if contributing to a personal pension scheme, or 50, if contributing to a retirement annuity.

NON-CONTRIBUTORY SCHEME: A pension scheme which does not require contributions from its active members.

*Not to be confused with a contributory scheme where contributions are suspended during a **contribution holiday**.*

NORMAL PENSION AGE (NPA): The age by reference to which the **normal pension date** is determined.

PSA 93 defines the term for the purposes of the preservation requirements as the earliest age at which a member is entitled as of right to receive unreduced benefits on retirement.

NORMAL PENSION DATE (NPD): The date at which a member of a pension scheme normally becomes entitled to receive his/her retirement benefits.

NORMAL RETIREMENT AGE (NRA): For employment purposes the age at which employees holding a particular position normally retire from service. This is usually (but not always) the same as **normal pension age**.

NORMAL RETIREMENT DATE (NRD): Commonly used with the same meaning as **normal pension date**.

OCCUPATIONAL PENSION SCHEME: An arrangement subject to the PSA 33, organised by an employer or on behalf of a group of employers to provide pensions and/or other benefits for or in respect of one or more employees on leaving service or on death or retirement.

A more detailed definition is to be found in S.1 PSA 93.

OCCUPATIONAL PENSIONS ADVISORY SERVICE (OPAS): A grant-aided body providing free help and advice to members of the public who have problems concerning their rights under either occupational or personal pension schemes. Its independent service is provided by a network of local volunteer advisers.

OCCUPATIONAL PENSIONS BOARD (OPB): A statutory body set up under SSA 73, with functions derived from that Act and PSA 93. The Board is responsible for issuing **contracting-out** or **appropriate scheme certificates** for pension schemes which meet the statutory requirements, for supervising those schemes to ensure that **GMPs** and **protected rights** are secure and for ensuring that **equal access** and **preservation** requirements are satisfied. The Board is required to report to the Secretary of State and to comment on draft regulations affecting occupational pension schemes.

The Board can make grants to persons or organisations who give advice or assistance in connection with occupational or personal pensions activities, and it has been appointed as the Registrar of Occupational and Personal Pension Schemes. The Board can, on application, authorise or direct occupational or personal pension schemes to be modified or wound-up, for example in cases where the power to do so does not exist in the **trust deed**. The Board is to be abolished with effect from 6 April 1997.

OCCUPATIONAL PENSIONS REGULATORY AUTHORITY (OPRA): The

Authority which is to take over some of the functions of the OPB, consisting of not less than seven members appointed by the Secretary of State. The Authority will have wider powers than the OPB in the regulation of schemes.

OPTING-OUT: A decision by an employee to leave or not to join an occupational pension scheme of the employer.

This was made a statutory right from 6 April 1988 under SSA 86.

PAY-AS-YOU-GO (PAYG): An arrangement under which benefits are paid out of revenue and no funding is made for future liabilities.

The state scheme is pay-as-you-go.

PENSION COST: Under **SSAP 24** the cost of providing pensions, which is charged to the profit and loss account of the employer over the expected service lives or **average remaining service life** of employees in the scheme. The amount may be more or less than the actual payments made to the pension scheme.

PENSION INCREASE: An increase in a pension in payment.

*Such an increase may arise as a result of indexation, or may be a **discretionary increase**. In practice the term may also embrace **revaluation** of preserved benefits.*

PENSION PROVIDER: A body by which a personal pension scheme or a free-standing AVC scheme must be established in order to be approved by the Inland Revenue.

PENSION SCHEME: An occupational pension scheme, a personal pension scheme or a free-standing AVC scheme.

PENSIONABLE AGE: The term used in legislation to denote **state pensionable age**.

PENSIONABLE EARNINGS: The earnings on which benefits and/or contributions are calculated.

One or more elements of earnings (for example overtime) may be excluded, and/or there may be a state pension disregard.

PENSIONS COMPENSATION BOARD: A body corporate, of not less than three members, appointed by the Secretary of State to oversee the running of the pensions compensation scheme set up under PA 95.

PENSIONS OMBUDSMAN: A post created under SSA 90 to deal with complaints against, and disputes with, occupational and personal pension schemes. The person appointed is completely independent and acts as an impartial adjudicator.

PERMITTED MAXIMUM: The term used in legislation to describe the earnings cap.

PERSONAL PENSION ARRANGEMENT: An individual contract made under a **personal pension scheme**.

PERSONAL PENSION SCHEME (PPS): Usually used to mean a scheme approved under Chapter IV of Part XIV of ICTA 88, under which individuals who are self-employed or in non-pensionable employment, not in an occupational scheme, make pension provision usually by means of unit trust or deposit account contracts.

PSA 93 uses a slightly different definition which excludes a scheme open only to the self-employed but also includes a free-standing AVC scheme.

PRESENT VALUE: The total of the amounts of a series of future payments or receipts discounted at interest to a current date, usually the **valuation date**, and allowing for the probabilities of payment or receipt.

PRESERVATION: The granting by a scheme of **preserved benefits**, in particular in accordance with minimum requirements specified by PSA 93.

PRESERVED BENEFITS: Benefits arising on an individual ceasing to be an **active member** of a pension scheme, payable at a later date.

PROJECTED ACCRUED BENEFIT METHOD: A valuation method which compares the accrued **actuarial liability** with the value placed on the scheme assets for valuation purposes. The **actuarial liability** is based on service up to the **valuation date** and makes allowance for projected earnings. Used only in the context of the Pension Scheme Surpluses (Valuation) Regulations 1987 (SI 1987 No 412).

PROJECTED UNIT METHOD: An **accrued benefits valuation method** in which the **actuarial liability** makes allowance for projected earnings. The **standard contribution rate** is that necessary to cover the cost of all benefits which will accrue in the year following the **valuation date** by reference to earnings projected to the dates on which benefits become payable.

This is known in the US as projected unit credit method.

PROSPECTIVE BENEFITS VALUATION METHOD: A **valuation method** in which the **actuarial liability** is the **present value** of:

- (a) the benefits for current and deferred pensioners and their dependants, allowing where appropriate for future pension increases; *and*

- (b) the benefits which active members will receive in respect of both past and future service, allowing for projected earnings up to their assumed exit dates and, where appropriate, for pension increases thereafter;

*less the **present value** of future contributions payable in respect of current members at the **standard contribution rate**.*

PROTECTED RIGHTS: The benefits under an appropriate personal pension scheme or a money purchase contracted-out scheme, deriving respectively from at least the **minimum contributions** or **minimum payments**, which are provided in a specified form as a necessary condition for contracting out.

The term may also be used in a general sense to describe rights given to certain members on change of rules or change of pension scheme which are superior to those of a new entrant.

PROTECTED RIGHTS ANNUITY: The pension provided from **protected rights** under an appropriate personal pension scheme or a money purchase contracted-out scheme by purchase from an insurance company or friendly society.

PUBLIC SECTOR PENSION SCHEME: An occupational pension scheme for employees of central or local government, a nationalised industry or other statutory body.

PUBLIC SECTOR TRANSFER ARRANGEMENTS: The arrangements of the **transfer club** to which certain schemes mainly in the public sector belong.

PUBLIC SERVICE PENSION SCHEME: A **public sector pension scheme** the particulars of which are statutorily defined, for example the schemes for the civil service, local authorities, the police and fire services.

QUALIFYING SERVICE: The term used in PSA 93 denoting the service to be taken into account to entitle a member to **short service benefit**. The current condition is for at least two years' qualifying service. If a transfer has been received from a personal pension scheme, the member is treated immediately as being entitled to short service benefits.

REBATE-ONLY PERSONAL PENSION (ROPP): An **appropriate personal pension scheme** which is funded solely by rebates of National Insurance contributions payable by the DSS to the **pension provider** in due course as a result of an election to contract out.

REVALUATION: 1. The application, particularly to **preserved benefits**, of indexation, or the awarding of **discretionary increases**. PSA 93 imposes revaluation in the calculation of **GMP** and of preserved benefits other than **GMP**.

2. An accounting term for the revision of the carrying value of an asset, usually having regard to its market value.

REVALUED EARNINGS: A term used to describe index-linking of earnings for calculating benefits.

REVALUED EARNINGS SCHEME: A pension scheme where the benefits are based on earnings for a given period revalued in direct proportion to a specified index of prices or earnings.

A notable example is the earnings-related component of the state pension scheme.

SECTION 148 ORDERS: Previously Section 21 Orders. The Orders issued each year in accordance with S.148 of the Social Security Administration Act 1992 (previously S.21 of SSPA 75) specifying the rates of increase to be applied to the earnings factors on

which the additional pension and **GMPs** are based. This revaluation is based on the increase in national average earnings.

*In respect of early leavers, see also **fixed revaluation rate and limited revaluation premium**.*

SECTION 32 POLICY: The term used widely to describe an insurance policy used for **buy-out** purposes where the member chooses the insurance company.

The term came into use as a result of S.32 FA 81, which gave prominence to the possibility of effecting such policies (now contained in S.591 ICTA 88).

SELF-INVESTED PERSONAL PENSION (SIPP): A personal pension under which the member has freedom to control investments.

The requirements governing self-invested personal pensions are set out in JOM 101.

SELF-REGULATING ORGANISATION (SRO): A body authorised by the Securities and Investments Board to regulate and supervise investment business or financial service activities.

SHORT SERVICE BENEFIT (SSB): The benefit which must be provided for an **early leaver** under the preservation requirement of PSA 93.

STANDARD CONTRIBUTION RATE: The contribution rate required by a particular valuation method before taking into account any differences between the **actuarial liability** and the **actuarial value of assets**.

STATE EARNINGS RELATED PENSION SCHEME (SERPS): A term widely used to describe the additional pension provisions of the state pension scheme.

STATE PENSIONABLE AGE: The date from which pensions are normally payable by the state scheme, being the 65th birthday for men and the 60th birthday for women born before 6 April 1950.

State pensionable age is being equalised at 65 for men and women. The change is being phased in over 10 years, starting in 2010.

STATE SCHEME PREMIUM: A payment made to the state scheme in certain circumstances. The categories of state scheme premium are: accrued rights premium, contracted-out protected rights premium, contribution equivalent premium, limited revaluation premium, pensioners's rights premium, personal pension protected rights premium, transfer premium.

STATEMENT OF STANDARD ACCOUNTING PRACTICE 24 (SSAP 24): The accounting standard which deals with the accounting for and the disclosure of pension costs and commitments in the financial statements of employers in respect of arrangements for the provision of retirement benefits for their employees.

TRANSFER CLUB: A group of employers and occupational pension schemes which has agreed to a common basis of **transfer payments**.

TRANSFER CREDIT: Under PSA 93 the benefit purchased by a **transfer payment**. The effect on **qualifying service** is to link that part of the previous pensionable service which gave rise to the transfer payment to the service in the receiving scheme.

TRANSFER PAYMENT: A payment made from a pension scheme to another pension scheme, or to an insurance company to purchase a **buy-out** policy, in lieu of benefits which have accrued to the member or members concerned, to enable the receiving arrangement to provide alternative benefits.

*The **transfer payment** may be made in accordance with the scheme rules or in exercise of a member's statutory rights under PSA 93.*

TRANSFER VALUE: The amount of the **transfer payment**, usually based on actuarial advice, which the trustees are prepared to make to another pension scheme or an insurance company.

TRUST DEED: A legal document, executed in the form of a deed, which establishes, regulates or amends a trust.

TRUSTEE: An individual or company appointed to carry out the purpose of a trust in accordance with the provisions of the trust instrument and general principles of trust law.

UNAPPROVED SCHEME: An occupational pension scheme which is not designed for approval by the Inland Revenue. Following FA 1989 an employer may provide benefits for an employee under an unapproved scheme without those benefits being taken into account in calculating maximum approval benefits under an **approved scheme**.

Such a scheme may be used to provide benefits on earnings in excess of the **earnings cap**. The Inland Revenue has published guidance notes on the tax treatment of unapproved schemes.

The term is sometimes also used to refer to a scheme which is awaiting approval.

UPPER BAND EARNINGS: Earnings between the **lower earnings limit** and the **upper earnings limit** on which the **additional pension** is calculated.

*Also used in the calculation of a **GMP**.*

UPPER EARNINGS LIMIT (UEL): The maximum amount of earnings (equal to approximately seven times the **lower earnings limited**) on which National Insurance contributions are payable by employees.

VALUATION DATE: The date by reference to which the **actuarial valuation** is carried out.

VALUATION METHOD: An approach used by the actuary in an **actuarial valuation**.

The main categories of approach are described under **accrued benefits valuation method** and **prospective benefits valuation method**. A variety of methods can be used but the method or methods used in a particular case should be adequately described in the actuarial report.

VESTED RIGHTS: (a) For active members, benefits to which they would unconditionally be entitled on leaving service;
(b) for deferred pensioners, their preserved benefits;
(c) for pensioners, pensions to which they are entitled;
including where appropriate the related benefits for spouses or other dependants.

WAITING PERIOD: A period of service specified in the rules which an employee must serve before being entitled to join the pension scheme or to receive a particular benefit.

*In some pension schemes the waiting period before being entitled to join may automatically count as pensionable service. Not to be confused with **qualifying service**.*

BIBLIOGRAPHY

Alexander Clay (1997), *The Shape of Things to Come? A Survey Report on Proposals for the Reform of Occupational Pensions in the United Kingdom*, April (London)

Annuity Bureau Ltd (1997), *You and Your Annuity. How Can I Get the Best Retirement Income from My Pension?* (London)

Association of British Insurers (1996), *Insurance Statistics Year Book 1985—1995* (London)

Association of British Insurers (1997), *Insurance Trends January 1997* (London)

Association of Consulting Actuaries (1996), *The Changing Face of United Kingdom Occupational Pensions in Smaller Companies*, September (London)

Atkinson, A (1996), *Growth and the Welfare State*, New Economy, Number 182 (London: The Dryden Press)

Bacon and Woodrow (1996a), *Pensions Pocket Book 1997* (Henley-on-Thames: NTC Publications Limited)

Bacon and Woodrow (1996b), *Personal Pensions Unit-linked Survey 1996/97* (St Albans)

Banks, J., Dilnot, A. and Low, H. (1994), *The Distribution of Wealth in the UK*, Institute for Fiscal Studies, Commentary Number 45, September (London)

Banks, J. and Tanner, S. (1996), *Savings and Wealth in the UK: Evidence from Micro-Data*, Fiscal Studies, Volume 17, Number 2, pp.37—64 (London: Institute for Fiscal Studies)

Beveridge, Sir W. (1942), *Inter-Departmental Committee on Social Insurance and Allied Services Report*, Cmnd 5404 (London: HMSO)

Blake, D. (1995), *Pension Schemes and Pension Funds in the United Kingdom* (Oxford: Clarendon Press)

Blake, D., Lehmann, B. and Timmermann, A. (1997), *Performance Measurement Using Multiple Asset Class Portfolio Data, A Study of UK Pension Funds*, Discussion Paper PI-9704, April (London: The Pensions Institute)

Booth, A., Francesconi M. and Garcia-Serrano C. (1996), *Job Tenure: Does History Matter?*, Technical Report, University of Essex, Programme in Labour Market Dynamics in a Changing Environment, September

BPP Publishing Ltd (1996a), *Advanced Financial Planning Certificate: A Study Text for G60: Pensions*, June (London)

BPP Publishing Ltd (1996b), *Financial Planning Certificate: A Study Text for FP2: Protection, Savings and Investment Products*, May (London)

British Social Attitudes Survey (1996), *13th Report*, November (Aldershot: Dartmouth Publishing Company)

Burgess, S. and H. Rees (1994), *Lifetime Jobs and Transient Jobs: Job Tenure in Britain 1975—91*, Centre for Economic Policy Research, December

Business Strategies Ltd (1996), *Labour Market Flexibility and Financial Services, Final Report*, 9 February (London)

Butler, E. (1997), *The Great Escape: Financing the Transition to Funded Pensions* (London: Adam Smith Institute)

Butler, E., M. Pirie and M. Young (1997), *Beyond Pensions Plus: Developing the Fortune Account* (London: Adam Smith Institute)

- BZW Ltd (1997), *The BZW Equity-Gilt Study, United Kingdom*, January (London)
- Castle, B. and P. Townsend (1996), *We CAN Afford the Welfare State*, 10 July (London: Security in Retirement for Everyone)
- Central Statistical Office (1990), *Family Expenditure Survey 1988* (London: HMSO)
- Charlton, J. (1997), *Trends in All-Cause Mortality: 1841—1994*, Chapter 3 pp. 17—29 in Office for National Statistics (1997), *The Health of Adult Britain: 1841-1994*, March (London: HMSO)
- Confederation of British Industry (1994), *Pensions: A View From the Top*, September (London)
- Consumers' Association (1996), *A Consumer Agenda, Financial Services Regulation*, June (London)
- Consumers in the European Community Group (1992), *EC Framework for Financial Services*, Briefing Paper (London)
- Continuous Mortality Investigation Bureau (1994), *Standard Tables Programme* (London and Edinburgh: Institute and Faculty of Actuaries)
- Curry, C (1996), *PENSIM, A Dynamic Simulation Model of Pensioners' Incomes*, Government Economic Service Working Paper Number 129, June
- Davies, B. (1991), *Women Without Appropriate Personal Pensions*, December (Manchester: Equal Opportunities Commission)
- Davies, B. and S. Ward (1992), *Women and Personal Pensions*, Research Series (Manchester: Equal Opportunities Commission)

Department of Social Security (1991), *Options for Equality in State Pension Age*, Cm 1723, December (London: HMSO)

Department of Social Security (1992), *Retirement and Retirement Plans* (London: HMSO)

Department of Social Security (1994a), *Pensions: Qualitative Research, A Summary*, October (London: HMSO)

Department of Social Security (1994b), *Survey of Employers' Pension Provision* (London: HMSO)

Department of Social Security (1995a), *About Pensions*, PEC 2, October (London: HMSO)

Department of Social Security (1995b), *Benefits After Retirement*, FB 32, August (London: HMSO)

Department of Social Security (1995c), Consultation Papers on *Transfer Values, Guaranteed Cash Equivalents, Transfer Arrangements from April 1997, Discretionary Benefits, Transfer Rights of Pre-1986 Early Leavers and Overseas Transfers* (London: HMSO)

Department of Social Security (1995d), *Family Resources Survey Great Britain 1993/94* (London: Government Statistical Service)

Department of Social Security (1995e), *Perceptions of Non-State Pensions*, In-house Report 8, December (London: Social Research Branch)

Department of Social Security (1995f), *Personal Pension Statistics 1993/94* (London: Government Statistical Service)

Department of Social Security (1995g), *Retiring? Your Pension and Other Benefits*, FB 6, October (London: HMSO)

Department of Social Security (1995h), *The 1995 Pensions Act*, PEC 3, October (London: HMSO)

Department of Social Security (1995i), *The Pensioners' Income Series 1993* (London: Government Statistical Service)

Department of Social Security (1996a), *A Guide to Income Support*, IS 20, April (London: HMSO)

Department of Social Security (1996b), *Marketing Pensions to Young People: Making an Impact*, Information Pack (London: HMSO)

Department of Social Security (1996c), *Occupational Pension Schemes and the Pensions Act 1995*, PEC 5, August (London: HMSO)

Department of Social Security (1996d), *Pensions Act and Associated Regulations: Compliance Cost Assessment*, June (London: HMSO)

Department of Social Security (1996e), *Social Security Benefit Rates*, NI 196, April (London: HMSO)

Department of Social Security (1996f), *Social Security Statistics 1996* (London: Government Statistical Service)

Department of Social Security (1996g), *The Pensioners' Incomes Series* (London: Government Statistical Service)

Department of Social Security (1996h), *Unfunded Pension Liabilities in the European Union. Reply by the Government to the First Report from the Select Committee on Social Security, Session 1996—97*, Cm 3519, December (London: HMSO)

Department of Social Security (1996i), *Women and Pensions*, Research Report Number 49 (London: HMSO)

Department of Social Security (1997), *Press Release, Guaranteed Secure Pensions for All Says Peter Lilley*, Number 97/044, 5 March (London)

Dilnot, A., R. Disney, P. Johnson and E. Whitehouse (1994), *Pension Policy in the UK: An Economic Analysis* (London: Institute for Fiscal Studies)

Disney, R. (1996a), *Ageing and Saving*, Fiscal Studies, Volume 17, Number 2, pp. 83—101 (London: Institute for Fiscal Studies)

Disney, R. (1996b), *Can We Afford to Grow Older?* (Cambridge, MA: The MIT Press)

Disney, R. and E. Whitehouse (1994a), *Choice of Private Pension Plan and Pension Benefits in the UK*, Institute for Fiscal Studies, Working Paper Series Number W94/2, 27 January (London)

Disney, R. and E. Whitehouse (1994b), *What are Pension Plan Entitlements Worth in Britain*, Institute for Fiscal Studies, Working Paper Series Number W94/1, 26 January (London)

Disney, R. and E. Whitehouse (1995), *Pensions in Britain: The Changing Role of the Public Sector*, Prepared for the 51st Congress of the International Institute of Public Finance (Paris: OECD)

Disney, R. and G. Stears (1996), *Why is There a Decline in Defined Benefit Pension Plan Membership in Britain?*, Institute for Fiscal Studies, Working Paper Series Number W96/4, 12 March (London)

Downs, C. and R. Stevens-Ströhmman (1995), *Providing Fair Pensions Efficiently* (London: Association of British Insurers)

Equal Opportunities Commission (1992a), *A Question of Fairness, Response by the EOC to Department of Social Security's Discussion Paper: Options for Equality in State Pension Age*, June (London: HMSO)

Equal Opportunities Commission (1992b), *Your Pension Matters: A Guide Through the Pension Maze for Women*, July (London)

Equal Opportunities Commission (1994), *What Price Equality? Women, Men and State Pension Age*, June (London)

Equal Opportunities Commission (1996a), *EOC Response to the Department of Social Security Green Paper The Treatment of Pension Rights on Divorce*, November (London: HMSO)

Equal Opportunities Commission (1996b), *The Pension Bill Implications for Sex Equality* (London: HMSO)

Exley, C., S. Mehta and A. Smith (1997), *The Financial Theory of Defined Benefit Pension Schemes* (London: Institute of Actuaries and Faculty of Actuaries)

Fleming Investment Trust Services Ltd (1997), *Press Release, Fleming Pension Map of Britain 1997 Finds Position for Women Worsened Last Year*, February (London)

Freshfields Employment, Pensions and Benefits Department (1995), *The Guide to the Pensions Act 1995* (Croydon: Tolley Publishing)

Gallie, D. (1991), *Social Change and Economic Life Initiative Surveys, 1986—7* (Colchester: ESRC)

Goode, R. (1993), *Pension Law Reform: The Report of the Pension Law Review Committee* (London: HMSO)

Government Actuary's Department (1994a), *Occupational Pension Schemes 1991 Ninth Survey* (London: HMSO)

Government Actuary's Department (1994b), *Pension Provision in Britain, A Report to the European Commission* (London: HMSO)

Green, C., R. Zurbrugg and H. Karlsen (1996), *A Licence to Operate: Education Initiatives and the Financial Services*, October (Manchester: Financial Services Research Centre)

Hancock, R., C. Jarvis and G. Mueller (1995), *The Outlook for Incomes in Retirement, Social Trends and Attitudes*, Retirement Income Inquiry (London: King's College London)

Hay Group (1988), *Pension Plan Cost Study, Technical Report* (Washington DC: Pension Benefit Guaranty Corporation)

Hay Group (1996), E.H. Husted, *Retirement Income Plan Administrative Expenses for 1996*, May (Washington: Employee Benefit Research Institute)

Her Majesty's Treasury (1996), *The Pension System in the United Kingdom*, presented at National Bureau of Economic Research Conference on *Privatizing Social Security*, 1—2 August (London: HMSO)

Her Majesty's Treasury (1997), *Press Release, Redress for Misselling Personal Pensions*, 6 March (London)

Holden, B. (1997), *A Framework for Good Pensions Governance*, Consumer Policy Review, Volume 7, Number 2, pp. 58—64, March—April (London)

House of Commons Social Security Committee (1996), *Unfunded Pension Liabilities in the European Union*, First Report, Session 1996—97, 23 October (London: HMSO)

Hutton, S., S. Kennedy and P. Whiteford (1995), *Equalisation of State Pension Ages: The Gender Impact*, Equal Opportunities Commission Research Discussion Series Number 10 (Manchester)

IMF (1996), S.K. Chand and A. Jaeger, *Aging Populations and Public Pension Schemes* (Washington)

Inland Revenue (1996a), *Inland Revenue Statistics 1996* (London: Government Statistical Service)

Inland Revenue (1996b), *Tax Treatment of Provision for Retirement: An Overview* (London: HMSO)

Institute and Faculty of Actuaries (1996a), *Exposure Draft No. 25, Retirement Benefit Schemes — Transfer Values [GN11]*, November (Edinburgh and London)

Institute and Faculty of Actuaries (1996b), *GN26: Pension Fund Terminology*, Version 1.0, 1 January (Edinburgh and London)

Institute and Faculty of Actuaries (1997a), *GN11: Retirement Benefit Schemes — Transfer Values*, Version 7.0, 6 April (Edinburgh and London)

Institute and Faculty of Actuaries (1997b), *GN27: Retirement Benefit Schemes — Minimum Funding Requirement*, Version 1.0, 6 April (Edinburgh and London)

Investors Chronicle (1996), *Top Annuity Rates*, p. 34, 1 November (London: Financial Times Magazines)

Ippolito, R. and J. Turner (1987), *Turnover, Fees and Pension Plan Performance*, Financial Analysts Journal, pp. 16—26, November—December

Johnson, P., R. Disney and G. Steers (1996), *Pensions: 2000 and Beyond, Volume 2* (London: Retirement Income Inquiry)

Joshi, H., A. Dale, C. Ward and H. Davies (1995), *Dependence and Independence in the Finances of Women Aged 33*, November (London: Family Policy Studies Centre)

Joshi, H., H. Davies and H. Land (1996), *The Tale of Mrs Typical*, Occasional Paper 21, April (London: Family Policy Studies Centre)

Key Note Ltd (1996), *Personal Finance in the UK* (London)

Labour Force Survey (1996), *Quarterly Bulletin* (London: Office for National Statistics)

Labour Party (1997), *A Safe Haven Product — The Labour Party View*, presented by John Denham MP at a one-day conference, *Pensions 1997 — The Changing Structure of Personal Pensions and Group Schemes*, London

Lange, T. and J. Atkinson (1995), *Employment Trends and Prospects for Older Workers to 2030*, Retirement Income Inquiry Report (Brighton: Institute for Employment Studies)

Large, A. (1993), *Financial Services Regulation, Making the Two Tier System Work*, May (London: Securities and Investments Board)

Life Insurance Association (1996), *1997 Training and Competence Handbook Incorporating the Financial Planning Certificate Course and Examination Details* (London)

LIMRA International Ltd (1996), *Tracking Public Opinion for the Life Insurance Industry Year 1995 Great Britain Full Report*, March (Watford)

London Economics (1997), *Consumer Detriment Under Conditions of Imperfect Information, A Draft Report for the Office of Fair Trading*, Forthcoming

Lynes, T. (1996), *Our Pensions, A Policy for a Labour Government*, August (London: Eunomia Publications)

MacGregor, J. (1996), *Pensions in the 21st Century: Why We Must Change the Regulatory Regime*, Policy Study Number 146 (London: Centre for Policy Studies)

McCarthy, D. and J. Turner (1989), *Pension Rates of Return in Large and Small Plans*, pp. 235—489, in J. Turner and D. Beller (eds.), *Trends in Pensions 1989* (Washington: US Department of Labor)

McRae, S. (1996), *Women's Employment During Family Formation* (London: Policy Studies Institute)

Mintel International Group Ltd (1996a), *Changing Work Patterns*, May (London)

Mintel International Group Ltd (1996b), *Retirement Planning*, April (London)

Mintel International Group Ltd (1997), *Personal Pensions* (London)

Money Management (1996a), *Flexible Retirement Planning*, pp. 69—80, December (London: Financial Times Magazines)

Money Management (1996b), *Unique Survey — Personal Pension Plans*, pp. 61—92, October (London: Financial Times Magazines)

Money Management (1997a), *Are Fair Markets A Fantasy?*, pp. 54—56, January (London: Financial Times Magazines)

Money Management (1997b), *Corporate Pensions — The Defining Moment*, Supplement, April (London: Financial Times Magazines)

Money Management (1997c), *Pensions Shortfall For Women Revealed*, p.12, January (London: Financial Times Magazines)

Money Management (1997d), *Rebate Only Pensions — Money Down the Drain?*, pp. 46—53, January (London: Financial Times Magazines)

Money Management (1997e), *Personal Pensions — Time For A Change*, pp. 69—70, March (London: Financial Times Magazines)

National Association of Pension Funds (1995a), *Evidence to the Retirement Income Inquiry* (London)

National Association of Pension Funds (1995b), *Summary Evidence to the Retirement Income Inquiry* (London)

National Association of Pension Funds (1995c), *Supplementary Evidence to the Retirement Income Inquiry from Research and Planning Committee* (London)

National Association of Pension Funds (1996a), *Annual Survey 1995* (London)

National Association of Pension Funds (1996b), *Budget 1996 Encouraging Pension Provision* (London)

National Association of Pension Funds (1997a), *Encouraging Pension Provision, Agenda for Pensions* (London)

National Association of Pension Funds (1997b), *Annual Survey 1996 Commentary* (London)

National Association of Pension Funds (1997c), *Annual Survey 1996 Results*(London)

National Audit Office (1990), *The Elderly: Information Requirements for Supporting the Elderly and Implications of Personal Pensions for the National Insurance Fund*, 4 December (London: HMSO)

National Consumer Council (1997), *Savings and Investments for Low-income Consumers*, February (London)

Occupational Pensions Advisory Service Ltd (1996a), *Getting Information About Your Pension* (London)

Occupational Pensions Advisory Service Ltd (1996b), *Ill-health Early Retirement* (London)

Occupational Pensions Advisory Service Ltd (1996c), *Information*, April (London)

Occupational Pensions Advisory Services Ltd (1996d), *Pension Problems: A Review of OPAS Cases 1995—96* (London)

Occupational Pensions Advisory Service Ltd (1996e), *Transferring a Pension to Another Scheme* (London)

Occupational Pensions Advisory Service (1996f), *What are AVCs?* (London)

Occupational Pensions Advisory Service Ltd (1996g), *Winding up a Pension Scheme, A Guide for Scheme Members* (London)

Occupational Pensions Board (1992), *Preservation of Occupational Pension Rights, Voluntary Contributions, Revaluation and Transfer Values*, Memorandum Number 78 (Newcastle-upon-Tyne)

OECD (1996a), *Ageing in OECD Countries: A Critical Policy Challenge*, Social Policy Studies Number 20 (Paris)

OECD (1996b), *Ageing Populations, Pension Systems and Government Budgets: Simulations for 20 OECD Countries*, Economic Department Working Papers Number 168 (Paris)

Office for National Statistics (1996a), *Business Monitor, Insurance Companies' and Pension Funds' Investment*, MQ5, Quarter One (London: Government Statistical Service)

Office for National Statistics (1996b), *Family Spending — A Report on the 1994—95 Family Expenditure Survey* (London: Government Statistical Service)

Office of Population Censuses and Surveys (1987), *English Life Tables*, Number 14 (London: HMSO)

Orloff, A. (1996), *Gender and the Welfare State*, Estudios Working Paper 1996/79, March

Pensions Investment Research Consultants Ltd (1990), *What's Wrong with Transfer Values*, Research Report Number 2 (London)

Pensions Ombudsman (1996), *Annual Report of the Pensions Ombudsman 1995—96* (London)

Pensions World (1997), R. Lymburn, *Annuities, Spoilt for Choice*, June (London)

Personal Investment Authority (1995), *Consumer Panel Report*, November (London)

Personal Investment Authority (1996a), *Consumer Panel Report 1996*, October (London)

Personal Investment Authority (1996b), *Life Assurance Disclosure: One Year On*, January (London)

Personal Investment Authority (1996c), *Survey of the Persistency of Life and Pension Policies*, December (London)

Personal Investment Authority (1997a), *Life Assurance Disclosure: Two Years On*, January (London)

Personal Investment Authority (1997b), *PIA's Evolution Project The Next Steps*, Consultation Paper 23 (London)

Personal Investment Authority (1997c), *Press Release, PIA Publishes Quarterly Figures on the Progress of the Pensions Review*, March (London)

Personal Investment Authority (1997d), *Simplifying the Pensions Review — Further Guidance*, January (London)

Personal Investment Authority (1997e), *Simplifying the Pensions Review — Statement of Policy*, January (London)

Retirement Income Inquiry (1996a), *Pensions: 2000 and Beyond, Volume 1* (London)

Retirement Income Inquiry (1996b), *The Evidence Received* (London)

Secretary of State for Health (1996), *A New Partnership for Care in Old Age*, Cm 3242, May (London: HMSO)

Secretary of State for Social Services (1985), *Reform of Social Security, Programme for Action*, Cmnd 9691, December (London: HMSO)

Secretary of State for Social Services (1993), *Equality in State Pension Age*, Cmnd 2420, December (London: HMSO)

Securities and Investments Board (1993), *Review Implementation, Six Month Progress Report, November 1993* (London)

Securities and Investments Board (1995), *The Background to Investor Protection* (London)

Securities and Investments Board (1996a), *Contracting Out of SERPS Via Appropriate Personal Pensions*, May (London)

Securities and Investments Board (1996b), *Press Release, The SIB Announces Plans to Speed up the Pensions Misselling Review*, PN/SIB/051/96, 13 November (London)

Securities and Investments Board (1997a), *Contracting Out of SERPS Through Appropriate Personal Pensions, Survey Results*, February (London)

Securities and Investments Board (1997b), *Simplifying the Pensions Review: Amending Guidance*, January (London)

Simplifying Pensions Group (1996), *Pensions For All — The Need for Simplification*, June (London)

Simpson, D. (1996), *Regulating Pensions: Too Many Rules, Too Little Competition*, Hobart Paper 131 (London: Institute of Economic Affairs)

Stonewall (1996), *Factsheet, Same Sex Couples and Pension Schemes*, July (London)

Trades Union Congress (1996), *Justice Delayed. A Report on the Mis-selling of Personal Pensions* (London)

Union Pension Services Ltd (1996), *Pension Scheme Profiles* (London)

Ward, P. (1996), *The Great British Pensions Robbery* (Preston: Waterfall Book)

Welfare Reform Group (1996), *Welfare: An Insurance Industry Perspective* (London)

Which? (1995), *Will Your Pension Stand the Test of Time*, July, pp. 30—37 (London)

Which? (1997), *Is Your Pension As Good As Gold*, January, pp. 44—49 (London)

World Bank (1994), *Averting the Old Age Crisis* (Oxford: Oxford University Press)

Yarrow, G. (1996), *Welfare, Mutuality and Self-Help* (London: Association of Friendly Societies)

