CENTRE FOR POLICY STUDIES

# Funding the Basic State Pension

*Report of the Independent Panel on Pension Reform*

CHAIRMAN: LORD BLACKWELL

CENTRE FOR POLICY STUDIES
2001

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# TERMS OF REFERENCE

*As set out in a letter from David Willetts MP*
*(Shadow Secretary of State for Social Security)*

"To consult pensions experts and others in the financial sector to provide an independent assessment of how our proposal to allow young workers to opt out of the basic state pension might work in practice and its possible implications for the financial markets and to produce a report based on this information which evaluates the existing proposal and identifies issues and options for implementation."

16 November 2000

# EXECUTIVE SUMMARY

THE PENSION REVIEW PANEL was established in November 2000 at the request of David Willetts MP to review and consult on the Conservative Party's proposals for pension reform published in October 2000. Under these proposals, summarised in Appendix 1, all individuals under the age of 30 would be given the option of transferring their basic state pension entitlement to a personal funded pension, with the state making an annual contribution to build up funds to buy a retirement income guaranteed to be at least equivalent to the basic state pension. This would sit alongside and aim to encourage take-up of voluntary contribution schemes such as stakeholder and AVC plans.

There are four primary aims described in the initial proposals:

1. to give all future pensioners the opportunity to receive a higher income in retirement through the benefits of their own long term investment fund;

2. to provide the security that individuals own their personal fund rather than being dependent on future government expenditure decisions;

3. to recognise and properly fund the liability the state currently has for payment of future basic pensions;

4. to give additional impetus to the development of additional funded pension provision in the UK.

The panel, whose membership is set out at the front of this report, has consulted widely since then with the major industry associations, significant life and pension companies, and with individual IFAs, economists and other interested parties. In total it has received over 30 submissions, and its website has had over 450 visits. A more detailed explanation of the process is available at Appendix 2. Based on the evidence taken in these consultations, and the analysis received – including calculations from the Government Actuary – the panel has reached a number of conclusions and recommendations for the implementation of the proposed scheme. These are reported below under three headings – Actuarial Estimates and Options, Macroeconomics and Funding, and Distribution and Management. In summary, the main conclusions are as follows:

1. The proposals do represent a viable option for progressively moving towards funded state pensions, and are broadly welcomed by the pensions industry.
2. It is appropriate and justifiable for the costs of funding the annual contributions to be wholly or partly raised through issuing new government debt, since the scheme simply recognises an existing undeclared government liability rather than creating any additional current expenditure stream.
3. Assuming investment in a portfolio of appropriate equities and assets, achieving returns above the costs of gilts could reasonably raise income in retirement by 20% to 50% above the basic state pension, based on historic experience. However sustaining returns at this level would depend on the operation of the scheme stimulating additional wealth creation through mechanisms set out in the second Chapter of this paper. The level of wealth creation that would result – and hence the ability to fund higher future pensions – remains an issue of valid economic debate.
4. The proposed government guarantee – that it will ensure the pay-out at least matches the basic state pension – will be important in encouraging take-up of the scheme and maintaining affordable sales and marketing costs (since it reduces the need for individual advice). Such a guarantee should not add substantially to the costs of the scheme so long as contributions are based on prudent assumptions about investment returns.
5. The government of the day has the option of allowing a number of pension providers to offer their own investment fund – within investment guidelines that limit the risk associated with the government guarantee – or creating a single, common fund under

an independent board, with management contracted to a number of different investment managers. While the latter has some advantages in terms of simplicity and equity, industry participants generally preferred the opportunity to market their own fund.

Although the pensions industry could not afford significant sales and administration costs on this product taken on its own, it would find it attractive to use this product as an entry point for building a savings relationship with customers – with the aim of promoting top-up pension contributions later in life. It could also be marketed and administered as a twin product alongside the new stakeholder pensions in which the individual and his/her employer make voluntary payments – and, so long as the product is simple enough to share the administration structure, may help to underpin the economics of offering stakeholder pensions to a wider market.

We consider there would be advantages in combining both approaches. The common fund could be offered as a default option particularly aimed at those who have no other pension provision, and who might not be attractive targets for the private providers to serve. Those who have – or can be sold – other stakeholder, SERPS, Personal or Corporate Pensions and who opt to have them managed together, and those who prefer to choose a private provider would be free to do so.

These points are elaborated in the Chapters which follow.

# CHAPTER 1

## ACTUARIAL ESTIMATES AND OPTIONS

TO PROVIDE A BASIS for the costing of the proposals, the Government Actuary was asked – through parliamentary questions – to provide official estimates based on conventional government assumptions. These suggest that a man aged 16 would need to invest £520 each year and a woman £580 each year for the rest of their working lives (up-rated for inflation) in order to accumulate a fund on retirement that would buy an annuity equal to the basic state pension maintained at the current real level. These figures rise to £740 and £840 for 25 year olds, and to £920 and £1040 for those who delay entering the scheme until 30.

**Table 1**

**Annual Amounts that would need to be invested (£)**

| Starting Age | Men | Women | All |
|---|---|---|---|
| **16** | 520 | 580 | 550 |
| **20** | 600 | 680 | 640 |
| **25** | 740 | 840 | 790 |
| **30** | 920 | 1040 | 980 |

The full estimates and notes provided by the Government Actuary on underlying assumptions are provided in Appendix 3.

Under a funded scheme, however, the value of the pension received depends on the rate of return achieved on the investment. The Government Actuary's assumption of a 3% real return on investment before retirement and a 2% return on annuities after retirement are prudent assumptions to ensure the fund is adequate – and limit the chances of the government having to pick up the additional costs if, as is proposed, it guarantees that the pay-out will at least equal the basic state pension. If actual returns exceed these levels the pension pay-out would be correspondingly higher.

**Economic determinants of returns on equities**

**Equities are nowadays the dominant asset in UK pension fund portfolios. The prospective long-run rate of return on equities is therefore fundamental to public policy in this area. Unfortunately, no well-established theory of the determinants of such returns exists. One approach is to posit a relationship between the return on corporate equity traded in the stock market and the return on capital (i.e. the assets – machinery, property, intellectual rights, goodwill – acquired with shareholders' funds). Obviously, there must be some connection between these two variables, but in practice it is rather loose.**

**As companies acquire assets with both equity and borrowed money, the return on capital will differ from the return on equity if – as is generally the case – the interest rate on the loan differs from the return on capital. Further, most companies retain at least part of their profits in order to build up capital and expand. The value of a company's equity depends as much on its shareholders' expectations about its growth (i.e. how they value a growing future stream of dividends) as on the return on capital in any particular recent year. But perhaps the most fundamental weakness of this approach is that the stock market value of a company may be very different from the value of the capital assets in its balance sheet. Plainly, if a company is valued by the stock market at three times its balance-sheet value and the return on capital (measured at book) is 12%, the implied rate of return on the equity investment is only 4%.**

**An alternative theory was proposed in a Lombard Street Research paper in 1991, and adopted in two consultancy projects for the Financial Services Authority in 1997 and 2000. It central idea was that, if the equities of a particular nation are taken as a class, the likely long-run real return – in % per annum – is likely to be:**

> **Initial yield % p.a. + Trend growth of the nation's real GDP % p.a.**

**The thinking behind this proposition began with the familiar idea that:**

> **Total real return % p.a. = Initial yield % p.a. + real capital gain % p.a.**

**Real capital gain could in turn be decomposed, as follows:**

> **Real capital gains % p.a. = (Decrease in dividend yield as % of initial dividend yield) % p.a. + Growth rate of real dividends % p.a.**

**On some interpretations of the evidence, the dividend yield on equities has shown a tendency over long periods of time to revert to a mean value. (In the UK this mean value has been between 4½% and 5%; in the USA between 3½% and 4½%.) If the hypothesis that the yield reverts to the mean were accepted, the effect of the change in the dividend yield on long-run capital gains could be eliminated and the equation became:**

> **Long-run real equity returns %p.a. = Initial dividend yield % p.a. + Growth rate of real dividends % p.a.**

**The final step in the argumentwas to note that, again in the long run, the ratio of profits to gross domestic product tends to be stable. If the ratio of dividends to profits (i.e., the distribution ratio) were also stable, the long-run growth rate of real dividends would approximately be equal to the long-run growth rate of real GDP. This led to the theory suggested above that, in any nation;**

> **Long-run real equity returns %p.a. = Initial dividend yield % p.a. + Growth rate of real GDP % p.a.**

**The trend growth rate of real GDP in the UK has been 2% to 2 ½% a year for most of the last two centuries. With the mean value of the dividend yield at 4 ½% to 5%, the implied long-run real annual return on equities is 6 ½% to 7 ½%, which has indeed been similar to actual experience. With the dividend yield on UK equities now down to 2 ½%, equity returns are likely to be lower in future than in the past. However, this conclusion is controversial, partly because companies have increasingly returned capital to shareholders by "share buy-backs" rather than dividends, making the dividend yield today not fully comparable to the dividend yield in the past.**

Over the post-War period, equity investments have provided an average compound real return of close to 7%. As the analysis on the facing note sets out, this reflects the combination of dividend yields and long term GNP growth rates. For a number of reasons this may have been an exceptionally favourable period, and returns at this level may not be repeated. Nevertheless, after taking account of a portfolio mix of equities, bonds and other assets, the economists we consulted believe it would not be unreasonable in current circumstances to expect invested funds to achieve a long-term average return of 4% to 5% per annum in the coming years.

As shown below in Table 2, if the return achieved on invested funds rose from 3% to 4%, with all other assumptions held constant, the balance at retirement for a 25 year old starter would be sufficient to raise the pension income by 27% – i.e. from the basic state pension of £75.50 per week to the higher level of £96 per week. If the return averaged 5%, retirement income would be raised by 63% to £123 per week.

**Table 2**

**Index of Pension Outcomes Based on Different Rates of Return**

| | Percentage Rates of Return | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Age** | **2.00** | **2.75** | **3.00** | **3.25** | **3.50** | **3.75** | **4.00** | **4.25** | **4.50** | **4.75** | **5.00** |
| **16** | 75 | 93 | **100** | 108 | 116 | 126 | 136 | 147 | 159 | 172 | 186 |
| **20** | 77 | 94 | **100** | 107 | 115 | 123 | 132 | 141 | 152 | 163 | 176 |
| **25** | 79 | 94 | **100** | 106 | 113 | 120 | 127 | 135 | 144 | 153 | 163 |
| **30** | 82 | 95 | **100** | 105 | 111 | 117 | 123 | 130 | 137 | 144 | 152 |

Note: This assumes the basic state pension in April 2002 will be £75.50, as per Government Actuary assumptions, and all values are expressed as percentages of 2002 levels.

However we note in the next Chapter of this report that the operation of this scheme and its funding requirements could affect the ability of the economy to sustain high levels of returns, depending on what real wealth generation results. It is therefore sensible at this stage to remain prudent on the 'base case' actuarial assumptions.

### 1.1 Should the basic state pension be guaranteed?

While these calculations show the potential upside from higher returns than those assumed by the Government Actuary, there is clearly a risk that – at least for some investment periods – the return achieved could be less than that required to pay out the basic state pension.

One stabilising factor is that periods when equity prices are low may correspond to periods of high interest rates – when a lower capital sum could buy a higher income. However, this clearly cannot be assumed to hold for all periods.

The initial proposal suggested that the government should underwrite the scheme by guaranteeing that the pay-out would not be less than the basic state pension on retirement. The panel endorses this guarantee. Our consultation received strong support for the view that a guarantee would be an important element of promoting widespread take-up. In addition it would reduce the cost of sales and distribution by eliminating the need for costly advice to individuals on whether they should take on the risk of a funded scheme.

A state guarantee of 'no downside' does however have implications for investment policy – ensuring that the pension funds do not exceed a sensible balance of their portfolio in more risky or speculative investments. It also implies an ongoing government liability to cover this residual risk, unless it is able to pass the risk on to investment managers. This is covered in Chapter 3 of this report.

An alternative formulation of the guarantee would be to limit the guarantee to preserving total income in retirement rather than this fund taken on its own – in other words a form of the Minimum Income Guarantee. While this would reduce the residual risk, it would complicate the sales task – by requiring individual advice on the appropriateness of the scheme – while making it less likely that it could achieve widespread take-up. The full guarantee is therefore preferred.

Clarity will however be needed over the terms of the guarantee – whether it applies only at the time the pension is taken up or continues to apply in each year after retirement (so that individuals are protected if at any stage the state pension rises above the income they are receiving from their fund). The latter could be achieved by simply allowing the individual to opt to revert to the state pension entitlement, in return for handing back their investment fund at that time.

### 1.2 Should contributions be flat rate or rising with age?

While the annual contribution figures quoted above are similar to those suggested in the initial proposal, they are actually calculated on a different basis. The initial proposal assumed that the amount invested each year would be the amount required to deliver one year's worth of pension entitlement – with a full pension, as now, earned after 44 years of contribution. While this may be simple to explain, the consequence is that the contribution level would need to rise each year – since it costs less to 'buy' 1/44th of the pension income in early years (with the benefit of a long period of investment returns) than in the later years.

The review panel concluded that this approach – with contribution varying by age – would substantially add to administrative complexity compared to a flat rate contribution scheme, and would miss out the potential benefits from more funds invested and earning returns in the early years. We have therefore worked on the flat rate contribution approach – and, to simplify the different rates that could apply depending on the age of joining the funded scheme, would recommend that contributions are standardised at the level for 25 year olds.

Younger joiners would have the same number of years' contributions, but would gain a small benefit from having their contributions invested for longer. Older joiners (up to the age of 30) could have an initial endowment from the state scheme to make up their fund at the time they joined the scheme.

### 1.3 Should individuals be able to opt to return to the basic state scheme?

The consequence of the flat rate scheme, however, is that it would only be practical to allow individuals to opt back into the standard state scheme by making a complete switch – and losing entitlement to their accumulated funds – rather choosing year by year which entitlement they wish to earn. This is because, as they come close to retirement age, the income added by one year's investment added to their fund will be less than one year's entitlement to the state pension calculated under current rules – and, without restriction, individuals would play the rules to get the best of both schemes. However, with the basic state pension guaranteed, we see little demand for people to leave the funded scheme before retirement – since they cannot be worse off than if they had stayed out altogether.

### 1.4 What about credits for those not earning?

For those who are temporarily non-earning – e.g. unemployed, mothers, etc – the scheme could continue to receive credits under exactly the same eligibility criteria as apply to the basic state pension. Similarly, since the funding levels calculated by the Government Actuary apply to individual pensions (rather than married couples pensions) the government – unless it changed the rules – would need to add an additional funding contribution where there was a dependent spouse. Alternatively it might choose to simplify the scheme by crediting everyone with a personal pension in his or her own right.

### 1.5 Should individuals be required to use the fund to purchase an annuity at the time of retirement?

This is a question that, as it relates to pensions as a whole, goes beyond the scope of this specific enquiry – although the panel and most of those to whom we spoke are supportive of the proposal to give people more freedom once their basic income needs are met. However, for the basic state pension fund – where the government guarantee applies – the government will clearly need to specify the way the investment is used to generate income. This could be through individual index linked or with profits annuities, or collective investments that achieve the same income profile.

### 1.6 Should participants also be required to opt out of SERPS/Second State Pension?

Whereas all individuals should be able to gain – or have the chance of gaining – by opting out of the basic state pension, the decision on SERPS is more complex, and depends on specific advice around an individual's income levels and entitlements.

With the 'second state pension' as envisaged by the current government this will be even more dependent on the individual – with those on low earnings gaining disproportionately from payments within the second state pension scheme. Furthermore, we are not yet in a position to make these calculations since, in response to a recent parliamentary question, the government stated that it has not yet determined the rate of rebate that individuals might receive from opting out of the second state pension.

Given these uncertainties the panel recommends against tying an opt out of the basic state pension to an opt out of the second state pension, since to do so would almost certainly lead to a requirement for costly advice – and exclude some low earners who the scheme is intended to bring into the funded pension regime.

# MACROECONOMIC AND FUNDING CONSIDERATIONS

The current basic state pension costs the government some £35bn annually in current expenditure, primarily raised through NIC contributions on the current working population. This is forecast to rise to over £50bn per year in current money by 2040, assuming continued indexation with prices.

Since existing workers regard their future state pension as an entitlement, the future payments are effectively an obligation on the state. We estimate the present value of these obligations for the current working and retired population – using real discount rates – is over £1000bn. Under resource accounting, this liability should properly be shown on the government's balance sheet in the same way as government debts – which are also promises of future payments.

Under the funded pension scheme proposals, the cost of funding an individual's investment contribution continues to fall on the state – but is explicitly recognised up-front by making an annual investment in an individual's pension fund.

The Government Actuary has provided estimates of the aggregate contribution that would be required for the proposed scheme, based on demographic forecasts and the individual contribution levels set out in the previous Chapter (see the Parliamentary Question in Appendix 3). If all eligible individuals under the age of 30 signed up to the scheme on day 1 – an unlikely assumption – the first year funding would amount to some £5bn. This crystallisation of liabilities rises to a peak of approximately £15bn per year after 35 years – the point at which all individuals below retirement age would be eligible for the scheme. The amounts would be correspondingly lower if take-up was slower.

**Table 3**

**Estimated Annual Funding Costs, £bn**

| | 2000 | 2005 | 2015 | 2025 | 2035 |
|---|---|---|---|---|---|
| **100% take-up** | 5 | 6 | 10 | 13 | 14 |
| **50% take-up** | 2.5 | 3 | 5 | 6.5 | 7 |
| **25% take-up** | 1.25 | 1.5 | 2.5 | 3.25 | 3.5 |

If the funds are raised by issuing government debt, the financing would also need to include additional debt interest – which after 35 years, we estimate could amount to another £15bn to £20bn per year assuming full take-up, or £3bn to £5bn with a 25% take-up (assuming a real interest rate of 3% on the aggregate balance). Beyond this point the new funding cost would then be progressively offset by savings on the cost of 'pay as you go' state pensions. In effect, as the debt builds up the government is eventually paying interest on debt rather than paying pension entitlements directly – with pensioners then receiving their income from the accumulated investment fund. There could also be savings on the Minimum Income Guarantee and other social security payments to the elderly.

### 2.1 Debt or Tax funding?

The panel has considered and consulted on the question of whether this funding should count as part of current public sector expenditure – which would need to be met out of current taxation – or whether it could be financed by issuing additional government bonds outside of the conventional tax and expenditure rules. We have concluded that it is justifiable to fund future pension costs wholly or partly through issuing matching public sector debt, and that this financing should not be classified as part of the surplus/deficit on current budget by which the government now controls its fiscal policy. However it is not yet clear whether this funding approach will enable the higher levels of return postulated in the last Chapter to be sustained.

The rationale for this conclusion is that, in issuing new gilts, the government is simply recognising a balance sheet liability that already exists to pay future pension costs – and is not creating any new current or future public expenditure commitment. Raising current taxation by an equivalent level without any additional current expenditure would in fact reflect a considerable tightening of the fiscal balance.

The clearest way to illustrate this is to assume, in the simplest case, that the government issued debt paying the interest rate assumed by the Government Actuary, and that all of this debt and accumulated interest was then held locked up in the pension funds of the individuals covered. At maturity the interest on the funds would be just sufficient to pay the pension costs, but the government of the day would instead incur the equivalent and matching cost of paying interest on the accumulated debt. In this model we would have created a closed system of accounting entries without changing anything in the real world.

**2.2 So where does the real wealth generation come from?**

Such a closed debt based model may work in accounting terms, but it does not address the question of whether and how a debt – funded pension scheme could create the real increase in wealth needed to pay higher pensions in retirement.

In reality it is not proposed that funds should be simply invested in government gilts – to achieve the higher returns illustrated in the previous Chapter the scheme would actually operate by selling gilts to raise funds which would then be invested in portfolios of higher return assets. Since the supply of new gilts would match the increase in demand for equities there would be no change in the overall balance of financial flows, but – at the margin – the price of gilts would fall and the price of equities rise. Additional wealth creation could then result from a number of mechanisms:

- by increasing demand for higher return equities, the cost of risk/equity funding will be reduced – and, at the margin, some riskier business investments and new ventures which had been unable to attract equity finance may now go ahead;
- by increasing the flow of risk funds outside the UK – going to areas of high potential returns – the cumulative investment income from overseas assets will increase. While UK fund flows are no longer unchanged, so long as overseas returns exceed the impact from reducing UK investment, national income will increase;
- by encouraging more individuals to build up additional long term savings to add to what they now see as their own 'pension pot'.

It is not possible at this stage to predict how much incremental wealth these mechanisms might create. If they fall short of the amount required to pay higher pensions based on higher real asset returns, the consequence may be both lower returns on real assets – as demand grows relative to the growth in supply – and some redistribution of returns between existing and new investors. However, given the mechanisms outlined above, the impact on national wealth will be more favourable under most scenarios than simply continuing with the hidden funding liability – and future pensioners will be correspondingly better off.

**2.3 What are the consequences of crystallising government debt?**
No government can deny its existing liabilities for future pensions without throwing doubt on its willingness to pay those pensions. However an overnight conversion of all the government's £1000bn+ pension liabilities into government debt would clearly be difficult to absorb. The proposed scheme provides a more manageable transition with a growing flow of new debt issues over a number of years.

Against the background of recent government budget surpluses, an increased supply of gilts would meet the structural demand for low risk assets in the portfolios of existing pension funds and annuities – a demand which will still remain even if the MFR is abolished as recommended by the Myners report. This would be welcome in helping these funds match their portfolios to their liabilities while reducing the pressures that have bid down long term yields – and annuity returns – to artificially low levels. Higher yields for existing and future annuity holders would also raise income and expenditure levels in the economy.

On the other hand higher gilt yields may limit the development of the corporate bond market and choke off some debt-funded investment that would otherwise take place. This could offset some of the economic growth benefits from the mechanisms set out above.

We estimate that after 35 years the cumulative debt issued (including rolled-up interest payments) might amount at maximum to some £600bn, or 20% to 30% of future GDP with full take-up – and more likely some fraction of this if take-up rises only gradually. While this is significant, if it were added to the existing level of debt – forecast to fall to just over 35% in the next 3 years on the Maastricht definition, and continuing to reduce – the UK should still remain within the Maastricht criteria for prudent financing. Furthermore, as noted above, the incremental ongoing interest payments would be offset by the elimination of ongoing state pension and minimum income guarantee costs; and the new pension funds would also create additional demand for debt as they matured.

Given these considerations we do not believe this level of debt is untenable. Indeed, as argued above, it can be seen as simply crystallising a liability that already exists, rather than creation of any new liability.

**2.4 Should contributions come out of the National Insurance Fund?**

The question of whether the funds for investment should be paid out of the National Insurance Fund or out of the general Exchequer is a cosmetic and accounting issue rather than one of economic substance. In either case the total amount of 'taxation' and of government borrowing remains the same.

On presentational grounds we do see a small advantage in individuals perceiving the contributions as coming from 'their' NIC payments; but for this to be feasible the rules would also have to accommodate those individuals for whom the pension fund payments exceed their NIC payments, or allow their NIC contribution to be 'topped up' from general government funds. However we do not see this decision as fundamental to the scheme.

# CHAPTER 3

# PRACTICAL ISSUES OF DISTRIBUTION AND MANAGEMENT

TO BE COST EFFECTIVE TO SELL AND MARKET, the basic pension fund needs to be simple and standardised – avoiding up-front advice. With a government guarantee, the state may also want to be assured that the risk level of the investment will be prudent, avoiding people speculating in a situation where their downside is protected.

The panel has considered two alternative ways in which these requirements might be met:

- Allowing individual insurance/investment companies to market their own pension funds, within defined risk parameters and expense levels, utilising the administrative structures and investment funds already created for stakeholder and SERPS opt-out pensions (while retaining a record of the value attributed to the basic pension fund for the purposes of the guarantee).
- Establishing a single 'state regulated' basic pension masterfund into which all contributions are automatically paid. The assets would then be allocated to a mix of private fund managers, with the fund selection handled by an independent appointed group of trustees – with the aim of minimising costs and avoiding inequality in performance.

Each of these options would have advantages and disadvantages.

### 3.1 Competing Industry Pension Funds

Allowing approved pension providers to market and administer their own pension fund could bring a number of benefits:

- it would allow scope for the existing private pension providers to develop direct customer relationships – and, over time, encourage additional savings into parallel top-up funds;
- combining the £700 to £800 a year subscription with stakeholder and SERPS opt-out payments would increase the economic viability of managing these small funds, spreading the administrative costs (so long as the individual chooses to place all with the same provider);
- providers would have an incentive to put their marketing effort behind the take-up of the basic pension – alongside government promotion – particularly where it could be combined with the sales and administration of employer based stakeholder schemes and SERPS opt outs;
- individuals with an array of privately managed pension funds could choose to have them managed alongside each other by one provider, with the convenience of one combined statement rather than an array of separate small entitlements.

Some felt that the development of these additional investment funds – in aggregate amounting to up to £15bn per year as noted earlier – could help underwrite the viability of the basic stakeholder offer. But there are also concerns about this approach:

- for many individuals who do not have other pension arrangements, the annual subscriptions to the basic pension fund may be too small to enable private pension funds to offer and market schemes at realistic expense levels. There is a risk that many people – those at whom this scheme is particularly aimed – may be excluded or ignored;
- a government taking this route would also have to be comfortable with the outcome that different people might end up with different pension payments on retirement as a result of a fairly random choice of fund manager;
- the government would bear the risk of the guarantee while investments would be managed outside of its control – with the risk that investors take a high risk approach knowing that their downside was protected.

On the last of these, there were differing views about how significant the 'moral hazard' risk would be of providing a government guarantee when funds were managed privately. Many in the industry felt that we could rely on the normal prudential judgement of pension funds to seek a course which secured a good return without undue risk. Some felt that privately managed funds should be outside the government guarantee. However there were also options proposed for how this risk might be managed.

The simplest route could be to authorise funds which were able to offer basic pension fund investment under the government guarantee, using appropriate prudential criteria (e.g. maximum asset allocations to certain categories of riskier assets). While this would not eliminate the risk of the guarantee, it could bring it within acceptable levels. The main concern would be ensure regulation and oversight did not become overly directive and burdensome.

An alternative proposal to reduce risk would be to require funds to operate on a pooled basis (as current defined benefit pensions) where returns were smoothed over the years. While this has attractions, it would complicate the administration and could make it more difficult to manage basic pension, SERPS and stakeholder contributions within the same investment structure – and for that reason is not recommended as a compulsory requirement. It could, however, be offered by providers as a way of reducing the individual investor's risk.

### 3.2 A single common fund

The alternative of a single state regulated fund meets some of these concerns, but raises a number of other issues. Under this proposal an independent board could ask for bids from private sector fund managers to manage part of each year's contributions, creating a single, common fund in which everyone would then be allocated units (or possibly a number of funds with reducing risk profile as individuals moved closer to retirement). Bids from fund managers could include their willingness to underwrite minimum rates of return or maintain index tracking. Individual entitlement records would continue to be maintained by DSS:

- since the payment would be made centrally from government funds – not collected from employers and employees as in the stakeholder scheme – there would be little additional administration required beyond that maintained by DSS for the current state pension (and recording opt-outs). Keeping it centralised would avoid duplicating costs;
- the initial sales and set up could be streamlined since the consumer would have no decision to make beyond opting for the private fund – and the state pension administration would ensure that every individual was given this option;
- it might be seen as 'fairer' if everyone ends up getting exactly the same returns – rather than having the ultimate pay-out vary according to the different performance of different fund managers;
- since the fund would be managed separately from other pension schemes, it could adopt a pooled or 'averaging' approach to returns in order to avoid large fluctuations in the pension pay-out year by year;
- the state would be protected against abuse of the pension guarantee, and could even lay off some of the risk by asking fund managers to bid on guaranteeing returns at least match market indices.

However there are also a number of drawbacks to this approach:

- it segregates the basic pension fund apart from other pension funds individuals may accumulate, and removes the possible advantage of pension funds using these accounts and customer contacts to market additional savings contracts;
- it also removes the potential cost benefit of co-managing basic pension, stakeholder pensions and SERPS within the same structure for that proportion of the population who have more than the basic state pension;
- the creation of a state controlled investment vehicle could lead to fears that pension money might be 'directed' towards favoured government objectives rather than managed independently.

There were differing views on the importance of the last point. A number of contributors and members of the panel were particularly concerned, since these funds would have a lifetime that could extend through many changes of government – and felt that even making the board answerable to Parliament would not necessarily safeguard its independence given our system of government by parliamentary majority. Others felt that the legal obligations on independent trustees, reinforced by Human Rights legislation, would provide sufficient guarantees.

### 3.3 Choosing between the options

While some members of the panel favoured each of these options, the consultation with the pension industry (not surprisingly) produced a general preference for the first – allowing each provider to develop their own scheme within clear specifications. Marketing would be likely to be focused through employers, alongside marketing of stakeholder schemes. There might well be scope for the employer to choose a preferred provider for both stakeholder and basic pension arrangements to simplify the sales and advice process. The longer-term marketing opportunity to attract new funds on top of these basic pension accounts was seen as significant and important.

One way forward could be to combine both approaches – with a default option of a single common fund for those who make no other determination, but with the ability to choose to have your contributions ( and any accumulated fund) paid into an approved pension provider's fund at any stage.

The government of the day will be able to make a choice between all these alternatives – including the extent of the guarantee – based on the political importance it attaches to delivering 'fairness' as against encouraging a broader savings market, its concerns about risk as opposed to concerns about government control of investment, and in the light of any further experience of the stakeholder model and its costs.

### 3.4 Further Issues in distribution

If the choice is to allow multiple providers, we consulted on a number of subsidiary issues that would need to be resolved in establishing the scheme:

1. *Should fund holders be required to invest all their funds through one provider, or could they keep different year's subscriptions in different schemes?* Not surprisingly there was a preference for keeping the funds together to reduce the administrative overhead, although this is not a requirement for ISAs or stakeholder pensions at present. In particular it would greatly complicate the calculation on whether or not the state guarantee needed to be invoked if, on retirement, the funds were scattered across a range of managers and annuities.

2. *Should fund holders be allowed to switch accounts from one provider to another?* Although we expected concerns about the administrative costs of allowing free switching between funds, the industry did not generally see this as a major problem given modern IT systems – and saw it also almost inevitable that switching would need to be allowed. In practice the right to switch might not be invoked that frequently, but provides protection against consistent under-performance – and administrative convenience if, for example, other stakeholder pension arrangements are switched with a switch in employer.

3. *Would basic pension funds be compatible with existing employer schemes?* If the guarantee operates, state contributions must remain identifiable within any product in order to assess performance of the qualifying funds. This becomes more complex for defined benefit schemes than it is for defined contribution schemes.

   <u>Defined Contribution Schemes</u> – The industry's view was that most pension products that existed today allowed contributions to be split between funds and that reporting mechanism already handled this well. If the state's contribution stands alone in a product then it would be simple to identify. In the case where the contribution is being made alongside personal investments then it should be possible to use existing products yet still identify within them the proportion of the fund that has been built up through state contributions. Performance reporting should not add significant costs.

   <u>Defined Benefit Schemes</u> – Although defined benefit schemes are in decline it is nevertheless important to ensure that those in these schemes derive benefits from opting out. It is already possible to

purchase AVCs within defined benefit schemes; this often involves, where the employee will not be in the scheme for the maximum term, purchasing 'additional years' aimed at bringing the benefit up to the maximum. It would be administratively difficult to reconcile this type of defined benefit investment against the guarantee. It also limits the scope for someone who has no room for an AVC under these rules. Some employer's schemes make it a condition of entry that you may only purchase the company scheme AVC, and this may be difficult to manage if the only option is to purchase additional years.

However, free standing AVCs are available for those in defined benefit schemes; these are managed separately from the employer's scheme and are effectively defined contribution schemes. Free standing AVCs could, therefore, serve as a vehicle for administering the basic state pension fund.

4. *What rules should be put around the investment of these funds?* As has been previously noted the existence of a government guarantee to eliminate any down side to opting out could encourage investments in assets with a high risk profile, a kind of one way bet. In order to avoid people taking on excessive risk the panel believes that funds would need to 'qualify' by meeting defined asset allocation criteria.

   If current rules are seen as not specific enough, then an independent review panel could be asked to specify the asset allocation for qualifying funds on a regular basis. This might consider both asset class allocations and/or overall volatility and risk measures. This review panel would need to be appointed from industry experts and would need to fully disclose the analysis and discussions that brought it to its decisions.

5. *What are the implications for advice and costs of selling?* This was the subject of much discussion within the panel and of great concern to the industry. Much of the process of selling a pension today is taken up with an advice element. Where contributions are low, the cost of advice can often eat into the fund considerably. Any arrangement that required a complex decision making process to opt out would require detailed advice from a qualified professional, an IFA.

As noted earlier, the offer of a guarantee changes this substantially. A guarantee, that ensures those who opt out receive at least the basic state pension in the event that funds do not perform as expected, effectively removes the requirement for advice within the decision making process. This simplifies the process at the same time as dramatically reducing the cost.

Assuming the government has a role in creating basic understanding about the benefits of opting for a funded scheme – and putting the choice in front of people at appropriate points – industry participants would then be able to make effective use of marketing materials to recruit new members rather than having to engage in individual sales discussions.

6. *Would it be possible to add attractive top up options? For employers as well as employees?* The basic contributions, made to a funded scheme, should deliver a higher pension income than the state pay-as-you-go scheme. However, to lift pension incomes substantially, additional contributions would be very important – and need to be encouraged from both individuals and employers.

   Additional contributions would need to be kept in separate accounts in order to allow the guarantee to be monitored, but it has already been noted that the basic state scheme could be marketed and administered alongside stakeholder, personal pension and corporate pension schemes which could receive additional contributions. The state contributions should be counted outside the existing revenue limits for personal and employer contributions – allowing these to be maximised and not penalising those already making personal contributions. The pension income derived from them should not generate payments from the state for income above the minimum income guarantee under the forthcoming arrangements for pension credits.

   Rules on concurrency will also need to be amended to ensure that individuals could hold these funds alongside other corporate and personal pension schemes.

The ground rules behind all these practical issues should be to maximise simplicity of the scheme and its operations, recognising that this may limit choice in the interests of low costs and wider take-up.

**CHAPTER 4**

# CONCLUSION

THE PANEL WOULD LIKE TO THANK all those who participated in this review and shared their comments and analysis. We believe it was extremely worthwhile in enabling a thorough and considered evaluation of an important potential reform of the UK's pension structure.

As the summary made clear, we concluded that there is strong support for proceeding with a proposal along these lines, while identifying and reporting a number of issues that will need to be resolved in the final implementation.

We also recognise that this proposal is not, of itself, a complete response to the significant challenge of ensuring tomorrow's pensioners can look forward to the standard of living they expect. It is one component of a much wider task of building greater funded provision through additional private and employer schemes. Nevertheless we believe it can make an important contribution in encouraging that development.

**APPENDIX 1**

# SUMMARY OF THE

# CONSERVATIVE PARTY'S PROPOSAL

APPENDIX 2

# PROCESS AND THOSE CONSULTED

**Review Process**

The review was launched in late November 2000, the target timetable is set out below. Participating bodies were sent copies of the policy proposal. Members of the panel held discussion workshops with those bodies over the course of the consultation. There was also the opportunity to make a submission to the review process through the web site, the results of this part of the process are shown in Appendix 4. The Pension Review Panel presented their conclusions and recommendations to David Willetts MP in February 2001, the final report is also published on the web site. The key dates for the process are listed below.

| | |
|---|---|
| 16 November | Pension Review Launched |
| Late November | Key Bodies & Organisations Contacted |
| December & January | Consultation Phase |
| January | Report Drafting |
| February | Presentation & Final Report |

**Participating Bodies**

The Pension Review Panel consulted widely within the industry. The process included discussions with or written submissions from the following groups and bodies:

Association of British Insurers – ABI
Association of Independent Financial Advisors – AIFA
Hermes
Lane Clarke & Peacock
Legal & General PLC
National Association of Pension Funds – NAPF
Prudential PLC
Scottish Equitable
The Institute of Directors
The Pensions Management Institute
UK Shareholders' Association
Zurich Scudder Investments
Zurich Financial Services

APPENDIX 3

# PARLIAMENTARY QUESTIONS AND INFORMATION FROM THE GOVERNMENT ACTUARY

**APPENDIX 4**

# ANALYSIS OF WEBSITE RESPONSES

The web site has proved a useful tool in widening the review and enabled the CPS to effectively consult with a larger and more diverse range of professionals and organisations. The CPS is particularly pleased to have received submissions from individual IFAs that have without doubt added value to the process.

The web site received 432 visitors over the period. 38 made detailed submissions. The key findings from the web site are listed below.

*1. Do you believe there should be rules to govern/control where funds arising from the basic pension rebate could be invested?*

| | |
|---|---|
| Yes | 96% |
| No | 4% |

*2. Which of the following investments should be allowable?*

| | |
|---|---|
| Gilts | 100% |
| Equities | 100% |
| Unit Trusts | 78% |
| Investment Trusts | 82% |
| Venture Capital Trusts | 67% |
| Property | 61% |

*3. Should it be possible to invest the resulting funds overseas?*

| | |
|---|---|
| Yes | 100% |
| No | 0% |

*4. 78% of consultees believed that a list of approved schemes for an individual to invest in. Of those:*

- 68% believed this could be achieved with the existing set of pension products available today;
- 100% believed that people should be able to make their own contributions to the fund;
- 100% believed that employers should be able to make their own contributions to the fund.

*5. Only 11% of people thought a 'national fund' managed by a government appointed board of trustees should be the preferred option. Of those:*

- 100% believed that the government should not be able to direct investments;
- 88% believed that the 'national fund' be made available for existing pension providers to offer as an investment option;
- 92% felt the 'national fund' should be invested directly into assets, through managed pension funds.

*6. Should it be possible for employers to make contributions?*

| | |
|---|---|
| Yes | 100% |
| No | 0% |

*7. The right to contract out is intended to be offered to those under 30, will these people need advice in order to opt out?*

| | |
|---|---|
| Yes | 42% |
| No | 58% |

*8. If the Government offers a guarantee that on retirement a person who has opted out will receive at least the equivalent of the basic state pension, through a top up if necessary, will people need advice on whether to contract out?*

| | |
|---|---|
| Yes | 21% |
| No | 87% |

*9. If choosing the opt out is made simple, through the offer of a guaranteed equivalent to the basic state pension, and that individuals needed little or no advice, do you believe this will make marketing the option easier and increase take up rates.*

| | |
|---|---|
| Yes | 100% |
| No | 0% |

*10. Should people receive an annual (at least) statement of combined pension benefits from all pension sources?*

| | |
|---|---|
| Yes | 63% |
| No | 11% |

*11. Is it important that the fund is portable?*

| | |
|---|---|
| Yes | 83% |
| No | 3% |

*12. Do you think there will be problems with the existing concurrency regulations?*

| | |
|---|---|
| Yes | 61% |
| No | 11% |