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Put the saver first

Catalysing a savings culture

MICHAEL JOHNSON

THE AUTHOR

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Acknowledgement
Support towards research for this Study was given by the Institute for Policy Research.

ISBN No 978-1-906996-59-8

57 Tufton Street, London SW1P 3QA

Printed by IMS Ltd, Ellis Square, Selsey, Chichester, PO20 0AF

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A note on the word "industry"

In this paper, "the industry" refers to all those engaged in the retirement savings arena, including fund managers, life insurers, trustees, regulators, the ombudsman and third party service providers (including actuarial and investment consultants).

NOTE

This report is an abridged version of Michael Johnson's more detailed, comprehensive paper on this subject (of over 200 pages). This can be purchased at a unit price of £45 from the Centre for Policy Studies website (www.cps.org.uk) or by telephone (020 7222 4488). Bulk orders qualify for a discount.

FOREWORD

Michael Johnson's sixth scholarly paper provides a dispassionate assessment of the UK's pension industry, an industry that matters because it is the crucial conduit between savers' capital and the investment needs of business. As an outsider, with no vested interests, Michael's previous papers considered government policy, and were addressed to politicians and political parties. This one is different: it is intended as a wake-up call to the industry itself.

Michael's motivation is a belief that catalysing the revival of a savings culture is fundamental to Britain's long-term economic growth and competitiveness. We also need a savings culture because increasing life expectancy has left the Government with little choice other than to send the State Pension Age into retreat, thereby extending people's working lives. And whilst we hope that the state pension will be increased, as envisaged in the DWP's 2011 Green Paper *A state pension for the 21st century*, this is of little comfort to those physically unable to work into their late 60s.

They face a lengthening period, between ending work and receipt of the state pension, of significant income shortfall, which they will have to bridge using personal savings. Some state benefits will be available, but these alone may be insufficient, not least given the financial climate and the prevailing ethos of personal responsibility. But the pensions and savings industry has yet to meet many people's discretionary and retirement savings needs, ideally presented as one, simple, low cost product. The exception is the Individual Savings Account (ISA), not least because drawings from ISAs are not subject to income tax.

The key objective of this paper is to encourage the industry to bring about transformational change from within. By taking a risk, and challenging its own vested interests, it could boost its efficiency. Lower prices, and enhanced transparency, would lead to more business with more customers: a "win-win". There is a window of opportunity. The alternative is to await the very real possibility of further state intervention, perhaps when auto-enrolment (and NEST) is reviewed in 2017.

This paper's broad-reaching collection of actionable ideas, for both the industry and the state, should serve as a catalyst for the debate as to the future of the pensions industry.

Patricia Hollis
(Baroness Hollis)

Howard Flight
(Lord Flight)

INTRODUCTION

In mid-2011, Robert Chote, the chairman of the Office for Budget Responsibility (OBR), declared the UK's economic outlook to be "unsustainable".[1] He was referring to the UK's public sector debt, expected to rise indefinitely in the longer term. The primary cause is our ageing population, driving sharp increases in the costs of health care, state pensions and long-term care, combined with a contracting tax base relative to total population size.

In addition, Britain is under a competitive assault from globalisation, particularly from countries with younger, and more dynamic, populations. Furthermore, some have little concern for the niceties of a true democracy (no need for planning permission for a new dam or railway in China); this gives them a competitive edge. Without radical policy changes, we can expect our deteriorating public finances to lead the UK into a vicious circle of slower growth and higher interest rates.

Furthermore, this grim outlook could be accompanied by inter-generational strife. Today's Generation Y (broadly, those in their twenties and thirties) could be the first generation to experience a lower quality of life than that enjoyed by their parents. Over the last five years, the UK's standard of living has declined by 4.8% and, given the outlook for national debt, there is the potential for considerable further decline.

Only now are politicians beginning to contemplate the pressures facing future governments, and how to avert what the data suggests is heading our way. They are, however, seriously compromised by facing a 50 year problem alongside a five year electoral cycle. The blue corner of the Coalition has, however, proffered a suggestion to head off the crisis-in-waiting, encompassed in its prevailing political ethos of "personal responsibility". This is thinly veiled code for "you're on your own, folks", essentially an attempt to catalyse a cultural shift away from being a nation of borrowers to one of savers, particularly (given our ageing population) retirement saving.

This is important to individuals… and critical to the nation. Savings fuel investment, which drives increased productivity and economic growth; without that, our quality of life will certainly deteriorate. This means engaging with the financial services industry which is widely, and justifiably, distrusted.

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1 At the launch of the OBR's *Fiscal Sustainability Report*, July 2011.

SUMMARY

This paper is concerned with catalysing a savings culture in the UK. Today it is impeded by an under-performing retirement savings industry ("the industry"), at least some of which is dysfunctional. In addition, the Treasury and the Department of Work and Pensions (DWP) have conflicting objectives ("spend" versus "save"): pushmi-pullyu government.

Furthermore, the interests of the nation and the industry are not aligned. Ordinarily this would not be of great importance, but financial services are an exception. Not only does the industry directly benefit from an annual subsidy of over £30 billion (via tax relief), but the Treasury fields the consequences of industry failure, via welfare payments, made manifest by an under-saving nation.

Consequently, the industry has to change, dramatically. **The guiding principle for this paper is that change would be more lasting if it were driven by the industry itself, rather than through intervention from another key stakeholder, the state.** The industry is in the Last Chance Saloon of public opinion. It now has a brief opportunity (between now and 2017) to take a lead and resuscitate its reputation. If it were not to have made substantial progress before the 2017 review of auto-enrolment (and the restraints on NEST), then this principle should wither, and the state should be entitled to take far more assertive action. The challenge would then be to work out what legislation, and regulation, would deliver a *transformational*, rather than incremental, change in attitudes towards saving.

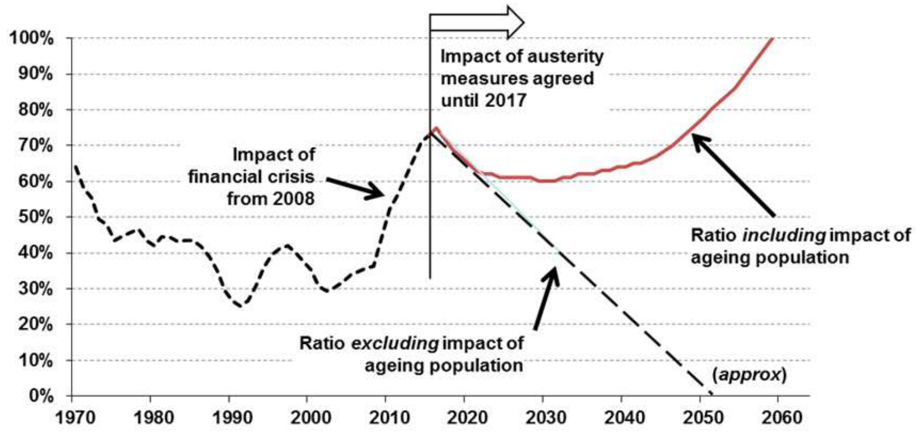
In the meantime, the Government is legislating within the pensions and savings arena at an unparalleled pace, and risks legislative overload. Ministers would welcome initiatives from within the industry, thereby obviating the need to further burden the legislature. Indeed, there is a golden opportunity for the industry to take the lead, by fundamentally realigning its interests with those of its customers, thereby rejuvenating its reputation. **Essentially, the industry should put the customer at the centre of everything it does.**

A battle for capital is coming to the developed world...

- The UK's public finances are being squeezed. Age-related state spending is rising, as the post-war bulge of "baby boomers" moves into retirement, the allied cost being exacerbated by rising life expectancy. Simultaneously, the ratio of people of working age to pensioners is falling, so the tax base is narrowing as a proportion of the total population.

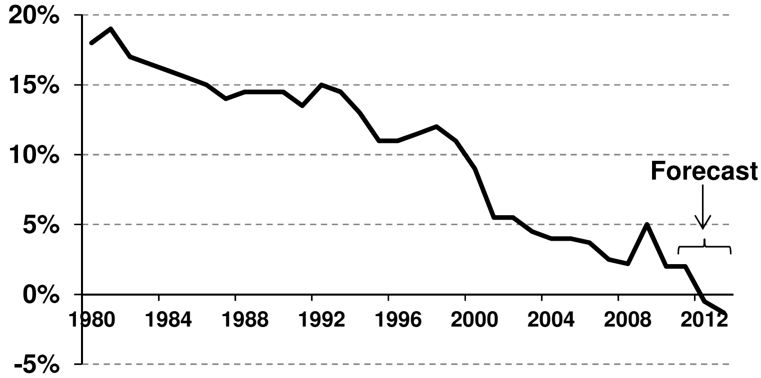
- The ratio of public sector net debt to GDP is projected to continue to rise, to 69% of GDP in 2015-16. Thereafter, the austerity measures agreed to 2017 could eliminate the national debt by around 2050 (assuming various assumptions hold true, notably for growth) *excluding* the deleterious impact of our ageing population. Once this is factored in, national debt is expected to fall back to 60% of GDP in the mid-2020s, and then climb inexorably through 100% of GDP (107% of GDP in 2060-61). Not so long ago the long-range target was 40% of GDP.

Central projection for UK national debt to GDP ratio, (%)[2]



- This, combined with Britain's lack of a savings culture, has profound adverse implications for our ability to finance investment and, consequently, economic growth and, ultimately, the quality of life of our citizens. Indeed, we could soon expect to reach a tipping point, after which the nation will be de-cumulating its aggregate savings. Japan is on the verge of being the first developed economy to experience this, primarily because of its rapidly ageing population; retirees consume savings on a net basis, as they draw down their past-accumulated assets.

Japan's national savings rate as a % of GDP[3]



[2] Data sources: OBR and IFS.

[3] Data sources: Japanese Cabinet Office and Goldman Sachs Global ECS Research.

- Demographically, the UK is perhaps 20 years behind Japan, but on a similar path (albeit mitigated by higher immigration). Consequently, there is an air of inevitability about a further deterioration in the nation's propensity to save. This, combined with our rising national debt, would have catastrophic consequences for the UK, not least because it is likely to coincide with other developed nations experiencing the same phenomenon: a scramble for internationally-sourced capital will then ensue. As a result, we should expect the cost of capital to rise significantly.

...so a savings culture is essential

- Since 1948 the UK's household savings ratio (HSR) has averaged 6% (today it is below 7%), whereas European HSRs are typically 11% to 15%. Our lack of a savings culture is partly (not entirely) due to widespread public enmity towards the industry. Its performance has been abysmal for at least a decade, amongst the worst in the developed world. The average annual return on UK workplace pension funds has fallen by 0.1% every year between 2001 and 2010. Conversely, returns on pension funds increased by an average of 3% per year in Germany, 4% per year in Poland, and 5% per year in Chile (i.e. a 64% better performance than the UK's pension funds, over the decade, on a compounded basis). Only two countries (the US and Spain) have performed worse. Meanwhile, the industry's remuneration has been excessive.

- The industry has to rebuild trust before it can expect pro-active consumer engagement. Fundamentally, it must resolve the "principal-agent problem", the abuse of asymmetric information by (industry) agents whose interests are not aligned with those of their customers. This, and a culture of opacity, exposes consumers to moral hazard, as well as the deleterious consequences of asset mispricing.

- The industry is inefficient, laden with a lengthy chain of agents that separates the end-users of markets: savers and investors at one end, and capital-seeking companies at the other. One consequence is excessive costs (particularly remuneration), indicative of competitive forces failing to operate effectively (notably a lack of pricing tension). These costs are borne by customers, resulting in the erosion of their savings. This ultimately damages the economic interests of the UK.

Consumer behaviour

- The industry's dysfunctionality is aided and abetted by how consumers behave (as well as the media, which feeds in the trough of the aggrieved). A long list of human foibles impedes the creation of a savings culture, including a short-termism, so deeply embedded that, for many people, it occludes any fear of poverty in retirement. Inconsistent and intermittent saving, our lack of comprehension of risk and return, and our vulnerability to unconscious biases (such as over-optimism and loss aversion) all add to our seemingly irrational behaviour towards money matters. But this is not due to a lack of analytical skills, financial acumen or access to information; it is the price of being human, and therefore very hard to fully explain, let alone address.

One simple goal would suffice for most of us

- Most people never think about establishing any specific savings objectives, let alone planning how to achieve them. The majority of the population should be encouraged to set themselves one simple goal at the point of retirement; to be a debt-free home owner (i.e. no mortgage and no consumer debt). Thereafter, they could perhaps downsize to top-up their retirement income, and perhaps finance long-term care. The unspecified objective is to curtail the erosion of capital, through years of paying interest out of post-tax earnings.

- In the meantime, the industry is facing many conundrums. For example, people like to start saving as late as possible and then save as little as possible, with minimal risk, yet they have high expectations for the (ex-post) outcome.

Only the industry can rescue its own reputation

- The industry should ask itself some tough questions, including *"What is our purpose?", "What could we do to demonstrate that we share a common purpose with our customers?"* and *"Where is the industry headed?".* This paper suggests that industry ownership, personal risk and remuneration need serious review. One conclusion is that if distribution issues are successfully addressed by auto-enrolment, the industry's primary focus should move to the remaining parts of the value chain: fund management, the provision of annuities, product manufacture, advice and administration.

Transparency: in the industry's interests

- The industry must become transparent. For example, standardised "on the road" pricing is required; the Total Expense Ratio is misleading and inadequate because it only captures explicit expenses charged directly to a fund. It excludes trading (i.e. transaction) costs, both implicit (primarily the bid-offer spread) and explicit (commission, stamp duty and any front-end and exit charges). In 2010, the City extracted some £7.3 billion in implicit charges, about which investors were told… nothing.

- Fund managers should provide an industry-standardised Total Cost of Investment (TCI), to include all up-front transaction costs and, crucially, the bid-offer spread, deducted as if it were a front-end charge. The TCI should be included in the woefully inadequate Disclosure Tables published by the Investment Management Association (IMA).

- Furthermore, the IMA should not be involved in the categorisation of funds, not least because, as a trade body financed by the industry, it lacks a common purpose with consumers. The IMA's position is that "*the IMA sectors are not and never have been risk ratings. The sector definitions have always been plain for all to see on our web site.*" But this is not the point. The issue is that many people *perceive* "Cautious Managed", for example, to imply "low risk". Distributors (including IFAs) harness this to maximum effect, thereby rendering the IMA unwittingly complicit in the predicament that, for example, Arch Cru's investors find themselves in today.

- In addition, the IMA's "Absolute Return" and "Protected" tags should be scrapped. The former promises "at least a meagre positive return" (2011 outcome: more than 60% of the funds produced negative returns). The latter holds out hopes of capital preservation for cautious investors (2011 outcome: 11 out of 13 such funds lost money).

- Fund managers should also provide an Indicative Net Return (INR), using a standardised range of *conservative* (i.e. gilt-based) assumptions for fund return. It should take into account any performance fees, with transaction costs based upon the prior year's portfolio turnover rate. The latter requirement is to tackle a serious issue; when fund management fees are negotiated down, a significant rise in portfolio turnover can result. For example, between 2003 and 2007, the average commission rate on public sector pension funds fell, but this apparent consumer triumph was extinguished by the revelation that portfolio turnover *tripled* over the period, more than doubling the total commission payments to brokers.

Industry remuneration

- The industry would appear to have forgotten that customers are providing the scarce resource upon which the whole of the savings industry relies: their savings capital. Fund managers, for example, should link almost all of their fee income to the value they add to clients' risk capital (i.e. the performance above a benchmark), with only a tiny fixed fee charged to meet services such as *modest* salaries and safe custody. Ideally, the industry will itself bring about such a change (perhaps after pressure from trustees, advisers and scheme sponsors) but failing that, state intervention should be considered.

Give customers what they want

- Much of the industry's ability to redeem itself rests on giving customers what they want. Most customers want less choice; it confuses the layman and provides a ready excuse to procrastinate and do nothing. Reducing choice is also in the industry's interests because choice increases marketing costs and adds to operational complexity. One of NEST's competitors (NOW Pensions) offers only one fund, i.e. no choice; based upon its experience in Europe, it expects to sell more. This paper exposes some investment banks' hypocrisy over choice; it is good for customers, but not for their own employees' pension arrangements. "Lifestyling", target date funds and default funds are also discussed, the latter drawing on an assessment of Australia's forthcoming MySuper scheme.

- The merits of passive (i.e. tracker), rather than active, fund management are considered in detail. A comparison of the post-cost performances of actively- and passively-managed funds suggests that the "purchasing" decision is, by and large, blind luck. Data also suggests that the probability of the average active equity fund manager outperforming his benchmark over three successive years is around 5%. Given that no one is able to accurately predict *which* fund managers will perform best, over future decades, the suggestion is that the additional costs of active management are not justified. The return-eroding consequences of portfolio turnover are also examined.

- Over 90% of the population (i.e. the mass market) has very simple requirements of the industry. But the industry is not meeting them. Motivated by the prospect of higher fees, it prefers to sell over-engineered, complex products, the demand for which is often imagined. The result is higher costs (at the consumers' expense) and lower sales. The industry should accept reality: most products do not meet the needs of most people and, for many basic rate taxpayers, particularly Generation Y,[4] this includes pensions (unless generous employer contributions are on offer). Product development efforts should be focused on ISAs.

It should be convenient to save

- Consumers would like to see the emergence of nimble new entrants to the distribution arena. Supermarkets, for example, are conveniently located, more trusted than the industry and keen to enter the financial services arena. But their growth ambitions are being frustrated by barriers to switching personal current accounts, lack of access to information and excessive regulation. Even Tesco, with its familiar brand, strong customer base and physical presence, is struggling to get a foot in the door of the UK retail banking market: lesser-known entrants have

[4] Generation Y; born between the mid/late 1970s and the early 1990s.

little chance. Aspiring new entrants to the financial services arena should collaborate to lobby the Government to facilitate a simple account-switching service.

- With lifestyles becoming increasingly digital, Generation Y, in particular, is looking to social media for many of their financial service needs. This paper describes Germany's Fidor Bank, which retains a focus on the core competencies of a bank ("old values") whilst serving people through new media. Fidor Bank is essentially engaged in community building. Everything it does is highly transparent, which builds trust with its customers. It is placing a significant emphasis on explaining why, not what, it does, appreciating that people buy the former, not the latter. Unsurprisingly, the emergence of Fidor's online community-based banking could present a serious headache for (German) regulators, but Fidor reports a surprising degree of regulator enthusiasm.

Annuities: simple, fair and transparent pricing required

- There is a growing awareness that pricing in the annuities market is "opaque and unfair" and "toxic", depriving retirees of up to £1 billion of income each year. The Open Market Option (OMO), which allows retirees to shop around for the best annuity rate, is widely regarded as a failure. This paper proposes that the exercise of the OMO should be made mandatory, achieved via an annuities clearing house; essentially, a marketplace in which all annuity providers participate. Contract standardisation would be a pre-requisite, and pre-auction aggregation would encourage stronger bids, the average size of DC pots being annuitised (roughly £25,000) being too small to appeal to some providers. The clearing house should be established by the industry, but if it were not operative within three years, say, then the DWP should itself establish such a facility.

People want simple products: little progress

- Ten years ago Ron Sandler's review called for a "simplified" range of low-cost, risk-controlled savings products. Since then, little progress has been made, perhaps because defining "advice" is difficult, and a definition for "simplified" products has yet to be agreed. Meanwhile, the three reasons cited by Sandler as to why the industry was failing to serve large portions of the population still hold true today: the complexity and opacity of many financial services, the failure of the industry to attract and engage with the majority of lower- and middle-income consumers, and the inability of consumers to drive the market.

The RDR and the advice conundrum

- The Retail Distribution Review (RDR) is discussed at length. It will produce some benefits to savers, including the creation of clear water between advice and product, improved transparency in respect of charges, a marked improvement in the quality of advice, and a resurgence in "sensible" financial products. The latter includes passive funds, investment trusts and National Savings & Investments (all ignored by commission-hungry salesmen). Commission-heavy products, such as With Profit endowments and investment bonds, may disappear altogether, through lack of demand.

- No one doubts that the RDR will lead to a contraction in the availability of affordable advice. It also invites an arbitrage; as the RDR only applies to "advised" sales, advisers could get round the ban on commission by focusing on "non-advised" sales. Information, guidance and market comparisons could all be provided without crossing the line into "advised sale" territory.

- The terms "independent" and "restricted" should be removed from the advice lexicon, thereby removing the scope for client confusion. Australian-style controls should be introduced on recurring advice fees, and all legacy trail commission should be stopped (failing that, strict disclosure requirements should be introduced). With regards to Europe, if the Government were to be unsuccessful in preventing the European Commission imposing Solvency II-style rules onto pensions, it should insist upon a very long transition period, perhaps 20 years.

The industry should forget about "advice" and focus on "financial planning"

- People want simple, common sense advice. No one has yet defined "simplified" advice, but it is likely to be of low value relative to "full" regulated advice, and thus unlikely to be commercially viable. But there is a deeper issue which the RDR fails to grapple with: what constitutes "good" advice, when it is impossible to measure, and its consequences may not be felt until perhaps decades later?

- This paper suggests that advisers should be encouraged to think about "personal financial planning" rather than "advice", embracing the Institute of Financial Planning's standards for professionalism. Furthermore, the IFA label represents an irretrievably damaged brand and should be consigned to history. "Advisers" should be re-termed "financial planners", perhaps sub-categorised in a manner that describes what they actually do, which could be product- or role-specific.

The communications challenge

- The pensions and savings arena is a blizzard of complexity, jargon and meaningless terminology; perfect material for obfuscation and bamboozlement. Add an overlay of distrust and regulatory excess to an inherently uninteresting theme (that mostly offers only distant, and uncertain, rewards), and it is no surprise that pensions are not "demanded" in the manner that other consumer goods are. They have to be "sold".

- The industry's communication challenge is exacerbated by having to sell to four distinct age groups (baby boomers, and Generations X, Y and Z), each with their own preferred modes of communication (as well as different product needs). Given that the DWP and NEST face a similar challenge, they and the industry should work together to establish a common language for retirement saving, rather than spawning a multitude of phrasebooks offering different interpretations of pensions jargon.

Implementation: collaboration required

- From the industry's perspective, today's situation is akin to a tragedy of the commons. By pursuing individual advantage, and common greed, almost none of the industry's participants are taking the concerted action required to rejuvenate their reputations. Given the strategic importance of savings (to fund investment and provide retirement incomes), the industry is risking assertive state intervention in the savings arena, which is unlikely to be to its advantage.

- The industry knows that it has to dramatically change, and confront the existing practices that are enshrined in the principal-agent problem. But individual businesses are struggling to accept that there could be any "first mover" advantage. This paper suggests a strategy to overcome what is akin to the prisoner's dilemma, based upon the "first mover" companies being "Nice, Retaliatory, Forgiving and Clear" to the other industry participants.

The state is part of the problem

- Successive Governments (irrespective of political hue) have exhibited a lack a common purpose. The DWP wants people to save, whereas the Treasury favours consumption, not least to bolster VAT receipts. This pushmi-pullyu position manifests itself as contradictory policies and ambiguous communication, which does nothing to stimulate a savings culture.

- Even worse, the Government has a strong vested interest in real interest rates remaining negative. This facilitates bank recapitalisation and erodes debt, benefitting the two most indebted sectors of the economy (the banks and the Government)… to the detriment of *cash*-based savers (i.e. most savers). Consequently, the Government cannot legitimately encourage most people to save; its message ought to be "*consider reducing your consumer credit debts as a form of saving.*"

Auto-enrolment: include ISAs

- The auto-enrolment legislation excludes Individual Savings Accounts (ISA). This is a mistake, not least because people *like* ISAs, perhaps the last trusted brand in the savings arena. In 2010-11, £53.9 billion was subscribed to ISAs, including £15.8 billion to Stocks and Shares ISAs, up 26% on the previous year. Conversely, personal pensions attracted only £14.3 billion, marginally down on the previous year. Clearly, ISAs are increasingly being considered as a flexible form of retirement saving, ready access to ISA assets being more valued than pensions' upfront tax relief on contributions. Consequently, ISAs should be included in the auto-enrolment legislation.

Pensions: limited early access is the lesser of two evils

- The lack of pension pot assets' immediate utility is a huge deterrent to engaging with retirement saving, and is at odds with how Generation Y, in particular, are living their lives. They want to be in control; pensions are just too inflexible. The stark truth is that the pension product is from another time, before college debt, fragmented careers and increasingly unaffordable housing. The risk is that Generation Y will *never* engage with pensions. The next cohort of pension-purchasing clients could be very thin.

- There is an understandable concern that early access risks a wave of unwise consumption, leaving people with less income in retirement than otherwise. The answer is *controlled* early access, in a manner that resonates with how people think; for example, "my home is my pension". Early access to pension assets should be permitted for the sole purpose of assisting in the purchase of a home (i.e. investment, not consumption), up to 25% of the value of the pension pot, say.

NEST: uncompetitive

- NEST is gearing up in the face of mounting private sector competition. It suffers from several serious structural disadvantages, notably the cap on contributions and the inability to transfer assets in or out: both limitations should be removed.

- In addition, NEST's default fund is excessively defensive, placing an emphasis on lower risk investments in the initial (foundation) stage, contradicting the conventional wisdom that younger investors, in particular, should be exposed to "growth" assets (such as equities). NEST's explanation is that consumer research pointed to people wanting low risk. This could seriously backfire; the combination of NEST's 1.8% up-front subscription fee plus significantly negative real interest rates could, in any event, lead to capital erosion. *In extremis*, a potential mis-selling scandal in the making? NEST's default fund should be redesigned to take account of inflation, with more emphasis placed on growth assets in the foundation stage.

Default options to the fore?

- It is unclear whether harnessing inertia through auto-enrolment alone will be sufficient to overcome the widespread procrastination in respect of (long-term) saving. Some believe that it will prove inadequate, and that if the private pension system is to succeed, it will have to use a whole series of additional default options to harness inertia, located at key decision-making points in the savings life cycle. These could include default investment funds, default transfer and consolidation of multiple asset pots, a default solution to minimise "lost" pots and default annuity provision. And if that does not work, much heavier state intervention could be the last resort, including the introduction of compulsory saving.

The Super ISA

- People crave simplicity, including a single savings account that serves two basic needs: discretionary (rainy day) savings and retirement savings: this report proposes the Super ISA account, an enhanced form of today's ISA. All new-borns should be allocated a Super ISA account at a default provider (the Post Office?), identified by their National Insurance number. In the meantime, today's ISAs could be linked to future NEST accounts (to become Super ISAs), capable of accepting lump sum and regular savings (including employer contributions), accessing a range of investment options and automatically differentiating between discretionary and retirement savings for the purpose of allocating tax-based incentives. Thus, all UK-born citizens would, in time, have at least one simple, seamless savings vehicle from cradle, via employment and into retirement.

Pension pot consolidation

- Steve Webb, the pensions minister, has embraced the small pots problem with his "Operation Big Fat Pension Pot" initiative. Indeed, NEST's inability to accommodate transfers is entirely inconsistent with his direction of travel. In light of the advent of auto-enrolment (expected to produce millions of additional small pots), the initiative is accompanied by a welcome sense of urgency (and perhaps state-funded incentives should be offered to hasten consolidation?). The Government should lead by example, by restructuring the Local Government Pension Scheme's (LGPS) disparate collection of 101 separate funds into a few (five?) much larger funds. The prevailing inaction contradicts a lot of what Steve Webb is seeking to achieve. It should also demand much greater disclosure of pension funds' all-in operating and transaction costs per member. This would help expose the inefficiencies of small pension schemes, and therefore help beneficiaries hold trustees to account.

- The industry, acting collaboratively, should be driving the process of pot consolidation, by establishing an industry-wide DC pension pot consolidation service. A "BACs for pensions" clearing house should facilitate the payment of contributions and transfer values, with a bridge across to NEST. Such a facility would benefit customers and providers alike (not least because it would cull the million "dead" pots that have to be administered); a rare "win-win". The DWP should set the industry a two year deadline within which to build this; if the industry were to fail to act decisively, then NEST becomes the obvious consolidation vehicle.

- Other on-going Webb initiatives are welcomed, including ending short service refunds. There are, however, some initiatives that the Government should not take, such as price capping (and it should continue to ignore the industry's clamour for state-issued longevity bonds). This paper also considers ways of resuscitating private sector DB schemes, along with (post-Dilnot) financing of long-term care (which is in competition with saving for a pension).

Tax: at the root of complexity

- The UK's long-term savings landscape can be characterised by one word: "complex". Tax is at the root of this complexity. There are multiple tax regimes in each of the three phases of saving (accumulation, decumulation and post-death). In addition, the life insurance industry has gravitated into the fund management arena by embedding what are sometimes mere slithers of insurance into investment products. These are often cosmetic, and sometimes valueless. From a tax perspective, this re-characterises the products as something very different to a conventional investment, confusing most savers. The Office of Tax Simplification (OTS) should simplify the taxation of investment products by ending the separate treatment for products with any (usually cosmetic) embedded life insurance.

State-funded incentives are ineffective

- Today's incentives to save for retirement are essentially financial, comprising tax relief on contributions (cost: £26.1 billion in 2010-11), the tax-exempt 25% lump sum at retirement (£2.5 billion), NICs relief on employer contributions (£13 billion) and tax relief on investment income (£6.8 billion). Over the last decade, relief on income tax and NICs has totalled a staggering £358.6 billion, excluding tax foregone on the tax-exempt 25% lump sum. Over the same decade, the Treasury's cost of funding tax relief (i.e. the yield on gilts) averaged a real 3.9% per annum, yet the average real annual return on all UK pension funds was a paltry 2.9%, i.e. 1% per annum *less*. Thus, the return on the Treasury's co-investment with people saving for retirement, through the medium of tax relief, has been a *negative* £17.5 billion. With most gilts being purchased by pension funds, this is largely explained by industry charges.

- Consequently, we should be questioning the effectiveness of retirement saving tax incentives. Today, they are crude and mis-directed (primarily towards the wealthy), they lack any emotional resonance and they do little to catalyse a savings culture amongst younger workers, thereby exacerbating the looming generational inequality.

- The savings incentives framework should be realigned, which would require a preparedness to confront deeply-entrenched vested interests within the industry. The annual contribution limits for tax relief on ISA and pension saving should be combined at no more than £40,000, with the full limit available for saving within an ISA. This limit could be used as a key cost control lever, with adjustments to it (driven by affordability) becoming a regular feature in the Budget.

- In parallel, higher rate tax relief should be shelved, saving £7 billion annually and, as a *quid pro quo,* the 10p tax rebate on pension assets' dividends and interest income should be reinstated, costing roughly £4 billion per year. Rising interest rates would increase this cost, but also probably herald a recovering economy, aiding affordability. Retaining additional income within pension pots would ensure that the positive power of compounding benefits the individual, rather than the Treasury.

- In addition, the 25% tax-free lump sum concession should be replaced with a 5% "top-up" of the pension pot, paid prior to annuitisation. This would be of more lasting benefit to retirees (the "top-up" adding to people's annuity income) and would be cost neutral (assuming higher rate relief has ended).

- This paper also considers a range of alternative scenarios for tax relief, including whittling it away entirely to mirror the next generation's preference for saving within an ISA for their retirement income. Ideally this would be built upon a bedrock of income certainty provided by a higher State Pension. The pensions industry would then need to refocus on delivering high quality asset management of (long-term) savings, the word “pension” having been consigned to history.

Incentivise employers… and also provide a “safe harbour”

- The crucial role that employers’ contributions perform in supporting occupational pension schemes should be acknowledged. Consequently, employers’ NICs relief should be retained, and this paper considers further incentivising employers with a 5% distribution reward, paid in respect of basic rate taxpaying employees’ contributions above the NEST minimum of 4% of band earnings.

- “Safe harbour” guidelines (not regulation) should be swiftly introduced (not least because of the onset of auto-enrolment), to exempt employers from class actions, provided it can be demonstrated that they were acting in the best interests of scheme members. This would help reverse employers’ increasing reluctance to discuss pensions with their employees.

Financial education: shambolic

- The delivery of financial education in the UK is through a melange of under-funded charities and private sector initiatives, the latter comingling good intentions with commercial and PR agendas. Notwithstanding the lack of any coherent national strategy, today’s focus on enhancing reasoning and technical capability, and avoiding disaster (an “away from”), is misdirected. The benefits of saving, rather than the disadvantages of not saving, should be emphasised, couched in lifestyle terms relevant to the individual. Carol Vorderman’s proposal for a new-style practical maths GCSE should be implemented.

- The educational focus should also deliver some stark home truths to disabuse people of financial alchemy and any notions of getting something for nothing. This culture should be confronted, with education focused on offering some insights into the ballet between risk and return. (NEST’s overly cautious default fund is unlikely to foster such an understanding.) The industry has a more prosaic rationale for encouraging savers to take more risk for themselves. The availability of risk capital is likely to diminish once Solvency II and CRD III have been implemented. Consequently, the cost to the industry of transferring risk to third parties is likely to rise, so the more risk that savers retain, the better.

- It is too early to tell whether the Money Advice Service (MAS) is a scandal in the making, or a force for good. Since its April 2011 launch it has experienced considerable turmoil, and a marked contraction in its ambitions. It could rise or fall, spectacularly; if the latter, then at least it is not public money that is being wasted (albeit that the consumer ultimately pays for it, via an industry levy). Its budget for 2011-12 was £43.7 million, with an extraordinary £13.5 million earmarked for staff costs (i.e. £168,750 per head, based upon a staff of 80). The 2012-2013 budget is £46.3 million, plus £34.5 million to help fund a new debt advice service.

The regulatory regime: not fit for purpose

- It is clear that many people are investing in products they do not fully understand, which are governed by a jungle of complex rules and tax regimes that, collectively, almost nobody understands. Savers are therefore putting their trust in the industry, and they need to be protected in situations in which the industry has a knowledge advantage. For almost all investors, this excludes very little. A less subtle description is that regulation should protect investors from the industry's self-interest, its inefficiencies and, in some cases, its predatory instincts. Historically, regulators have regulated the industry hoping to improve the latter's relationship with consumers. They have patently failed.

Regulators: a new approach, and cultural change, required

- This paper suggests some guiding principles for regulation, describes the current regulatory framework and proposes that prudential oversight should be de-emphasised. The blunt instrument that is (an ever-increasing volume of) classical regulation is totally unsuited to engendering trust, which is not created *through* regulation. A dramatically new approach to regulation is required, to usher in a period of regulatory enlightenment and innovation.

- Essentially, regulators should "encourage" the industry to sell benefits, not products, and dramatically improve its efficiency by cutting costs. The latter should be measured against quantifiable yardsticks that include a sharp reduction in the number of pension schemes, the creation of a functioning (industry-wide) mechanism for the consolidation of individuals' multiple pension pots, and *total* transparency in respect of charges, costs and fees. If performance benchmarks are not met within the three years, say, then the regulators' stance should change gear, to "require".

- Regulatory reformers' perennial favourite, a fixation with changing *structures*, is eschewed. The exception is to propose that the Pension Protection Fund and The Pensions Regulator (TPR) should merge, to concentrate on issues facing (withering) DB schemes, with the TPR's DC schemes being transferred to the FSA.

- Unfortunately today's regulators are not equipped, neither operationally or culturally, to experiment and take risks. This would represent a major departure from their traditional (classic public sector) behaviour, which has perhaps been overly-influenced by self-preservation.

Governance: trustees should be *much* more assertive

- Trustees are falling well short of performing what ought to be a pivotal role within the industry. They are uniquely well positioned to align the industry's interests with those of its customers, notably by confronting the principal-agent problem. This paper describes a range of measures that trustees should be taking to drive reform, including demanding more transparency, the unbundling of charges, the surfacing of hidden counterparty risks (with full disclosure of allied income) and, crucially, catalysing the scaling up of pension schemes.

- Scaling up would provide many opportunities to harness economies of scale, including exercising leverage on investment price, an ability to afford better quality in-house expertise and external advice, and improved access to both co-investment opportunities and a wider range of asset classes, geographies and (fixed income) asset maturities. Larger schemes could also exercise annuity buying power on behalf of retiring members, harvest the "governance dividend" attributed to large schemes, and lower the administration cost per member.

Professional trustees are conflicted… and a few are untrustworthy

- Notwithstanding the expressed duty of trustees to act in the beneficiaries' interests, it is naïve to expect professional trustees to be pursuing scheme consolidation ("scaling up") with enthusiasm; it runs contrary to their interests. Fewer schemes means less business; ultimately, trustees are agents and, even with the best will in the world, it is nigh impossible to perfectly align their interests with those of their principals (the scheme members).

- Not all trustees can be trusted. Some need to free themselves from the corrupting influences of so-called "corporate entertainment". Others are unmotivated to study the relevant data, so they are uninformed and do not ask the right questions. More serious, however, are conflicts of interest between some trustees and service providers; trustees' purchase of services from sister companies, and reciprocation, should be banned. All trustees should be licensed and regulated, and held to account in respect of their individual legal liability. Professional trustees looking to demonstrate that their interests are truly aligned with their beneficiaries should consider adopting mutual status.

Fiduciary duty to the fore

- Irrespective of any progress with simplification, the ethos of fiduciary duty should be resuscitated across the industry, not least given the on-going demise of trust-based DB pension schemes. The contract-based DC alternatives lack any obvious fiduciary obligations and, in workplace schemes, a lack of governance responsibilities on the employer. Ideally, all pension schemes should be subject to fiduciary-like obligations, to close the growing "governance gap" between trust- and contract-based schemes.

- The objective of this paper is not to demonise the industry, although some within it may see it that way. As custodian of individuals' private retirement savings, a healthy financial services industry is in everyone's interests (not least because of its export potential), but today it sometimes serves itself ahead of its customers, and that is not in the national interest.

- There are 104 proposals, including 19 primary proposals.

What next? Some suggestions for further work

- Once readers have had an opportunity to digest the contents of this paper, it is hoped that some will be motivated to focus on addressing some of the paper's challenges……. before it is too late.

- More specifically, the industry and the Treasury, ideally working collaboratively, should develop a single savings product that *combines* the attributes of ISAs and pensions, as envisaged as the Super ISA account.

- A second stream of work is required concerning the decumulation of pension pot assets, notably around the design of annuity products and the establishment of an efficient clearing house (or market). Again, collaboration between industry and government would be preferable, not least because the lack of capital available to support annuity risk is likely to be exacerbated by the implementation of Solvency II (currently the subject of government negotiations with the EU).

- Thirdly, the Treasury should take a close look at the effectiveness of the incentives framework in catalysing a savings culture; a radical *redeployment* of resources is required (as opposed to simply cutting tax relief).

THE 104 PROPOSALS

The 19 primary proposals are identified by ☆

The macro-economic case for a savings culture

Proposal 1: The Government should implement public and fiscal policies designed to support a target household savings ratio of 12% by 2020.

The consumer: self-imposed barriers to saving

Proposal 2: John Kay's on-going review of short-termism should be broadened beyond the industry, to include all of the retirement savings' stakeholders, notably the Government, the regulators and savers themselves.

Pushmi-pullyu government: a lack of common purpose

Proposal 3: The Government should be extolling to cash-based savers the merits of negative debt ("negadebt"): "*consider reducing your consumer credit debts as a form of saving".*

Proposal 4: The Government should establish an independent, standing body to monitor pension saving levels, and the effectiveness of pensions policy, including tax-based incentives. This remit could be extended to include producing a suite of proposals that would "shove" the industry into putting the customer at its centre. ☆

What is the role of the state?

Proposal 5: The Government should provide simple guidelines to help people decide whether to opt out from auto-enrolment, or to stay in to, perhaps, benefit from employer contributions.

Proposal 6: ISAs should be included in the auto-enrolment legislation, eligible for employee contributions as an alternative to an occupational pension scheme or NEST. Tax relief, and the employer's contribution, should go into NEST or another pension savings vehicle (to ensure funds retention).

Proposal 7: The proposed removal of existing consumer protection legislation related to workplace personal pensions, to accompany auto-enrolment, should be stalled until a clear reason for so doing becomes apparent.

Proposal 8: NEST's default fund should be redesigned to take account of inflation, with more emphasis placed on growth assets in the foundation stage.

Proposal 9: NEST should make available an inflation-indexed fund, to help head off the risk of a high opt-out rate, perhaps as part of a redesigned default fund.

Proposal 10: When the Government reviews auto-enrolment in 2017, it should commit to increase the minimum NEST contribution rate to 12%, in stages, the additional 4% coming from employees.

Proposal 11: The state should, if legally possible, write off NEST's start-up costs to remove the 1.8% subscription charge, consistent with the Treasury's philosophy of "spend to save".

Proposal 12: NEST's annual contributions cap should be removed immediately.

Proposal 13: The ban on transfers into (and out of) NEST should be lifted at the earliest opportunity, ideally before October 2012 (subject to operational considerations).

Proposal 14: All public sector employees faced with rising pension contributions should be compelled to pay the additional contributions into their own NEST accounts, rather than to the Treasury.

Proposal 15: All new-borns should be allocated a Super ISA account at a default provider (the Post Office?), identified by their National Insurance number. This single savings account would serve two basic needs: discretionary (rainy day) savings and retirement savings. In the meantime, today's ISAs could be linked to future NEST accounts (to become Super ISAs). ☆

Legislative changes; looking ahead

Proposal 16: It is imperative that a simplified state pension comes to fruition before the end of the current government's term of office (as described in the DWP's 2011 green paper *A state pension for the 21st century*).

Proposal 17: Early access to pension assets should be permitted for the sole purpose of assisting in the purchase of a home, up to 25% of the value of the pension pot, say. The property should be the buyer's sole property.

Proposal 18: The Office of Tax Simplification (OTS) should simplify the taxation regime of investment products by ending the separate treatment for products with any (usually cosmetic) embedded life insurance.

Proposal 19: The industry, acting collaboratively, should establish an industry-wide DC pension pot consolidation service. As a "BACs for pensions" clearing house, it should facilitate the payment of contributions and transfer values, with a bridge across to NEST. The DWP should set the industry a three year deadline within which to build this.

Proposal 20: A default option could be introduced so that anyone leaving a pension scheme with a pot below £5,000 *automatically* receives a transfer value, either as a payment to their new employer's pension fund or into NEST. Employees should be allowed to "opt-out", then leaving the pot in situ.

Proposal 21: The £2,000 trivial commutation limit in respect of occupational schemes (and personal pensions from 2012) should be increased to £5,000.

Proposal 22: The DWP and the industry should establish a joint task force to create a set of standard procedures and documentation templates to facilitate occupational schemes transfers and personal pension pot consolidation across the UK.

Proposal 23: The disclosure requirements accompanying transfer values should be improved, to ensure that scheme members are making well-informed decisions and not unwittingly losing out on valuable pension rights. If the industry were to establish a code of conduct (as Steve Webb has requested), it should be enforced by TPR (DB schemes) and the FSA (DC schemes).

Proposal 24: The Government should make it clear to the industry that it expects all providers to offer an asset re-registration service, within two years, say.

Proposal 25: Short service refunds should be banned and individuals should have full vesting rights from the first day of employment (i.e. pension scheme benefits cannot be revoked).

Proposal 26: Providers should be required to make explicit the cost consequences of any dual charging practice, in respect of deferred membership of a scheme.

Proposal 27: The Government should resist any temptation to issue longevity bonds.

Proposal 28: Product price capping is not the way forward. It risks unintended consequences and does not tackle the core problem of misaligned interests between industry and customers.

Proposal 29: Government initiatives to loosen the strictures on private sector DB pensions provision could include:

- unwinding the regulations which converted discretionary benefits into onerous, legally hard-wired, pension guarantees;
- amending employment and pension scheme legislation to remove ancillary benefits that are not directly related to pension provision; and
- lobbying the Accounting Standards Board (ASB) to soften the accounting treatment of DB pensions, notably FRS17.

Proposal 30: Carol Vorderman's proposal for a new-style practical maths GCSE should be adopted, complemented by an educational focus that confronts the "something for nothing" culture and offers some insights into the ballet between risk and return.

Proposal 31: Adult financial education should focus on increasing engagement with personal finance, not enhancing individuals' technical capability. The benefits of saving, rather than the disadvantages of not saving, should be emphasised, including the virtues of saving through negadebt (negative debt), i.e. paying down debt, perhaps as part of debt counselling.

Proposal 32: The office of the Pensions Ombudsman should be transferred into a new Pensions Jurisdiction in the Financial Ombudsman Service, as first proposed in a DWP-sponsored independent review of pensions institutions (in 2007).

Proposal 33: The CRAG guidelines for assessing assets in respect of LTC means-testing should be amended to include so-called insurance products that are, in reality, investments, *particularly* investment (or "insurance") bonds.

Proposal 34: If the Dilnot proposal to cap individuals' LTC contributions at £35,000 were to be implemented, then consideration should be given to very specifically and publicly meeting the associated cost by ending higher rate tax relief.

Proposal 35: Early access to pension assets should be permitted, to specifically pay for long-term care *once the need has arisen*. In addition, the use of pension savings should be permitted to meet the purchase cost of disability-linked annuities.

Proposal 36: The weak demand for equity release products to finance long-term care needs to be fully understood, as part of the post mortem of the Dilnot report.

State-funded incentives for retirement saving

Proposal 37: The annual contribution limits for tax relief on ISAs and pensions saving should be combined at no more than £40,000, with the full limit available for saving within an ISA. This limit could be used as a key cost control lever, with adjustments to it (driven by affordability) becoming a regular feature in the Budget. ☆

Proposal 38: Higher rate tax relief should be abolished, the annual £7 billion saving being partly used to reinstate the 10p tax rebate on pension assets' dividends and interest income (costing some £4 billion). Alternatively, this would more than meet the cost of foregone tax on dividends and income, were the ISA subscription cap raised to £40,000. ☆

Proposal 39: The Chancellor should consider replacing all income tax relief with a single flat rate of 25%, or even 30%. This would particularly incentivise low earners to save for retirement. Costs could be controlled by adjusting the annual contribution limit on which relief could be gained.

Proposal 40: The 25% tax-free concession on lump sum withdrawals at retirement should be replaced with a "top-up" of 5% of pension pot assets, paid prior to annuitisation. ☆

Proposal 41: To be eligible to make any lump sum withdrawal at retirement, the individual should meet the Minimum Income Requirement of £20,000 a year (subject to trivial commutation rules).

Proposal 42: Salary sacrifice schemes are essentially a tax arbitrage at the Treasury's expense. As such, their cost should be reflected alongside income tax relief, to provide a clearer picture of the total cost of tax-based retirement saving incentives. A simplification step would be to ban them.

Proposal 43: The rate of tax relief on contributions to children's pensions should be increased to 30%, irrespective of the donor's marginal rate of income tax.

Proposal 44: Employers should be incentivised to encourage basic rate taxpaying employees to boost their pension contributions. This could take the form of a 5% distribution reward from the Treasury, paid in respect of employee contributions above 4% of band earnings, say. ☆

Proposal 45: "Safe harbour" guidelines (not regulation) should be swiftly introduced (not least because of the onset of auto-enrolment), to exempt employers from class actions, provided it can be demonstrated that they were acting in good faith. ☆

Governance

Proposal 46: Trustees should encourage employers to remove any short service refund option from their schemes (as an interim measure, until the option is banned).

Proposal 47: The providers of master trusts should be wholly independent of the trustees, to minimise the scope for conflicts of interest.

Proposal 48: The DWP should set itself the objective of directing all pension scheme sponsors, or their delegates, to either abandon contract-based provision or amend it to incorporate fiduciary-like obligations.

Proposal 49: Trustees should insist that all pension scheme counterparties provide unbundled charging structures; every cost component should be clearly discernible.

Proposal 50: Trustees and scheme sponsors should eschew providers that differentiate their charges between active and deferred scheme members.

Proposal 51: Fund managers should disclose all counterparty risks to which they are exposing their investors, notably counterparty risks associated with stock lending. Income derived from such activities, and how it is divided between managers and investors, should also be disclosed. Ideally, all lent stock should be secured by G10 government bonds.

Proposal 52: FairPension's proposal in respect of defining fiduciary duties should be supported: it is that a parallel Section 172 of the Companies Act (spelling out directors' duties to shareholders) should be introduced for institutional investors, spelling out their duties to pension fund beneficiaries.

Proposal 53: All pension funds should be required to publish, annually, their all-in operating and transaction costs per member. The data should then be compiled, by the FSA and TPR, into a public league table that includes scheme size, as measured by membership and assets.

Proposal 54: The Department for Communities and Local Government (DCLG) should demonstrate the benefits enjoyed by pension funds "scaling up". It should facilitate the consolidation of today's 101 separate LGPS funds into five much larger funds (each with some £30 billion in assets, on average). The funds should be overseen by a single, trust-based, body.

Proposal 55: Trustees should not transact with fund managers whose fees are simply linked to the volume of assets under management. Fees should primarily be related to the value added, through skilful fund management (for active-managed funds) or cost-plus (passive funds).

Proposal 56: Trustees should only appoint administrators who demonstrably embrace automation, standardisation (data format and documentation) and scale.

Proposal 57: Independent trustees should be paid and subject to a code of conduct (i.e. self-regulation), so that those who are purchasing trustee services know what they will be getting. This should be accompanied by an industry-agreed “buyers guide”. Separately, trustees’ purchase of services from sister companies, and reciprocation, should be banned.

Proposal 58: Trustees should free themselves from the corrupting influences of so-called “corporate entertainment” proffered by service providers, by just saying “no”.

Proposal 59: Serious consideration should be given to imitating Australia’s tough approach to trusteeship, including the licensing of trustees.

Proposal 60: Professional trustees looking to demonstrate that their interests are aligned with their beneficiaries should consider adopting mutual status.

Proposal 61: Trustee boards should evidence to scheme members that they meet Ronald Capelle’s four good governance principles concerning board accountability, who actually conducts the work (i.e. not the board itself, nor related entities), board membership selection criteria and board capabilities.

Regulation

Proposal 62: The PPF and TPR should merge to concentrate on issues facing DB schemes. All DC schemes under the aegis of TPR should be transferred to the FSA.

Proposal 63: The words “independent” and “restricted” should be removed from the advice arena, thereby removing the scope for consumer confusion.

Proposal 64: When considering the payment for advice, the FSA should focus its attention on what customers prefer, rather than pursuing its current path, of consulting the industry.

Proposal 65: All customers who pay advisory fees on an on-going basis should be required to opt in to the arrangement on an annual basis. If they fail to do this, fee payments should cease.

Proposal 66: Ideally, all legacy trail commission should be stopped upon RDR implementation. If this is illegal, advisers in receipt of trail commission should be required to tell their clients of the trail’s present value, calculated to the client’s normal retirement age, as at 1st January 2013, the date of RDR implementation. The FSA should provide a table of the appropriate discount rates to use.

Proposal 67: Every piece of regulation should be accompanied by a description of how it helps stimulate a savings culture. The Regulatory Impact Assessment (RIA) should also include a summary of whatever burdens the new regulation would impose on the industry (which inevitably has a cost consequence for consumers).

Proposal 68: The regulators should provide the industry with a three year notice period, within which it must dramatically improve its efficiency, measured against quantifiable yardsticks that include:

- a sharp reduction in the number of pension schemes;
- a functioning (industry-wide) mechanism for the consolidation of individuals' multiple pension pots, with reports on the rate at which individual pot sizes are increasing; and
- *total* transparency in respect of charges, costs and fees.

If performance benchmarks are not met within the three years, the regulators' stance should change gear, to "require" rather than "encourage". This could be achieved by extending the criteria to meet Qualifying Workplace Pension Scheme (QWPS) status, including minimum thresholds for asset and membership size.

Proposal 69: The FSA, ideally working with a consumer group such as Which?, should produce a set of standards to protect DC scheme members, covering the quality of administration, governance, investment policy and transparency.

Proposal 70: The regulators should establish a flexible regulatory framework for schemes which include risk sharing between employer and employee, rather than automatically applying the DB rule book.

Proposal 71: The Government should ensure that European retail financial services legislation reinforces the objectives of enhanced transparency and assertive scheme governance. In particular, it should encourage Europe to appreciate the merits of consolidating individuals' pension pots and the scaling-up of pension schemes.

Proposal 72: If the Government were to be unsuccessful in preventing the European Commission imposing Solvency II-style rules onto pensions, it should insist upon a very long transition period, perhaps 20 years.

Proposal 73: In the event of Solvency II-style capital rules being introduced for pension products, the Government should resist any industry pressure to assume longevity "long tail" risks.

Proposal 74: The regulators' focus should shift away from prudential oversight of the industry to facilitating a dramatic rise in consumer engagement with the industry, by driving the industry to make transformational improvements in its efficiency and customer service. The regulators should answer a question of themselves: *"if we shared a common purpose with the industry's customers, what would we be talking about amongst ourselves, and what would we be doing?"*

The industry should ask itself some tough questions

Proposal 75: Industry participants looking to create long-term value with a positive social impact, rather than short-term economic gain, should consider adopting partnership status (or mutuality).

Proposal 76: Fund managers should aim to return to their investors at least 65% of their target excess return. No fees should be charged in respect of performance below the benchmark, other than a small access fee to cover the cost of the basic service being provided (primarily administration and safe custody).

Proposal 77: The industry should aspire to design pension schemes that combine:

i. Peter Drucker's proposals to reduce agency-derived costs, namely that single-purpose pension mutual organisations should be created to build economies of scale and foster good governance, with
ii. Keith Ambachtsheer's proposals to address human foibles: automatic enrolment with a set minimum contribution rate, and "auto-pilot" processes for both the investment of savings and the subsequent capital conversion into deferred life annuities.

Transparency

Proposal 78: In addition to their Total Expense Ratio (TER), fund managers should provide an industry-standard Total Cost of Investment (TCI). It should take account of all up-front transaction costs, i.e. including any front-end charges (divided by that fund's average holding period), taxes and, crucially, the bid-offer spread, deducted as if it were a front-end charge.

Proposal 79: An Indicative Net Return (INR) should be provided by fund managers, using a standardised range of *conservative* (i.e. gilt-based) assumptions for fund return. It should take into account any performance fees, with transaction costs based upon the prior year's portfolio turnover rate.

Proposal 80: The IMA Disclosure Tables should be expanded to detail not just the Total Expense Ratio (TER) but also the aforementioned Total Cost of Investment (TCI). The tables should include the fund's annual portfolio turnover and the average bid-offer spread.

Proposal 81: The IMA should establish a standard Income, Expenditure and Risk Disclosure Table that lists *all* sources of a fund's income, and how it is distributed, along with all expenditure. There should also be a risk summary that includes any counterparty risks to which the fund is exposed.

Proposal 82: Ideally, all volume rebates should be banned. Failing that, their allocation between distributors and customers should be disclosed. Scheme trustees should use this data to negotiate with distributors for a larger share, on behalf of scheme members.

Proposal 83: All pension schemes (including funded public sector schemes) should be compelled to make publicly available all the IMA Disclosure Tables pertaining to the schemes, accompanied by a scheme-wide summary of the tables' content.

Proposal 84: For the purposes of information disclosure, "sophisticated" (or "qualified") investors should be afforded the same level of protection as "retail" investors.

Proposal 85: The IMA should cease its involvement in the labelling of funds. A body representing consumers' interests, and independent of the industry, should be appointed by the DWP to opine on what fund labels are for, who the intended audience is, who should do the work, and who should pay for it.

Give customers what they want

Proposal 86: Trustees and scheme sponsors should seek to emulate Australia's MySuper by offering DC workplace schemes that have a simple default product offering a single, diversified investment strategy.

Proposal 87: The industry should modernise the optimal default "lifestyle" strategy to accommodate some flexibility around an individual's date of retirement, salary profile and attitude to risk.

Proposal 88: Trustees, and others with savers' interests at heart, should exert some control over fund managers' rate of portfolio turnover, to limit transaction costs. They could start by demanding complete transparency as to the managers' return objectives, and the allied cost to customers.

Proposal 89: When investing in mainstream asset classes, scheme trustees should generally favour passive (index-tracking) funds over actively-managed funds.

Proposal 90: The industry, encouraged by trustees and scheme sponsors, should seek to improve "back office" efficiency, by emulating Australia's SuperStream plans.

Proposal 91: The industry should acknowledge reality, that the inflexibility of pension products renders them unattractive to many people, notably basic rate taxpayers and Generation Y. Product development efforts should be focused on ISAs.

Proposal 92: Aspiring new entrants to the financial services arena should collaborate to lobby the Government to facilitate a simple bank account switching service.

Proposal 93: The industry should end the provision of “financial advice” and think in terms of providing “personal financial planning”, embracing the Institute of Financial Planning’s standards for professionalism.

Proposal 94: The industry should consign the IFA label to history. “Advisers” should be re-termed “financial planners”, perhaps sub-categorised in a manner that describes what they actually do, which could be product- or role-specific.

Proposal 95: The financial adviser community should set its sights on attaining QCF Level 6 if it wants to be perceived as truly professional, respected on a par with accountants and lawyers.

Proposal 96: A qualifications sub-stratum could be introduced to accommodate those within the “advice industry” who are not actually giving advice. This could include product-specific advisers and a recognised “Facilitator” who takes people through a process that culminates in them making their own decisions.

Proposal 97: The annuity Open Market Option should be replaced by mandatory exercise through an annuities clearing house, established by the industry, in which all annuity providers participate. The clearing house should offer a limited number of simple, standardised annuity contracts, plus a more tailored suite of enhanced annuities. If it were not operative within three years, say, then the Government should itself establish such a facility.

Proposal 98: The industry should commit to pay a return on Cash ISAs that is *at least* equivalent to the *gross* interest rate on the provider’s ordinary savings.

Proposal 99: In light of auto-enrolment, the industry should consider adopting a more progressive pricing model (i.e. large pots subsidise small pots) to increase its engagement with the mass market (following GSK’s (pharmaceutical) example).

Proposal 100: The industry, acting collaboratively with the DWP and the FSA, should develop a standard DC pension scheme that incorporates risk pooling, with adequate protections to satisfy the DWP’s (reasonable) concerns over the inter-generational transfer of risk.

Proposal 101: The industry should work with DWP and NEST to establish a common language for retirement saving, rather than spawning a multitude of phrasebooks offering different interpretations of pensions jargon.

Proposal 102: The industry, in collaboration with the state, should embark upon a communications campaign around the theme of risk and return, perhaps based upon "nothing ventured, nothing gained".

Proposal 103: The majority of the population should be encouraged to set themselves one simple goal at the point of retirement; to be a debt-free home owner (i.e. no mortgage and no consumer debt).

Implementation: collaboration required

Proposal 104: "First mover" companies, i.e. those taking a lead to reform their industry, should consider adopting Robert Axelrod's strategy of being "Nice, Retaliatory, Forgiving and Clear" to the other industry participants.

CONCLUSION

The guiding principle for this paper is that change would be more lasting if it were driven by the industry itself, rather than through state intervention. However, the industry's pursuit of its own self-interest, at the expense of its customers, may ultimately prove to be its nemesis. Public opprobrium is such that many people believe that there is no prospect of the industry challenging its own, deeply entrenched, vested interests.

If politicians were to arrive at a similar conclusion, the industry risks muscular state intervention, well beyond NEST in its current form. Once NEST has "bedded down", the government could, for example, dramatically enhance its capabilities (including removing the subscription charge), thereby exerting considerably more competitive pressure on the industry. The government could initiate this by asking an independent standing body (see Proposal 4) to produce a suite of proposals that would "shove" the industry into putting the customer at its centre.

In the meantime, the majority of the population lack the financial wherewithal (and, in many cases, the will) to make their own retirement saving arrangements. Certainly, 90%+ of the population has no need for complex, expensive savings products. Mass mutualisation of their pension pots would be of great service to them. A small number of large, collective, DC schemes would enable people to pool their longevity risk and harness enormous economies of scale to drive costs down. Retirement incomes would then be larger, reducing pensioner poverty and the demand for state benefits, and the underlying pools of assets could, in effect, become akin to our sovereign wealth fund.

But, with the economy weak, the Government is not *currently* pushing to catalyse a savings culture. There is an opportunity for the industry to exhibit leadership (and discover some humility), by implementing a range of initiatives to put the customer at the centre of everything that it does. The industry must confront its own short-termism, and start delivering value for money to its customers, whilst bearing in mind that customers want to feel in control of their savings. It would also have to overcome its fear of simplification, standardisation and transparency, and discard the deleterious practices that are enshrined in the principal-agent problem.

A leap of faith is required by the industry, because whilst profits may diminish in the short term, the long-term outcome could be a rejuvenated reputation… and business growth. Finally, and crucially, trustees need to start behaving as the principals they really are, helping to drive the reshaping of the industry. Indeed, trustees ought to be the catalysts for change.

ACKNOWLEDGEMENTS

This paper was supported by Fidelity Worldwide Investment, as an independent and detailed analysis of the challenges and opportunities facing financial consumers, the industry and its many stakeholders. The report and its conclusions are the work of the author and do not necessarily reflect the views of Fidelity, or any of the other contributors. The author would like to thank Fidelity for its kind sponsorship and, in particular, Robert Higginbotham, former European CEO of Fidelity International. Robert catalysed the paper by asking the author to produce a policy white paper on how the UK financial structure should look in the future, stressing the importance of putting the customer at the centre of the industry.

Patricia Hollis (Baroness Hollis) and Jeannie Drake (Baroness Drake), along with Robert Higginbotham, provided invaluable advice and encouragement, with additional insights from many other contributors, including:

Flora Rose and Dr Yvonne Braun (ABI), Ronan Kearney (Allium Capital), Kevin Wesbroom (Aon Hewitt), Prof Peter Sinclair (Bank of England), Jeremy Cooper (Challenger), Ben Stafford (Cicero), Peter Morris (Civitas), Martin Wigginton (Cofunds), John Howard (Consumer Insights), David Haigh (DWP), Christine Berry (FairPensions), Richard Parkin (Fidelity), Matthias Kröner (Fidor Bank), Martin Palmer and Colin Williams (Friends Life), Milton Cartwright and Sheila Nicol (FSA), Barry Clark (Future Foundation), Kent Choi, Ravi Tanna and Colin Simpson, (Goldman Sachs), Hamish Wilson (Hamish Wilson Ltd), Tom McPhail (Hargreaves Lansdown), David Pitt-Watson (Hermes), Jeremy Sherwood, Tunde Ojetola and Anish Mehta (HM Treasury, OTS), Lord Flight (House of Lords), Nobby Clark and Nick Robinson (HSBC), Phil Hall (ifs), Prof. John Kay, Patrick Lewis and Charlotte Cool (John Lewis Partnership), Edward Bonham-Carter (Jupiter Asset Management), Mike Taylor (LPFA), Paul Woolley (LSE), Laurie Edmans (MAS and NEST), Bob Woods (Mattioli-Woods), Jon Hocking (Morgan Stanley), Lindsay Tomlinson (NAPF), Nick Hungerford and Iain Hollingshead (Nutmeg), Bob Head (Old Mutual), Steve Bee (Paradigm), Steve Groves (Partnership), David Norgrove (PensionsFirst), Wendy van der Hende (PFEG), Robin Ellison (Pinsent Mason), Stuart Southall (Punter Southall), Marc Hommel, Mark Packham and Ed Wilson (PwC), Alan Miller and Gina Miller (SCM Private), Ian Naismith and Robert Fletcher (Scottish Widows), Ian Price and David Lamb (St. James Place), David Nish and John Lawson (Standard Life), Josh Harris (Steve Webb's office), Alasdair Palmer (Sunday Telegraph), Katherine Edwards (Tesco), Nigel Stanley and Helen Nadin (TUC) and David White.

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