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Put the saver first

Catalysing a savings culture

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THE AUTHOR

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ORGANISATION OF THIS PAPER

This paper is divided into five parts.

Part I considers the impetus for change, notably the macro-economic case for a savings culture, and a description of the industry's dysfunctionality.

Part II examines motivation, and people's antipathy towards retirement saving. It suggests a framework to help the industry and the Government identify barriers to consumer engagement that they themselves have erected. Once identified, it becomes easier to work out how to lower them, and this is the focus of the remainder of the paper.

Part III evidences why the state is partly to blame for Britain's lack of a savings culture, and discusses recent government initiatives, notably auto-enrolment and NEST. It then considers the implications of the swathe of on-going initiatives, before examining the effectiveness of the state-funded incentives to save for retirement.

Part IV takes a close look at governance and regulation.

Part V is focused on the initiatives that the industry itself could take to rejuvenate its reputation and restore public trust, an essential pre-requisite to establishing a savings culture.

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
An **abridged version** of this paper can be acquired from the Centre for Policy Studies website (www.cps.org.uk) or by telephone (020 7222 4488).

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)

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 import, 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.

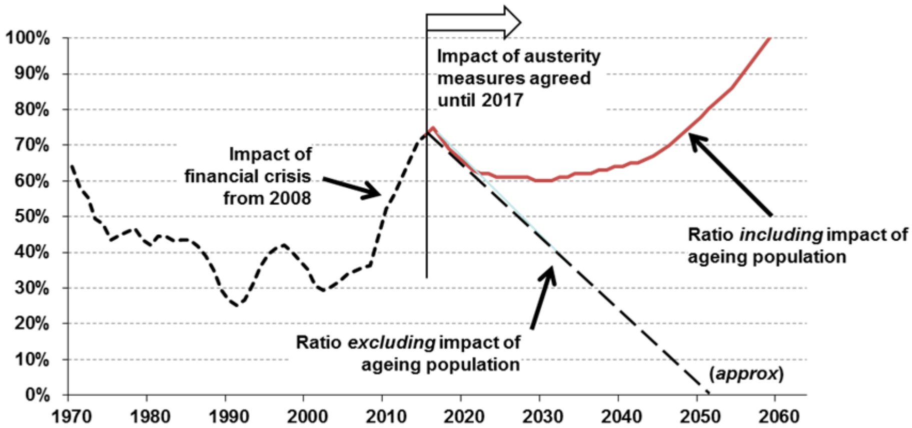
In the meantime, the Government is legislating within the pensions and savings arena at an unparalleled pace, and risks legislative overload. Ministers would welcome initiatives from within the industry, thereby obviating the need to further burden the legislature. Indeed, there is a golden opportunity 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.

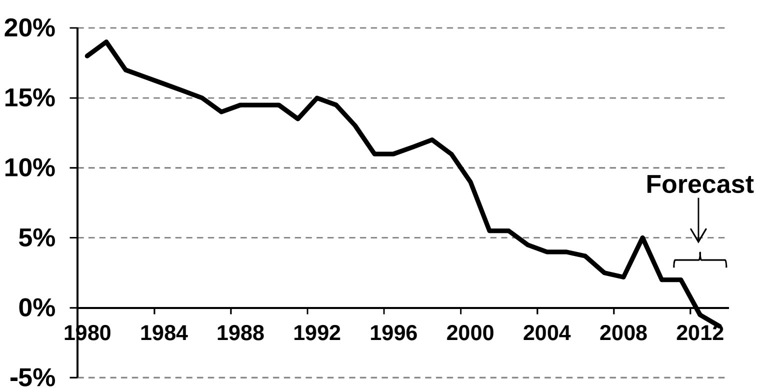
- The ratio of public sector net debt to GDP is projected to continue to rise, to 69% of GDP in 2015-16. Thereafter, the austerity measures agreed to 2017 could eliminate the national debt by around 2050 (assuming various assumptions hold true, notably for growth) *excluding* the deleterious impact of 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, (%)[1]



- 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[2]



[1] Data sources: OBR and IFS.

[2] 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 from UK workplace pension funds was *negative* 0.1% between 2001 and 2010. Conversely, over the same period, the average annual returns from German, Polish and Chilean pension funds were *positive* 3%, 4% and 5% respectively, 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 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,[3] 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 little chance.

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3 Generation Y; born between the mid/late 1970s and the early 1990s.

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 three 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 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.

INTRODUCTION

In mid-2011, Robert Chote, the chairman of the Office for Budget Responsibility (OBR), declared the UK's economic outlook to be "unsustainable".[4] 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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4 At the launch of the OBR's Fiscal Sustainability Report, July 2011.

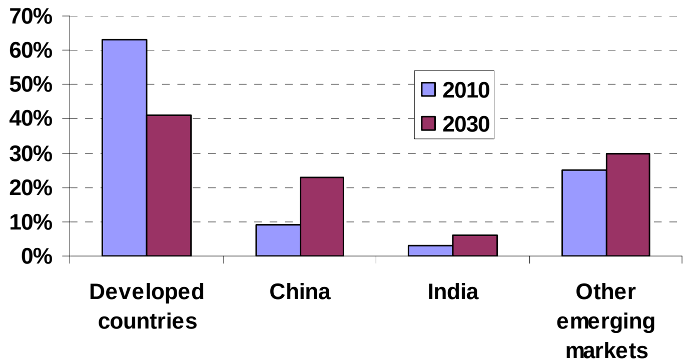
PART I: THE IMPETUS FOR CHANGE

1. The macro-economic case for a savings culture

1.1 The global economy is changing shape

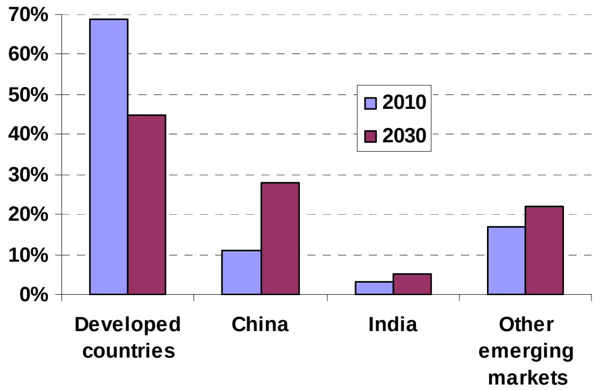
Over the next few decades, the developing economies are likely to grow much more quickly than the developed ones. Consequently, we can expect a dramatic shift in the distribution of global GDP, the centre of gravity moving from the developed countries to those characterised as "emerging".

Figure 1: Share of nominal global GDP[5]



Economies that have excessive current account deficits need to consolidate their public finances (Europe has started, but the US has not). Developed countries' wage levels are likely to experience further downward pressure from heightened global competitiveness, and unemployment could remain uncomfortably high. If it is accepted that political power is derived from economic strength, then the transfer of power in favour of developing nations is reiterated by the forecast (Figure 2) for global equity market capitalisation.

Figure 2: Global equity market capitalisation (% of world)[6]



[5] Goldman Sachs.

[6] ibid.

Table 1 shows that UK fund managers would appear to be anticipating the shift in geo-political and economic power, reducing their allocation to the UK stock market in favour of the booming emerging markets.

Table 1: Equity allocation of UK investment managers[7]

	2006	2007	2008	2009	2010	Change 2006 - 2010
UK	59.2%	51.4%	46.2%	47.1%	42.6%	-16.6%
Europe (ex UK)	16.2%	18.1%	20.6%	17.0%	19.9%	3.7%
North America	12.1%	14.8%	15.6%	13.7%	15.1%	3.0%
Pacific (ex Japan)	4.7%	5.8%	5.2%	8.1%	7.3%	2.6%
Japan	4.3%	4.7%	5.8%	4.7%	4.3%	0.0%
Emerging markets	1.8%	4.3%	6.0%	8.4%	9.7%	7.9%
Other	1.7%	0.9%	0.6%	1.0%	1.1%	-0.6%

Developing nations' economic growth is likely to be accompanied by an increase in leverage. Conversely, developed economies need to deleverage from the today's unsustainably high levels (Table 2), not least because interest rates are likely to rise, squeezing disposable incomes and adding to debt service costs.

Table 2: Leverage; debt as a % of GDP[8]

	Developed economies	
	Household debt	**Govt debt**
UK	**114%**	**77%**
US	99%	83%
Japan	62%	178%
France	63%	86%
Spain	88%	53%
Italy	76%	118%
Average	**84%**	**99%**

	Developing economies	
	Household debt	**Govt debt**
Brazil	18%	66%
Russia	10%	11%
China	24%	17%
India	13%	76%
Mexico	7%	22%
Turkey	47%	48%
South Africa	48%	46%
Poland	33%	51%
Average	**25%**	**42%**

The UK's household debt, relative to the size of the economy, is clearly extremely high by international standards. Other sources suggest that we have 10% of Europe's population but 60% of its personal debt: some £1.46 trillion, i.e. £24,000 per capita, made up of £1.23 trillion of mortgage debt and £228 billion of consumer debt (such as on credit and store cards).[9] This equates to an average of £29,500 per British adult, about 123% of average earnings. In 2011, UK households paid an average of £2,432 in annual interest repayments, equivalent to £173 million per day (£63 billion per year). Furthermore, the OBR expects UK personal debt to grow by nearly 50% by 2015, to £2.12 trillion. The only point of succour is that these *gross* figures are mitigated by an aggregate pool of home equity and pensions savings that is higher than in many other countries.

[7] *Investment Management Association survey of 76 member firms, 2011.*

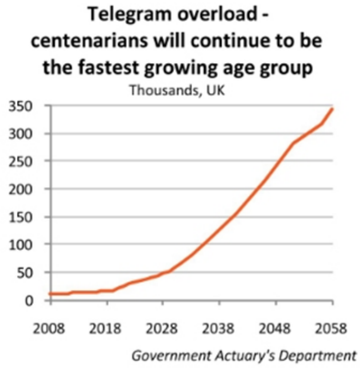
[8] Data as at mid-2011; OECD, HSBC.

[9] Data as at January 2012. *Sources*: National Audit Office and Credit Action.

1.2 The UK population is ageing

Today there are some 10 million people in the UK over 65 years old (17% of the population); that number is expected to nearly double by 2060, to 19 million, 24% of the forecast population of 79 million. The number of people over the age of 80 is expected to rise from three million today to eight million by 2050, indicating that population increases will be concentrated amongst older people.

These figures reflect improvements in life expectancy.



Since 1981, in the developed world, life expectancy at birth has increased by roughly five years, and this trend is expected to continue, perhaps by another seven years by 2060.

Table 3: Life expectancy in the UK, years[10]

	65 year olds		At birth		
	1981	2050	1981	2011	2030
Men	14.0	25.3	84	89	91
Women	18.0	27.7	89	92	95

Meanwhile, developed countries' fertility rates have fallen sharply, to below the replacement rate of 2.1. The corollary of an ageing population is a deteriorating worker dependency ratio. The UK currently has some 3.2 workers supporting each pensioner; this is expected to drop to 2.9 workers per pensioner by 2051, i.e. after the increases in State Pension Age (SPA) which are due to take place under current legislation.[11] The European (i.e. non-UK) ratios are worse, primarily because Europe has lagged the UK in terms of sending its SPA into significant retreat.

Table 4: Dependency ratios for Europe[12]

	2010	2060
Workers (aged 15-64) per pensioner (65+)	3.6	2.1
Workers per non-worker (children and pensioners)	2.0	1.3

1.3 An ageing population: impact on the public finances

An ageing society increasingly consumes, rather than generates, resources, demanding a growing share of public services such as the NHS (as well as retirement benefits). In addition, it is less likely to be innovative, entrepreneurial or adaptable, all qualities necessary to improve productivity, crucial for GDP growth. Within twenty years, this, combined with the deteriorating worker dependency ratio, is expected to hinder the UK's economic growth by 1% per annum (similarly Australia, Austria, Denmark, Germany,

[10] ONS; *Pension Trends, Chapter 2: Population change,* April 2010.

[11] By 2046 the SPA will be 68 years (although some suggest that this is too low, and that we should be 70 by then).

[12] Eurostat projections.

Ireland and the USA).[13] This will depress government revenues and, given that expenditure tends to be sticky, put further pressure on our structural deficit. In the meantime, our growth potential is expected to hover around 2% until 2020, before slowing to 1.5% beyond 2030.[14]

Beyond 2030, unless there are major policy changes, age-related spending is expected to continue to consume an increasing share of national income. A report from the OBR (November 2010) suggests that it will climb from 22.5% of GDP in 2009-10 to 27.1% of GDP in 2049-50. A more recent OBR report[15] projects spending out by fifty years, the main age-related components being:

(i) **health**, rising from 7.4% cent of GDP in 2015-16 to 9.8% of GDP in 2060-61, rising smoothly as the population ages;

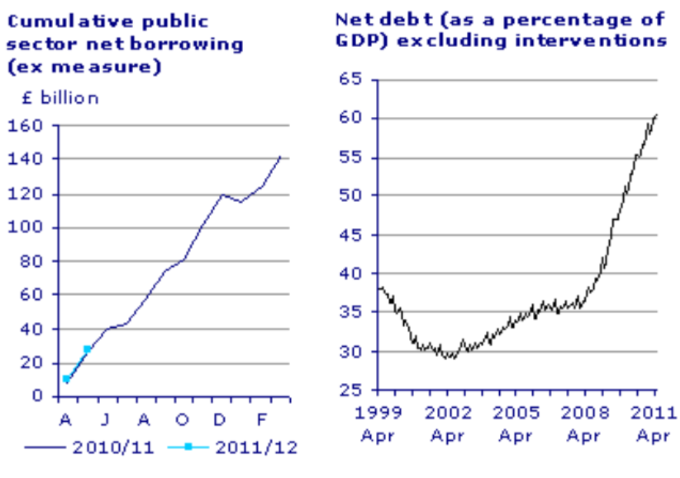
(ii) the **State Pension**, increasing from 5.5% of GDP today to 7.9% by 2061; and

(iii) **social care** costs, nearly doubling from 1.2% of GDP in 2015 to 2% of GDP by 2060.

But our changing demography is expected to leave government revenues roughly stable as a share of GDP. Consequently, spending on the UK's ageing population can be expected to squeeze our financial wellbeing……very hard indeed.

And we should not forget where the UK is starting from. The banking crisis and recession of 2008 and 2009 fuelled the largest budget deficit in the UK's peacetime history; public sector net borrowing was £143.2 billion in 2010-11 (Figure 3). In parallel, public sector net debt (PSND) is rocketing; £920.9 billion (60.6% of GDP) at the end of May 2011, *excluding* the cost of the bank rescue packages ("financial interventions", an additional 90% of GDP).

Figure 3: The UK's deteriorating public finances.[16]



[13] IMF. It is perhaps of little comfort to note that other developed economies are far more exposed than the UK, notably Luxembourg and Greece (an adverse impact of 5.5% of annual GDP).

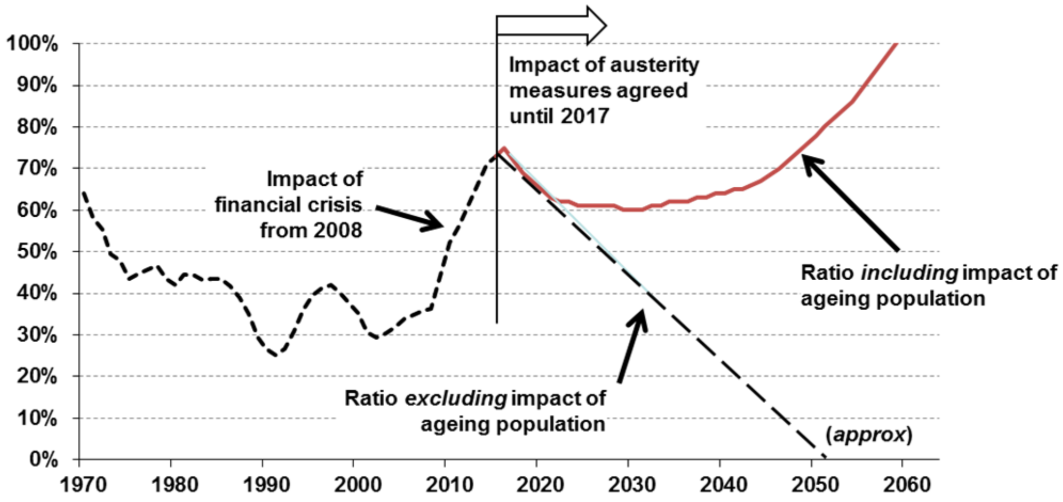
[14] *European Commission's 2009 reports on ageing and debt sustainability*.

[15] OBR; *Fiscal sustainability report*, July 2011.

[16] All source data from the ONS.

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 (see Figure 4). 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.

Figure 4: Central projection for UK national debt to GDP ratio, (%)[17]



In parallel, the primary budget balance (the difference between revenues and non-interest spending) is projected to move from a surplus of 1.3% of GDP in 2015-16 to a deficit of 3.2% of GDP in 2060-61, a deterioration of 4.5% of GDP (£66 billion in today's terms).[18]

The ideal way to reverse the forecast decline in public finances is through economic growth (in excess of that forecast): unlikely to materialise. Other, less palatable (but more realistic) remedies include the erosion of debt through inflation (destroying savings), further austerity, protectionism (ultimately disastrous), higher taxation (thereby reducing disposable incomes and slowing consumption), smaller (and / or later) pensions and other benefits (also hindering consumption), shrinking the state and default.

1.4 The Whole of Government Accounts (WGA)

The national accounts are incomplete because they omit a number of (off balance sheet) items, some of which are huge. These are, however, identified in the Whole of Government Accounts (WGA), a set of consolidated accounts for the entire UK public sector that use commercial accounting principles.[19] The WGA therefore treats UK plc as if it was a business that has to comply with the International Financial Reporting Standards.

[17] Data sources: OBR and IFS.

[18] OBR; *Fiscal sustainability report, Chart 1,* July 2011.

[19] HM Treasury; *Whole of Government Accounts, Unaudited Summary Report for the year ended 31 March 2010,* July 2011. Compiling the WGA was a huge undertaking, started in 2001. It includes data from 1,500 bodies, including central government departments, local authorities, devolved administrations, the health service, and public corporations.

The first WGA results were published in July 2011, comprising the nation's finances for the financial year 2009-10, the final year of the last government. They show public sector assets of £1.2 trillion offset by public sector liabilities of £2.4 trillion, for a net liability of £1.2 trillion, 84.5% of GDP. For comparison, the national accounts show public sector net debt to be £760bn (53% of GDP) on the same date.

The WGA's £2.4 trillion of liabilities includes:

- £1.13 trillion in respect of public service pensions (79% of GDP);
- £803.8 billion of debt in the form of gilts;
- £105 billion of provisions (including £60.6 billion for nuclear power plant decommissioning); and
- £379.4 billion of "other liabilities".

The age-related public sector pensions liability is the dominant component, but its significance should be treated with caution. For example, the reduction in the discount rate used to value the 2009-10 liability increased it by £260 billion, and this would quickly be reversed should interest rates start to rise (as they will, one day). Existing legislation means that the cost of public sector pensions is set to fall[20] from 2% of GDP in 2015-16 to 1.4% in 2060-61, albeit based upon a potentially overly-optimistic GDP forecast.[21] Furthermore, negotiations are on-going to water-down the benefits, notably by moving from a final-salary to a CARE-base framework, and linking the retirement age to the SPA.

The WGA report concludes: *"Further tax increases or spending cuts are likely to be needed after the current fiscal consolidation to help meet the budgetary costs of an ageing population…..A tax rise of 1.5% of national income (£22 billion) would be needed in 2016 to put public sector debt on a path to return to 40% of national income by 2060."* This would be the equivalent of increasing VAT by 4%, to 24%, and is remarkably consistent with another recent report that suggests that an additional £20 billion of tax rises (or spending cuts equivalent to 1.3% of GDP per annum) is needed by 2020 to cut public debt to pre-crisis levels.[22]

1.5 The forthcoming battle for capital

People in retirement typically run down their savings. Consequently, given the UK's ageing population, we should expect, one day, to reach a tipping point after which we, as a nation, start to de-cumulate our aggregate savings, on a net basis. Transition could coincide with other developed nations experiencing the same phenomenon, in which case a scramble for internationally-sourced capital may then ensue. As a result, we should expect the cost of capital to rise…..significantly.

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[20] As a result of up-rating pensions in payment by CPI rather than RPI, the current pay freeze and planned workforce reductions.

[21] Independent Public Service Pensions Commission (Lord Hutton); *Final Report, Chart 1B,* March 2011.

[22] PwC; *UK Economic Outlook,* July 2011.

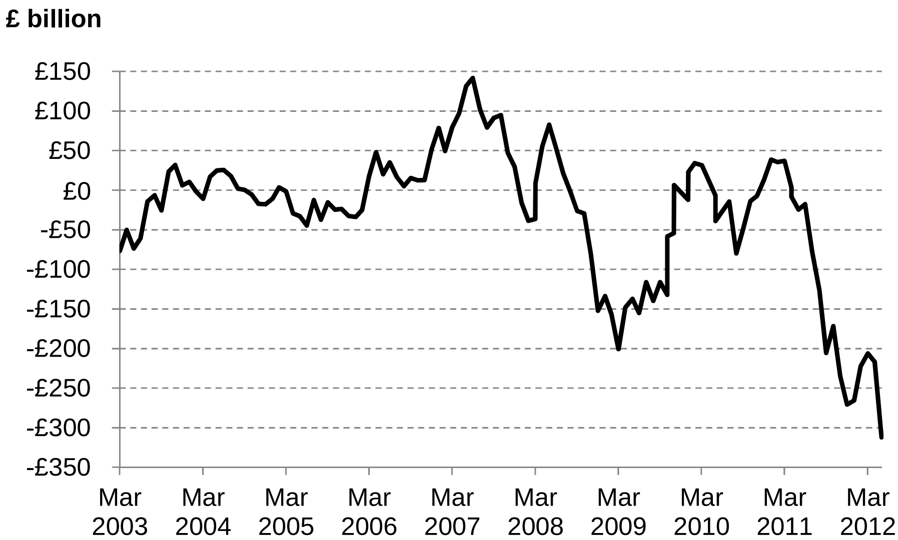
1.6 *In retirement, we are increasingly on our own*

(a) Defined benefit (final salary) schemes in terminal decline

The risk of low incomes in retirement is increasingly being transferred from the state to the individual; witness the retreating State Pension Age (SPA), the covert rise in (state-paid) healthcare rationing, and a less generous welfare state. Similarly, employer sponsors of defined benefit (DB) pension schemes face the cost pressures of rising longevity, poor investment results and red tape. Consequently they are placing more post-retirement financing risk with their employees, by moving from DB to defined contribution (DC) pension provision.[23] In January 2012, Royal Dutch Shell signalled the end of an era for the UK pensions industry, by announcing plans to close its DB scheme to new members, making it the last FTSE 100 company to do so.

Not only is access to DB schemes in decline, but so is their quality. Benefits are being eroded through, for example, the shift from RPI to CPI indexation, slower accrual rates and the introduction of caps on pensionable salary increases. Furthermore, scheme members who consider themselves well provided for, come retirement, are increasingly having to consider their scheme's financial health. Figure 5 shows the aggregate net balance of assets and liabilities of the DB occupational schemes in the Pension Protection Fund's eligible universe.

Figure 5: UK's occupational DB pension schemes: net assets.[24]



At the end of May 2012, the UK's private sector DB pension schemes' aggregate deficit was £312 billion, a record high (and up nearly £100 billion over the previous month). Total assets of £1031 billion and total liabilities of £1343 billion resulted in a funding ratio of 76.8%, with 5,503 schemes (86%) in deficit and 929 schemes in surplus.

[23] 90% of private sector DB schemes are now closed to new entrants, 40% are closed to future accrual (in 2008 it was 3%) (*source*: Association of Consulting Actuaries) and only 19% are still open to new joiners (88% ten years ago). 30% of the DB schemes that are still open to current members (but closed to new entrants) expect to close within five years (*source*: NAPF annual survey).

[24] The Pension Protection Fund's 7800 Index, up to May 2012.

Low investment returns, in particular, are leading to a growing black hole in many schemes. This, plus the realistic prospect of an economic Lost Decade amongst western economies, should be prompting many scheme members to consider just how robust their DB pension promises really are. Yes, there is the Pension Protection Fund (PPF), but those who earn more than around £50,000 a year will not receive full compensation, should their company get into difficulties.[25]

Given the on-going deterioration in access to, and the quality and health of, DB occupational schemes, individuals will have to assume more personal responsibility for mitigating the risk of poverty in retirement. Their choices are limited: work longer and / or save more (perhaps reframed as "consume less"). But in 2010, only 8.3 million (28%) of the UK's 30 million employees contributed to a company DB or DC occupational pension scheme.[26] Of these, 5.3 million were in the public sector, leaving only 3 million private sector employees saving within an occupational scheme (down from 3.6 million in 2008): a mere 12% of the private sector workforce.

Once workplace pensions are included (i.e. membership of group personal pensions, which includes group stakeholder pensions and group self-invested personal pensions), this rises to 39% for men and 28% for women.[27] In 1997, the corresponding figures were 52% and 37%, respectively, confirming the depressing reduction in the number of people saving for a pension (occupational or otherwise) through their place of work. Furthermore, almost 90% of employees now have less trust in their company pension than 15 years ago, up from 74% in 2008.[28] Given that pension scheme membership accounts for almost 75% of pre-retirement saving, retirement incomes are likely to fall (unless other forms of savings increase).

(b) De-risking

Pension funds have, for years, been reducing their exposure to growth assets (i.e. equities), under the onslaught of equity market volatility and increased regulatory pressures. In addition, with most DB schemes now closed, the (growing) majority of members are either deferred or pensioners. Consequently, de-risking is naturally in the ascendency because most trustees accept their consultants' recommendations to adhere to liability-driven investment (LDI) principles. Their primary objective is to meet pensions in payment, rather than long-term assets growth, so default risk is a more prominent concern than otherwise. Equities are therefore sold in favour of less risky fixed income assets (i.e. corporate and government bonds).

Furthermore, the move to linking PPF levies to schemes' asset riskiness (from 2012-13) may well exacerbate this de-risking trend, as would the Institutions of Retirement

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[25] The maximum compensation under the PPF is 90% of accrued pension at the date the pension fund is taken over by the PPF. But there is a cap, so the maximum compensation is £29,897 at age 65. Assuming a person is in a final salary pension scheme and expects to retire on two-thirds of final salary, in today's money a rough calculation means that anyone earning around £50,000 a year or more won't get full compensation for their lost pension.

[26] ONS; *Occupational pension schemes annual report 2010*, *Table 3.2,* October 2011.

[27] ONS; *Pension Trends, Chapter 7: Pension scheme membership, Figure 7.7,* June 2011.

[28] Towers Watson research, January 2012.

Provision's (IORP) mooted introduction of insurance-style funding solvency requirements for DB pension schemes, modelled on Solvency II.[29]

Consequently, the majority of UK DB schemes are now heavily weighted towards fixed income bonds, perhaps rising towards 70% of total assets by 2017 (up from 35% in 2008 and 50% in late-2011).[30] This is bad news for UK plc., which needs equity investment, as well as compromising schemes' ability to recover any deficits (fixed income does not produce capital growth).

(c) Abysmal pension fund performance

The performance of UK pension funds has been abysmal for at least a decade, amongst the worst in the developed world. The average real annual return on all UK pension funds over the last decade (2002 to 2011) has been a paltry 2.9%.[31] The main reasons cited are falling equity markets, low fixed income yields and risk reduction (within DB schemes).

Using the narrower definition of UK workplace pension funds, i.e. excluding occupational schemes and group personal pensions (including group stakeholder pensions and group self-invested personal pensions), the average annual return was *negative* 0.1% between 2001 and 2010.[32] Conversely, over the same period, the average annual returns on German, Polish and Chilean pension funds were *positive* 3%, 4% and 5% respectively, 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, where the value of money in pension funds has fallen by between 1% and 2% per year over the last decade.

This dreadful performance by the industry results in smaller pensions for many. Meanwhile, the industry's ability to over-reward itself continues unabated.

1.7 A nation of under-savers

The most frequently quoted indicator of the UK's savings activity is the household savings ratio[33] (HSR, see Figure 6). It includes both pension contributions and debt repayment (which is akin to saving), and is closely associated with how people view their economic situation. The ratio tends to rise when economic confidence is low (e.g. when job prospects are uncertain), and vice versa.

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[29] European Commission, Green Paper: *Towards adequate, sustainable and safe European pension systems,* 7 July 2010.

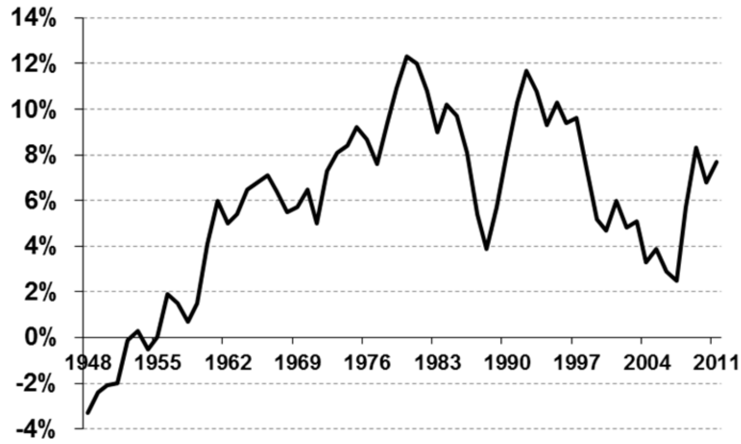
[30] JLT Pension Capital Strategies, December 2011. Other sources provide different data; TheCityUK suggests that the allocation to bonds was 34% (end-2011), up from 20% a decade earlier, with the allocation to equities falling from 71% to 50% over the same period.

[31] TheCityUK; *Pension Markets 2012 report*, March 2012.

[32] OECD; *Pensions Outlook 2012*, June 2012.

[33] Defined as household saving expressed as a percentage of gross household disposable income (adjusted for the change in net equity of households in pension funds). See the ONS's Economic & Labour Market Review, Volume 1, No 10, *The treatment of pensions in the National Accounts*, October 2007.

Figure 6: The household savings ratio (HSR), % p.a.[34]



The HSR has averaged 5.9% since 1948, but since 1992 (when it reached 11.7%) the ratio has generally reduced, to a low of 2% in 2008. Plummeting consumer confidence and de-leveraging then reversed the downward trend; today, the HSR is around 7%, still well below the typical European level of 11% to 15%.

Furthermore, those who do save are predominately focused on the short term. In 2011, UK pension (i.e. long term) savings hit an all-time low, with only 46% of people saving enough for their retirement; 5% down on 2010, 8% down on 2009. 22% have put nothing aside for later life, a figure that is rising year-on-year.[35] 35% of the UK population are saving *nothing at all* (a figure that has doubled in the last three years).[36] And in 2011, 41% of those who say they are "savers" had failed to save anything.

1.8 A warning from Japan

The Japanese were once renowned for their legendary high savings ratio, near to 20% in the 1970's. Not anymore. Over the last thirty years, Japan's national savings rate (the percentage of GDP saved by households) has collapsed (see Figure 7), for a number of reasons, including:

- economic stagnation. One facet of this is that incomes slow down ahead of spending habits, shrinking the pool of disposable income *potentially* available for saving;
- a rapidly ageing population; retirees have a negative savings rate, drawing down assets that have been accumulated in the past;
- the arrival of a "live for today" cultural (particularly amongst the under-40s), and, perhaps surprisingly;
- the introduction, in the mid-1990's, of higher state pensions and public long-term care insurance. This reduced people's anxiety about financing their

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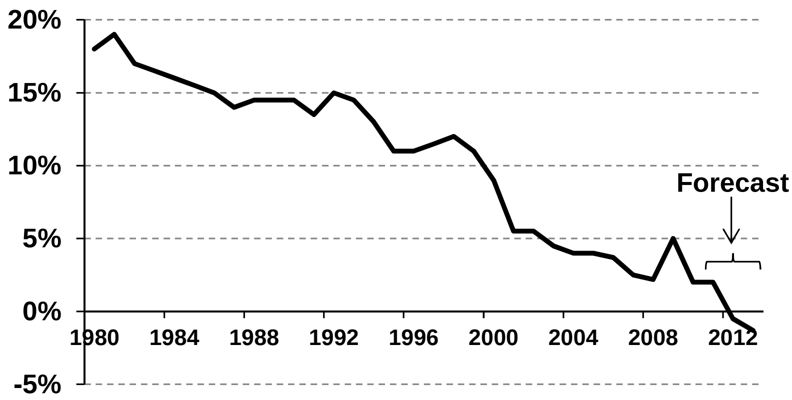
[34] ONS.

[35] Scottish Widows Pensions Report 2012, 21 May 2012.

[36] Scottish Widows; *Savings and Investment Report 2011. Preparing for the Future: Britain's Savings and Investment Landscape*.

retirement……diminishing their propensity to save. Proponents of a higher basic State Pension in the UK should take note.

Figure 7: Japan's national savings rate as a % of GDP.[37]



The 2009 spike in the savings rate (up from 2.2% to 5%) is explained by the 2008 financial crisis, which prompted a deterioration in sentiment; spending subsequently declined more than incomes. Japan's household savings rate is forecast to become negative in 2012, as the dominate underlying cause of reduce saving reasserts itself: the country's ageing population. This may provide a short-term boost to the economy, but it is likely to prove detrimental to the future financing of government debt and investment, with disastrous implications for long-term growth.

Japan is in the vanguard amongst developed economies seeking to head off the adverse economic consequences of an ageing population. The UK is perhaps 20 years behind, demographically speaking, but on a similar path. Consequently, we should note the effectiveness (or otherwise) of Japanese policy initiatives aimed at addressing their emerging predicament.

1.9 The macro-economic perspective: summary

The principal causes of the projected long-term squeeze on the UK's national finances are the rising costs associated with our ageing population, notably:

(i) the one-off pressure arising from the post-war "baby boom" generation (born between 1946 and the mid-1960s), now moving into retirement. The pensions, health and long-term care costs of this relatively large generation will have to be paid for by smaller numbers of working age people in later generations; and

(ii) the on-going trend for people to live longer, leading to a steady rise in age-related state spending.

There are two major consequences:

(i) the nation's financial capability to look after its pensioners can be expected to deteriorate; in retirement, personal financial self-sufficiency will become key, not

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

least to maintain a degree of inter-generational harmony. The alternative is a rising tax burden on the younger generations, fuelling generational inequality and the risk of societal schism; and

(ii) the cost of capital is likely to rise, as developed nations' domestic supply of capital is depleted by a rising welfare burden and a shrinking savings pool. Competition to attract foreign capital for investment will therefore intensify.

It is therefore of paramount importance that the UK significantly increases its savings pool, and reduces its reliance on debt, to provide businesses with the capital to invest (and compete abroad), and retirees with a source of income other than the state. Currently, millions of Britons are going to retire with inadequate savings, not least because 7 million people over the age of 25 are not contributing anything to a private pension.

Enlarging the savings pool is a pre-requisite to building a more prosperous society; not to do so would be to the detriment of the quality of life of many of our citizens. This is particularly the case at a time of an on-going transfer of income-in-retirement risk from the state to the individual; the retreating State Pension Age (SPA), the likelihood of rising (state-paid) healthcare rationing and a less generous welfare state. Similarly, employers are placing more post-retirement financing risk with employees, notably through the move from DB (defined benefit, or final salary) to DC (defined contribution) pension provision.

The UK's household savings ratio needs to return to where it was thirty years ago, at around 12%, rather than being allowed to languish close to today's 6%.

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

2. Dysfunctional finance

2.1 Markets are inefficient

Successive governments, regulators, market professionals and other service providers have, for decades, believed in the hegemony of markets. In the financial arena, market forces are viewed as the optimal mechanism for the efficient allocation of capital. The central belief is that competition (amongst market participants) ensures that asset prices adjust back to "fair value"[38], to reflect publicly available information.

Not everyone accepts the primacy of markets[39] and, increasingly, some regulators are realising that the persistent erosion of hapless customers' capital is not in the national interest. Further evidence of pricing anomalies that contradict the efficiency of markets include:

(i) **increasingly erratic asset prices, and rising market volatility,** i.e. the expectation that markets are self-correcting is not being borne out;

(ii) **the marked lack of elasticity in the price of financial products** (with the exception of index-tracking funds), unlike almost all other consumer goods, hinting at oligopolistic behaviour. In the context of securities trading, the houses with the largest turnover offer the highest level of liquidity, which attracts business, thereby entrenching their position; and

(iii) the **bloated nature of the financial services sector**, and the disparity of wealth between its employees and their customers.[40] One could expect competitive forces within the industry to exert downward pressure on remuneration (as in every other industry), yet this disparity persists. The efficient markets theory implies that vast profits are a sign of a job well done; until recently, few have questioned whether society is being well served by the financial services industry.

In addition, challenging the industry's faith in the efficiency of markets is to encourage it to question some of its own guiding principles. Investment managers, for example, extensively use indices as benchmarks, implying that they believe them to constitute efficient portfolios. Indices also underpin risk management and diversification strategies, as well as the pricing of many derivative products.

But *why* are financial markets inefficient? Historically it has been partly caused by the inefficient dissemination of information, but that is no longer the case, care of the internet. Today's market inefficiency is primarily explained by the propensity for investors (i.e. customers, or "principals") to sub-contract their investment activity to an array of banks, brokers, fund managers and insurance companies (collectively, "agents").

[38] Whilst accepting that "fair value" is a nebulous concept; impossible to define?

[39] Including Lord Turner, Jeremy Grantham (GMO) and Paul Woolley (LSE).

[40] This is not a recent phenomenon; see the seminal *Where are all the customers' yachts?* by Fred Schwed; first published in 1940.

2.2 The principal–agent problem, care of delegation[41]

(a) Information asymmetry

The financial services industry is characterised by investors (principals) sub-contracting their investment activity to chains of intermediaries (agents). Agents, having been empowered by their customers, are able to harness information asymmetries to their own advantage. They have access to more, and better, information than their clients, and this helps them preserve the pricing framework. Consider, for example, the on-going ability of some actively managed funds to charge 5% up-front fees (plus an annual management charge). This is sustained by a "star" fund manager culture and the burgeoning variety of specialist funds (particularly in the field of alternative assets), which make performance comparison difficult. Both are of the industry's own (self-serving) manufacture, and they facilitate remuneration packages for employees that are unparalleled in any other business, bar investment banking.

Information asymmetries facilitate damaging asset mispricing and what economists term "rent capture"; the ability of agents to generate revenue and profits without delivering anything of real worth.[42]

(b) Asset mispricing

(i) Herding and momentum

The pricing of financial assets is dominated by market-making intermediaries; prices are *not* set by an army of private investors. For example, the market price of shares in Rolls Royce plc is vulnerable to the herding behaviour of perhaps a dozen equities traders and a few influential analysts. This creates momentum, the propensity for trending in prices, which is reinforced, rather than exhausted, by widespread adoption.

Furthermore, price distortions are then amplified in the options and futures markets that are priced by reference to the underlying securities. This is incompatible with efficient market behaviour based on the convergence of prices to a stable "fair value". Thus, in this context, human behaviour manifests itself as a flawed process for pricing assets, facilitated by an army of investors delegating to relatively few agents.

(ii) Short-termism

Asset mispricing is exacerbated by short-termism, be it derived from momentum trading, investor behaviour (further discussed in Part II) or agents' remuneration structures and the allied bonus culture. Product pricing structures reinforce short-termism; annual performance fees, for example, encourage discretionary fund managers to focus on high-turnover, trend-following investment strategies.

Mispricing provides incorrect signals for resource allocation, and, at worst, causes stock market booms and busts. In the meantime, long-term investors attempt to exploit short-termism's distortion of market prices.

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[41] After Paul Woolley; *Why are financial markets so inefficient and exploitative?*

[42] See Lord Turner's; *What do banks do, what should they do and what public policies are needed to ensure best results for the real economy?* Cass Business School, 17th March 2010.

(iii) A side effect; flawed risk management

Many of today's risk managers rely heavily on excessively complex models parameterised with empirical evidence, i.e. observations of past market prices. But if it is accepted that market prices are mis-priced, because they are significantly influenced by flows of funds unrelated to what an asset is *really* worth (i.e. fair value), then those models are invalid. Furthermore, a common risk management practice is to use past price volatility as a proxy for risk, which sheds no light on the gap between an asset's fair value at the time of purchase, and the price actually paid.

This begs serious questions about the validity of daily marking-to-market, particularly in respect of fixed income assets that are held to maturity.

(c) Rent capture

Agents are well placed, care of their information advantage over investors, to promote opaque investment products (such as Collateralised Debt Obligations, or CDOs) and induce investors to take on risks they do not fully understand; a form of rent capture, care of the fees paid. Paul Woolley: *"rent capture causes the misallocation of labour and capital, transfers substantial wealth to bankers and financiers, and, at worst, induces systemic failure. Both impose social costs on their own, but in combination they create a perfect storm of wealth destruction."*

2.3 Moral hazard

(a) Background

The financial sector is replete with moral hazard, the term itself dating back to the 17th century. It became widely used by English insurance companies by the late 19th century, implying fraud or immoral behaviour (usually on the part of an insured party). Its scope has burgeoned as the industry has expanded, to include the "too big to fail" genre pertaining to vast banks (Citigroup, Lloyds, RBS et al, in 2008) and insurers (AIG), facilitated by "lenders of last resort" (central banks and taxpayers).[43] More recently, questions concerning moral hazard have arisen in respect of countries (such as Greece).

In the context of pensions and savings, moral hazard is a special case of information asymmetry coinciding with misaligned interests, i.e. it is inherent part of the principal-agent problem. It typically arises when an agent, insulated from risk, has more information about his actions and intentions than the principal who is paying for the negative consequences of the risk. Agents are therefore exposed to the temptation to act less carefully than otherwise.

(b) Performance fees

Hedge funds' "two and twenty" fee structure epitomises moral hazard within financial services. Fund managers retain their 2% base fee irrespective of fund performance, whilst also taking 20% of a periodic positive return (albeit sometimes above a threshold return). "Heads" the fund manager wins, "tails" the client loses, an arrangement that incentivises managers to take excessive risk.

[43] According to the World Bank, of the nearly 100 banking crises that have occurred internationally during the last twenty-years, all were resolved by bail outs at taxpayer expense.

(c) Stock lending[44]

Similarly, stock lending harbours moral hazard. It involves fund managers lending out assets in exchange for a fee and collateral (to secure the counterparty risk of the borrower). It therefore exposes investors to the risk that a borrower becomes insolvent combined with the value of the collateral falling below the cost of replacing the loaned securities. But whilst investors potentially bear 100% of the risk, the managers typically retain 35% of the income. Consequently, they have every incentive to accept risky collateral (for higher income), but only a third of managers fully disclose the split of fees between themselves (and stock lending agent) and the fund.

(d) Dubious research

The "independent" research that is written for investors is produced by the same institutions whose salesmen are persuading investors to buy; the industry is fundamentally conflicted. Nowhere is this truer than with equity flotations. The higher the price, the bigger the fees, so overvaluations are commonplace. Banks not involved in a particular transaction are reluctant to produce negative research because they do not want to risk competitor banks subsequently reciprocating. Nor do they want to risk offending potential clients.

Fortunately, many principals have become increasingly cynical of research, not least because "buy" recommendations invariably outnumber "sell" recommendations, irrespective of where we are in the macro-economic cycle.

2.4 Product innovation; rarely in the customer's interests

The personal financial needs (excluding insurance) of at least 95% of the working population are very basic; a bank account, an ISA, a SIPP and / or an occupational pension scheme. That is it.

But the industry loves to innovate, because it provides for competitive advantage and helps justify high charges. The (initial) result can be higher profits, which help convince innovators of their products' robustness, but this opens the door to a basic human foible; laziness. The quality of risk management can then deteriorate (often outsourced to credit rating agencies), sometime leading to catastrophic failure; witness the rise and fall of many hedge funds, and the fallout from securitisation (including CDOs) and credit derivatives.

It is perhaps no coincidence that the 2008 banking crisis was presaged by a burst of financial innovation (2000 to 2005), and a rapid acceleration in remuneration off the back of rising fee income.[45]

Innovation is often accompanied by increased opacity, which elevates the risk of moral hazard. Hedge funds rarely fully disclose their asset holdings, the extent to which they are leveraged and their strategies, and trading has moved increasingly away from listed

[44] Data based upon a survey of 20 UK retail fund managers, conducted by SCM Private, 1st September 2011.

[45] Thomas Philippon and Ariell Reshef; *Wages and Human Capital in the U.S. Financial Industry: 1909-2006,* NBER Working Paper No. 14644, January 2009.

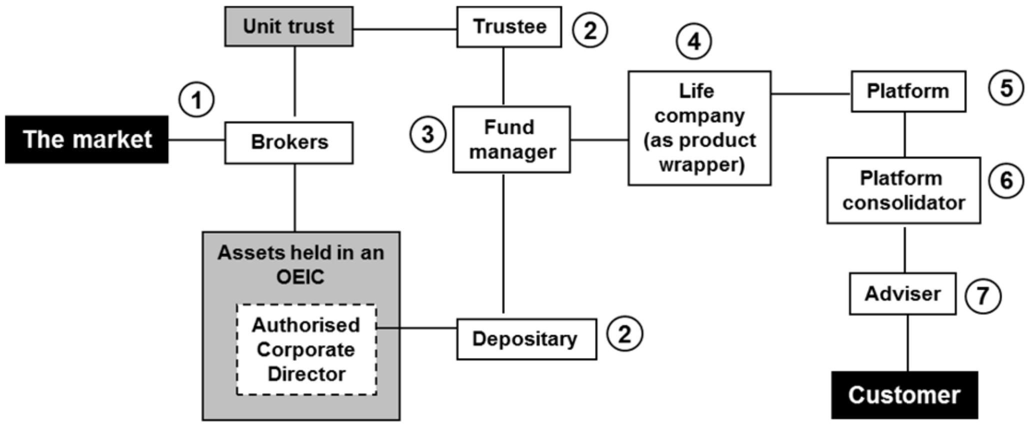
markets to “over-the-counter” (OTC), which circumvents the discipline of open markets and regulation.

2.5 Excessive costs

Much has been written about the industry’s excessive costs, which lead to the erosion of capital, care of, in particular, the damaging power of the compounding of annual charges.[46] If a typical annual management charge (AMC) were 0.5% instead of the conventional 1.5%, a potential pension would be 38% higher (and 60% higher if the AMC were eliminated).[47] This excludes any initial charge, sometime some 4% to 5%. The AMC’s corrosive impact on capital in put into stark relief when the offsetting contribution from the compounding of reinvested income is relative small, care of the prevailing very low interest rates (and with that, low dividend yields).

One of the principal causes of the industry’s excessive costs is the extended supply chain of agents. There can be up to seven intermediary layers between the market and a potential customer. Not every investor is exposed to all the layers, but each link in the chain incurs a cost, eroding the investor’s capital. Figure 8 shows a typical example, for a customer investing in either an open-ended investment company (OEIC) or a unit trust.

Figure 8: The cost chain



The main sources of charges are as follows.

1 **Transaction costs.** When assets are bought or sold, commissions and stamp duty (tax) are incurred, as well as the cost of crossing the bid-offer spread. In addition, fund managers can add fractional mark-ups (when buying) and discounts (selling) when transacting with the market. Trading costs are implicit; investors do not pay for them openly, but they reduce the return. OEICs are bought and sold at a single price to protect on-going investors, i.e. the transactor pays, rather than there being a dilution of fund value.

The transaction costs of actively managed UK equity funds typically come to 1% per annum. This is based upon 100% fund turn over (i.e. the assets are bought

[46] See Michael Johnson, *Simplification is the key, Section 2.7,* CPS, June 2010.

[47] David Pitt-Watson, *Pensions for the people: addressing the savings and investment crisis in Britain*, *Appendix I,* RSA, 2009. Example based upon someone saving for 40 years and receiving a pension for 20 years.

and sold once a year), 0.5% Stamp Duty (on transactions of over £1,000), 0.1% commission each on buying and selling, and a bid-offer spread of 0.2%-0.3% for mid-cap shares (the typical area of fund interest). Transacting with tracker funds costs a lot less. Clearly, transaction costs rise with portfolio turnover.

② **Fiduciary costs.** Investors' interests are protected by an independent trustee (unit trusts) or depositary[48] (OEICs), which also provide services, including safe custody. Third-party costs, such as audit and trustee fees are typically 0.2% per annum (less for large exchange-traded funds (ETF), perhaps just under 0.1%).

③ **Fund management charges.** The initial charge for investing in an OEIC or unit trust can be as high as 5%, incorporated either within the bid price (unit trusts) or as a separate commission (OEICs). Annual management charges (AMC) typically vary between 0.5% and 2%, depending on the underlying asset class and the manager's reputation. It is possible to reduce these charges by investing through a discount broker or fund supermarket, but this usually means acting without financial advice. Other types of funds, such as investment trusts and exchange traded funds (ETFs) tend to have lower charges, particularly for bigger funds.

In 2012, the 1% management charge cap on stakeholder pension plans comes to an end. This has acted as a benchmark for personal pension plan pricing, but some major providers have indicated that post-2012, their charges will rise.

As an aside, fund managers (and their clients) may like to ponder the thoughts of Daniel Kahneman, psychologist and Nobel-winning economist. When asked whether the instincts of experts can be trusted, he responded "*there are domains in which expertise is not possible. Stock picking is a good example*".[49]

④ **Life company product wraps[50].** Wraps are typically used to marry life insurance with an investment product, the latter sometimes sourced from third parties ("white labelling"), adding another link in the chain. They also provide life insurers with a way to market their pension-related annuities. The range of assets that could be wrapped is expanding; it now includes retail mutual funds, direct equity investments, ISAs, collective investments (unit trusts, OEICs and investment trusts) and life and pensions products (including SIPPs). The construction and administration of wrap propositions are sometime outsourced, further adding to the cost chain.[51]

⑤ **Platforms** provide a **distribution** capability, both direct to the consumer and the IFA community; they are sometimes combined with wraps, i.e. "wrap platforms". They are either provider-owned (and some are biased towards the provider's own products) or fully independent. Platform build and administration is often

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[48] OEICs are companies and are therefore required to be operated by an FSA-authorised person; the Authorised Corporate Director (ACD). The ACD appoints the depositary.

[49] Time Magazine "10 Questions" interview, 5 December 2011.

[50] A full wrap incorporates five key elements; all available tax regimes, open architecture (i.e. not product-specific), the full suite of financial tools, online availability and a single transparent price.

[51] Aegon, for example, is working with Novia Investment Services.

outsource, again lengthening the cost chain. Platform usage typically costs 15 to 55 basis points, usually funded by a fund manager rebate (paid to purchase the platform's distribution capability).

6 **Platform consolidators.** With at least 28 UK-focused platforms, consolidator platforms are emerging, not least to help IFAs to meet the FSA's suitability criteria (matching customers' needs with the right products). A "wrap of wraps" service may cost 25 basis points.

7 **Advisers**. The Retail Distribution Review (RDR, further discussed in Chapter 11), effective from the end of 2012, will transform the manner in which advisers are remunerated (given the end of (provider-financed) commission). The quality of advice will improve and become more independent, and its cost will become more transparent, but the latter is unlikely to be reduced.

In addition, there are other costs attributable to more than one particular industry participant, notably the cost of "manufacturing" increasingly complex products, including allied derivative instruments, a panoply of servicing costs and other distribution-related costs (including transfer agency, i.e. the administration of sales, purchases and switches between pooled funds).

Given the extent of the agent chain and their sub-contractors, intermediaries have assumed customer ownership from fund managers, accentuated by the increasing use of platforms. This has put upward pressure on distribution costs, ultimately reducing investor returns. Having lost direct contact with their customers and, equally serious, the advisory community, it is now harder for fund managers to understand what investors *really* want. And, perhaps conveniently, this separation can accommodate the abdication of any responsibility for the kind of mis-selling (of *their* funds) that catalysed the RDR. This is not in consumers' interests.

2.6 Some in the industry are in retreat

(a) Life insurers: for some, a future without a purpose?

Life insurance companies are particularly exposed to the winds of change. For too long, their interests have not been aligned with those of their customers, and they have failed to move with the times, inhibited by inertia. Closed life-funds are now being cannibalised by life company aggregators, suggesting that this part of the industry is taking itself to pieces (which partly explains the low staff morale).

Post-RDR, some life companies will have little left to contribute to the investment business, lacking any distinctive savings products. Furthermore, after selling off their direct sales forces in the 1980s and 1990s (to cut costs), they lost their distribution-derived income. Some subsequently purchased third party distribution (through IFAs, brokers and platforms), but in so doing they lost control over their customer relationships.

It is clear that life companies are having to adapt to survive in the market. They need to find alternative revenue streams to replace their increasingly outdated traditional life assurance and pensions income, especially with more flexible pensions now available. Some are now trying to recover their client relationships by turning predatory, signalling their (distribution) intentions by acquiring wrap platforms[52], enabling them to go direct to clients (i.e. circumventing advisers).

The prospects for mid-size life companies are particularly bleak. Unable to compete with larger life companies in the servicing of IFAs, some are focusing on investment management, where they have no obvious competitive advantage. Indeed, funds are being transferred into wrap products and life companies are therefore losing out.

Life companies' only remaining source of any growth potential could be to return to their protection origins, i.e. the provision of protection products, notably annuities, one year renewable death, disability, critical illness and permanent health insurance, and long-term care benefits. In the meantime, they must confront a root problem; their high cost base. Appendix I details why the future of some life insurers is so grim.

(b) IFAs: on the brink

The IFA community is under assault on many fronts. If the travails of the RDR are not enough, many IFA firms are under-capitalised, and, as already mentioned, they are also at risk of being dis-intermediated, by life companies in particular.

With an increasing number of assets on platforms (over £120 billion[53]), advisers are facing the possibility of providers ending their agency agreements and, instead, using wraps to access consumers directly. Thereafter, those advisers who currently rely on commission will struggle to survive.

Furthermore, advisers are increasingly wary of life companies, not least because of their inclination to attempt to poach clients. Axa, Friends Life, L&G and Standard Life (amongst others) have all written to clients without copying in the clients' advisers, perhaps trying to cut out the middle men. (Alternatively, they may simply have been updating their records…). Consequently, it is essential for advisers to create and market their own brand identity, not least to reduce the risk of clients succumbing to the life companies' advances.

2.7 Regulators: do they understand markets?

Historically, regulators have believed that markets are, by and large, efficient. They have therefore pursued light-touch regulation, with pretty disastrous results. The 2008-09 crisis is clear evidence (once again) that the financial sector can destabilise the real economy. Nations, as well as the general public, need to be protected from a financial services industry that is, in parts, dysfunctional and exploitative.

But this is not to suggest that more regulation is required. Consumers are already immersed in a sea of regulation, the tides and currents pulling in different directions. The challenge is to identify regulation that best serves consumers' interests and, ideally, reverse today's situation whereby it is simpler to borrow £10,000 on consumer credit than it is to put aside £1,000 in a retirement savings vehicle.

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[52] For example, Standard Life's acquisition of support services company threesixty, including its wrap.

[53] Pensions Management's individual wrap platform survey 2011.

2.8 Summary: the failure of competition

The dysfunctional nature of the industry is multi-faceted. It includes the abuse of asymmetric information, ludicrous complexity (notably, products and their allied taxation regimes), opacity and moral hazard (together enshrined in the principal-agent problem) and endemic short termism, all of which combine to work against the savers' interests. Subsequent chapters discuss what all this means for governance models (Chapter 10), including the exercise of fiduciary duties by those exercising discretion in the management of savers' assets, and regulation (Chapter 11). More fundamentally, the efficiency of the shareholder model for controlling markets is also questioned (Chapter 12).

Clearly, competitive forces (notably pricing tension) are failing to operate effectively: the result is inefficient markets and excessive industry costs (partly care of extended chains of intermediaries), which are borne by customers. Consequently, savers' capital is eroded unnecessarily, which sows distrust of the industry and a reluctance to engage with it. This ultimately damages the economic interests of UK plc.

It is tempting to lambast the industry, and whilst it is far bigger than it needs to be, some parts of it do facilitate the crucial link between savings and investment. It is in everyone's interest for the socially useful parts of the industry to be profitable, but currently, given its failure to best serve savers' interests, it is reasonable for the state to intervene (for example, NEST). Unfortunately, the Government is also part of the problem.

PART II: UNDERSTANDING BEHAVIOUR IS KEY

3. The consumer: self-imposed barriers to saving

3.1 Introduction

The finance industry's short-comings are aided and abetted by how consumers behave; when it comes to money, we are sometimes our own worst enemy. Many people appear to be irrational with matters financial, accompanied by a belief in alchemy. But, to be clear, they are not incorrect; it is just that they have a different model of the world to those who, for example, may have a financial background. There is a litany of human foibles that impede the creation of a savings culture. This leaves the industry facing an inescapable conundrum: 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.

3.2 Short-termism

People are usually motivated into action by the prospect of *immediate* reward, at odds with the *long-term* nature of retirement saving. This timeframe problem is at the heart of the challenge to catalyse a savings culture. We are increasingly conditioned to instant gratification, a behavioural driver that is today reinforced by instant, and omnipresent, communication channels.

For many people, short-termism is so deeply embedded that it occludes any fear of poverty in retirement. A "live for today" philosophy predominates: our "spend now", consumerist culture is endemic. This is particularly understandable amongst those on low incomes whose behaviour is more influenced by immediate deficiency, rather than the prospect of distant, and uncertain, future reward. And when that concern does eventually surface, for many people it is too late to do much about it.

Professor John Kay's review of short-termism[54] was catalysed by Vince Cable's concerns (as the Business Secretary) about the mismatch between long term pension fund liabilities and the relatively short-term horizon of many (but not all) fund managers. Consequently, John Kay examined the lengthy investment chain (including equity fund managers). But, in the context of retirement saving, short-termism afflicts *all* the stakeholders; a broader study is required.

> **Proposal 2:** John Kay's 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.

[54] *The Kay Review of UK Equity Markets and Long-Term Decision Making,* July 2012.

3.3 Low persistency

There are at least three different themes behind inconsistent savings behaviour, sometimes generically referred to as "low persistency".

(a) Changing jobs[55]

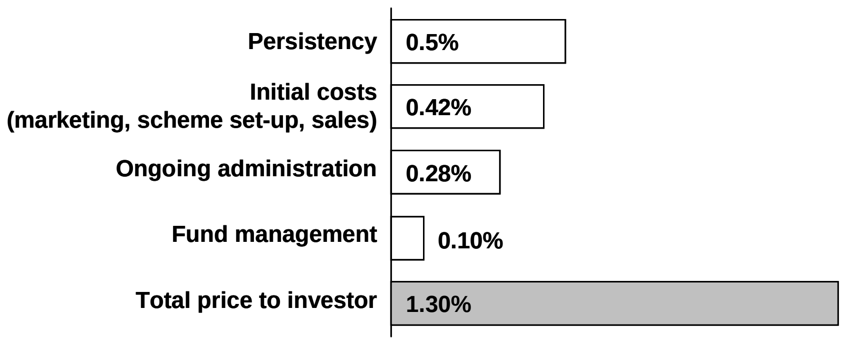
The average British worker is expected to have 11 different jobs over his working lifetime. Given the lack of asset portability between occupational schemes (or into private pension arrangements), this requires people to keep changing their pension provider, thereby incurring unrecoverable joining costs (passed on by fund managers via their AMCs). In addition, some legacy GPP schemes accumulate a proliferation of account maintenance costs (although they are dying out). More seriously, through no fault of their own, frequently changing jobs leaves people with a number of relatively small, inefficient pension pots, each bearing an on-going, asset-eroding, maintenance cost.

At retirement, the annuity purchasing power of a saver with a multiplicity of small pots is considerably less than someone with a single, relatively large, pool of assets. Addressing the issue of multiple small pots is further discussed in Chapter 8.

Lord Turner's seminal 2005 report[56] identified low persistency as the largest cost component within a typical AMC of 1.3% (Figure 9). Although Lord Turner's report is six years old, his assessment of costs remains valid. Typically, only 40% of personal pensions are still receiving contributions after ten years (so upfront costs end up being amortised over relative short periods).

Ultimately, the cost of low persistency manifests itself as capital erosion, the damage accumulating over decades. People are of course oblivious to this, because we do not miss assets that we have never had.

Figure 9: The components of a typical AMC of 1.3%[57]



[55] In this context, low persistency manifests itself as a combination of stopping and, later, restarting saving, along with frequent changes of savings vehicle, leaving the saver with multiple (small) asset pots.

[56] Adair Turner, Pension Commission; *A new pensions settlement for the twenty-first century*, 2005.

[57] ibid (Figure 1.52).

As an aside, it is noticeable that the cost of the actual fund management (which is where the value is added) is dwarfed by the upfront, and on-going, administration charges. It is hoped that NEST will help improve portability (further discussed in Chapter 7).

(b) Impatience; asset churning

Buying and selling investments too frequently ("churning") is a common trait, partly reflecting our naivety and our susceptibility to marketing. Frequently switching investments in the hope of a rapid return is accompanied by only one certainty; capital erosion, care of transaction costs allied to portfolio turnover and performance drag. A similar argument supports the case for passive, rather than active, fund management; this and performance drag are further discussed in Chapter 14.

(c) Intermittent saving

Repeatedly stopping and restarting saving exposes the saver to timing risk, notably investing at market "price highs". Saving for retirement is better served by smoothly accumulating assets over a very long time; a marathon, rather than a sprinting, mind-set. Unfortunately many people exhibit bursts of saving enthusiasm, punctuated by periods of inactivity, the latter perhaps being caused by a temporary contraction in disposable income.

3.4 Little comprehension of risk and return

A number of surveys have been conducted to identify what investors want from their savings, and they keep producing the same result.[58] Investors show a strong preference for security (i.e. capital preservation)…..and strong returns. This inconsistency of objectives demonstrates an inability to reconcile risk and return, and it is sometimes accompanied by an expectation of something for nothing and reluctance to accept personal responsibility. Furthermore, many people want to save as little as possible and start as late as possible.

3.5 Unconscious biases

Much of our seemingly irrational financial behaviour 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.

(a) Hyperbolic discounting

Many of us are financially myopic. For example, we irrationally discount time, preferring £1 today rather than £2 next year; we are hopeless at balancing the immediate with something longer term. Overly-generous future rewards are perceived as inadequate to catalyse the action today that would secure them.

Confirmation of our financial myopia can be found in advertising. The "Quick Quid" advertisement, for example, says "*Get a short-term loan in one hour…representative APR of 1734%*" Given that the company behind this is prepared to spend money to post the advert (on London's Tube), this suggests that this APR is no deterrent to some people.

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[58] Including Tomorrow's Investor interim report of 2008 and Mercer's Work and Savings Survey, 2007.

The annualised cost of a tiny, very short term loan from Wonga.com is up to 4210% (in late-2011).

(b) Over-optimism

"Optimism bias", people's systematic tendency to be overly optimistic about outcomes, is well documented.[59] It includes over-estimating the likelihood of positive events and under-estimating the likelihood of negative events. Combined with risk amnesia and the illusion of control and illusory superiority, this is, in the context of personal finance, perfect preparation for huge disappointments. Research has shown that 8% of working adults (three million people) are relying on a lottery win to fund their older age, with 9% banking on an inheritance windfall.[60]

(c) Over-confidence

Most people have excessive confidence in their own abilities. In the financial arena, we substantially underestimate the probability of experiencing serious financial problems, not least because the prospect of a sudden job loss or severe illness is considered unrealistically remote. We also overestimate the odds of our doing things, such as remembering to pay a credit card bill.

Companies wilfully exploit these behavioural biases. Late payments on cards, for example, attract punitive interest rates for what is really a minor transgression, but it is not in companies' interest to "help", perhaps by sending a gentle reminder text, a week before the payment date. Misaligned interests abound.

(d) Loss aversion

Loss aversion refers to people's preference for avoiding losses (including realising losses) rather than the pursuit of gains. Research suggests that losses are twice as powerful, psychologically, as gains.[61] Losing £100 is far more "painful" than a £100 windfall is "rewarding".

The industry is, of course, well aware of this bias, and harnesses it to influence consumer behaviour; propositions are deliberately framed as avoiding a loss rather than making a gain.[62] Equally, people prefer to assume risk if it might mitigate a loss rather than produce a gain.

In marketing, the use of trial periods and rebates try to encourage people to possess something before paying for it. Once "owned", it is incorporated into the status quo, and because giving it up is more painful than having never acquired it, people are then more inclined to pay for it.

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[59] For example, Thomas Gilovich, Dale Griffin, Daniel Kahneman; *Heuristics and biases: The psychology of intuitive judgment*, 2002.

[60] YouGov survey for NAPF, May 2011.

[61] Loss aversion was first convincingly demonstrated by Amos Tversky and Daniel Kahneman*; Loss aversion in riskless choice: a reference dependent model.* Quarterly Journal of Economics 106, 1991.

[62] People would prefer to avoid a 10% surcharge (a "loss") over receiving a 10% discount (a "gain").

(e) We (and actuaries) underestimate our own longevity

There is abundant hard data to confirm that successive generations are living longer, but the adverse implications for our retirement finances do not register. If they did, we would probably save more.

(f) Paying for advice.....to avoid regret

The complexity of financial markets, and the Niagara of available information, ensures that there is a ready market for advice. But many people pay for advice not for the advice *per se*, but as a mechanism to (sub-consciously) abdicate personal responsibility. If investments subsequently under-perform, it is comforting to know that it was not our fault. In addition, most of us dislike uncertainty; some forecast (indeed, *any* forecast) is therefore comforting. As a noted psychologist has observed, *"we believe in experts in the same way that our ancestors believe in oracles; we want to believe in a controllable world and we have a flawed understanding of the laws of chance."*[63]

We have a remarkable tendency to rely on expert advice, even when the advice is clearly useless. Research, for example, into unbiased coin-tossing demonstrated that we will pay for outcome predictions, notwithstanding that they are known to be random.[64] Furthermore, the more the predictions prove to be correct, the more we are willing to pay for them, faith in an individual coin flipper being built upon his track record. Any notions of probability, and outcome distributions, are seemingly abandoned. And so it is with *some* financial advice, the price being false comfort (and fees).

3.6 Confused objectives

An increasingly flexible working culture, and inconsistent career trajectories, appears to accommodate people's reluctance to plan ahead. Many perceive that they will be able to work past retirement age, unconcerned by the potential lack of employment opportunities. The consequence of such laissez faire is that people want to have control of their money now, which rules out saving within a pension product.

ISAs blur the distinction between general saving (with ready access) and long term saving, because some 50% of annual cash subscriptions remain within ISAs over subsequent years, i.e. ISA savings are *persistent.* Initially attracted by instant access, many ISA savers succumb to inertia and, over time, come to consider their ISA as a core part of their retirement saving. But some 50% (£192 billion) of the funds held in ISAs is held as cash[65], rarely the ideal asset class for *long term* investment compared, for example, to property. Furthermore, 66% of all ISA accounts only hold cash (15.6 million accounts, out of a total of 23.6 million).[66] This demonstrates muddled saving objectives; few savers have a savings strategy, a problem compounded by a lack of financial wherewithal.

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[63] Philip E. Tetlock, Professor of Psychology at the University of Pennsylvania.

[64] Powdthavee and Riyanto; *Why do people pay for useless advice? Implications of gambler's and hot-hand fallacies in false-expert setting,* Institute for the Study of Labour, Germany, May 2012.

[65] ONS, *Table 9.6*, September 2011. The ISA has two components; Cash ISAs and Stocks & Shares ISAs. Prior to April 2008 they were known as Mini ISAs and Maxi ISAs, respectively.

[66] ONS, *Table 9.10,* April 2011.

3.7 Widespread distrust of the industry

Consumers have, for decades, been sending a persistent signal; they do not trust the financial services industry. Mis-selling scandals, overly-complex products, high costs, poor performance and mis-aligned interests all contribute to raising the barrier to saving. Overlay the noise of recent years' economic instability, and people's antipathy towards retirement saving becomes very understandable.

4. Nudge, and all that

4.1 Introduction

Ideally, the Government could flick a switch and ignite a retirement savings culture, but we know that that is not going to happen. Not saving enough is as much behavioural as due to a lack of money. Many people can afford to save, but choose not to. Our consumer-oriented and financially myopic behaviours are too deeply entrenched.

Successive governments have repeatedly attempted to boost saving by manipulating behaviour, tinkering with the savings environment, notably incentives, products' regulatory regimes and tax frameworks. To-date, few, if any, past governments could legitimately claim to have made much progress.

Today's environment is characterised by overwhelming complexity (particularly concerning tax), an excessive regulatory burden, care of "wedding cake" (i.e. multi-layered) legislation, an inefficient and expensive industry, confused customers, which encourages procrastination, and a cynical media. It is no surprise that most people are not saving enough (notwithstanding our financial myopia and consumerist culture).

Consequently, all the stakeholders within the retirement savings arena (the Government, regulators, companies (investment managers, life insurers and pension funds), savers and non-savers, service providers (including accountants, actuaries, financial advisers and lawyers) and the media), will have to change how they behave, to varying degree, as a pre-requisite to establishing a savings culture in the UK.

4.2 Little progress beyond auto-enrolment?

There have been numerous reports lamenting our (apparently) irrational behaviour towards personal finance, but little by way of actionable ideas to address it.

In recent years, academics have jumped onto the "nudge"[67] intellectual bandwagon, and the underlying principles would appear to be well suited to persuading people to save for their retirement. Nudge theory seeks to resist short-termism by nurturing individuals' better instincts, such as holding back on excessive consumption and creating situations in which people will make better decisions for themselves.

But, within the pensions and savings arena, beyond harnessing inertia through auto-enrolment (a classic "reframe" in which people have to opt out (of saving) rather than opt in), there has been a paucity of actionable ideas for materially increasing people's propensity to save. And whilst hopes are high, it will be years before we can be sure of auto-enrolment's impact (accompanying the introduction of NEST in 2012).

4.3 Save more tomorrow?

Auto-enrolment could be combined with "save more tomorrow" thinking.[68] This encourages people to commit *today* to save more, but only when they have more

[67] *Nudge: Improving Decisions about Health, Wealth, and Happiness,* Richard Thaler and Cass Sunstein, 2008.

[68] As proposed by Richard Thaler and Shlomo Bernartzi.

money, perhaps following a pay rise a year hence. Part of future pay rises are then automatically redirected into savings, so that savings "auto-escalate".

4.4 After nudging........shoving?

There would appear to be a mood swing (certainly amongst industry executives) in favour of compelling people to save for their retirement. It would certainly allow them to reduce their marketing costs, and if the savings were to find their way into investor (rather than shareholder) returns, that would be welcomed. Politicians are (publicly) silent on the issue, not unreasonable so given the imminent arrival of auto-enrolment.

(a) Auto-enrolment; unfortunate timing?

But this could change. It is quite possible that the cranking up of auto-enrolment (2012-2016), into NEST and other qualifying schemes, could coincide with rising interest rates. This would squeeze disposable incomes, particularly amongst auto-enrolment's target audience of low to middle range earners. This would raise the prospect of a rapid rise in the opt-out rate (to above 30%[69], say), perhaps prompting the Government to move beyond "nudging", to "shoving" i.e. compulsory saving. Indeed, auto-enrolment is to "nudge" what compulsion is to "shove".

(b) Compulsory retirement saving

(i) Not new to the UK

Compulsory saving is not new in the UK; until 1988, employers could make it a condition of employment to join the company pension scheme. But, regrettably, this became illegal when personal pensions were introduced in that year, the prevailing (political) philosophy being to encourage personal provision. Further back, Keynes advocated compulsory saving in 1940 (to pay for the war), as an alternative to raising taxes.

There are only a few examples of compulsory saving being imposed upon individuals, and it is usually by authoritarian governments; Singapore[70] (introduced in 1955), Chile[71] (1981) and Hong Kong[72] (2000) are perhaps the best known examples. One democratic exception is in Denmark. All wage-earners have to pay contributions into the ATP scheme, to complement the national pension scheme. The amount paid depends solely on the number of hours worked (minimum of nine hours per week) but the *maximum* contribution is only 1% of earnings, i.e. not very much. Thus, the ATP is arguably an example of "marginal compulsion".

(ii) Compulsion; politically challenging

Australia's state-sponsored Superannuation Guarantee ("Super G") programme is often held up as an example of compulsory saving, but this is mis-leading. Super G

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[69] Opt-out expectations vary, including 11% with 20% undecided (Scottish Widows), 20% "definitely or probably" (DWP, 2009) and others suggest a figure near to 40% (including Duncan Howorth, former President of the Society of Pension Consultants).

[70] The Central Provident Fund (CPF); from September 2011, employees must contribute 20% of monthly salary above S$1,500, employers 16% (total 36%).

[71] Obligatory Social Security savings of 12.3% of monthly payroll (up to an income threshold).

[72] The Hong Kong Mandatory Provident Fund requires contributions of 5% of income from both employee and employer (subject to maximum and minimum levels of monthly income, currently $20,000 and $5,000 respectively).

compulsion is only in respect of employer, not employee, contributions; introducing the latter is perceived to be a much more challenging proposition (indeed, a last resort measure). It would expose politicians to accusations of an "additional tax" (quite wrongly, particularly if the personal nature of the account were emphasised), as well as a degree of (moral) responsibility in respect of subsequent investment performance.

Governments may also be nervous about public liability, perhaps triggered by the irresponsible behaviour within the financial services industry. In the meantime, as auto-enrolment is rolled out, any bad performance or industry scandals would dent confidence on a massive scale, leading to opt-outs and saving levels remaining low. Proceeding to compulsion using industry providers would then be politically impossible: a far more radical piece of state intervention would then be needed. If one were to consider the UK to be in a period of "contingent compulsion", then the industry is now "on probation".

Full compulsion would require tougher conditions in respect of the quality of pensions products, for example, and the fiduciary duties of trustees and other service providers would then need to be unambiguously explicit.

(iii) Compulsion; justification

The state could claim that it has a legitimate right to compel people to save for their retirement because it (i.e. taxpayers) is exposed to under-savers.[73] Compulsion would address the problem of our endemic financial myopia (the "consume now" culture) blocking any rational assessment of the long-term benefits of retirement saving. It would also resolve a problem with discretionary saving, that of day-to-day pressures simply overwhelming people.

The short-term / long-term issue has justified other precedents for state intervention, such as the funding of major infrastructural projects with PPP and PFI, and the state funding of scientific research. Compulsion could also be presented as a way of heading off the looming generational injustice, whereby today's workforce is increasingly burdened, through taxation, with an ageing population.

The TUC has long been in favour of compulsory saving. In 2005 it proposed 10% employer and 5% employee contributions, citing "the obvious failure of voluntarism".[74] The employers' perspective is different, compulsory contributions being viewed as a tax. The retirement savings industry would of course welcome compulsion (more business).

(iv) Compulsion; not a panacea

But there are other considerations. The introduction of savings compulsion would not address the industry's ills; indeed, it could make matters worse as it would provide a tame client base. It would also offend libertarian instincts (with implications for national identity) and diminish personal responsibility (at odds with the prevailing political ethos). The challenge is to find ways to encourage people to act in their own (and society's)

[73] Hopefully, reform of the state pension will address the problem of people who could afford to save choosing to consume instead, only to subsequently fall back onto the state via means-tested benefits.

[74] TUC's submission to the Turner Commission, February 2005.

long-term interests, while respecting individual freedom. When nudging becomes shoving, we have returned to conventional regulation to enforce change, which is unlikely to change people's behaviour and catalyse a savings culture.[75]

In one sense, introducing compulsion feels like a lazy approach to the problem. In any event, auto-enrolment needs to be given time to prove itself, but in the meantime the industry should be exploring other ways of encouraging people to save for retirement, primarily by transforming itself.

4.5 Overcoming the sceptics

There are some examples of significant attitudinal changes being achieved.

(a) Climate change

What, for example, brought about the change in attitudes towards climate change and the environment over the last twenty years? Whilst scientific evidence has improved understanding, and omnipresent media now bring natural disasters into our homes. The personal discomfort experienced during the recent succession of hot summers (2001-2007) has perhaps had the biggest impact upon our attitude to climate change.

(b) Smoking

Similarly, attitudes towards smoking are changing; in 1992, some 29% of British adults smoked; today it is 20%.[76] This has been achieved primarily through state intervention[77] and changing social attitudes, often prompted by state-funded campaigns to raise awareness of the adverse health consequences. Some people suggest that cost is the primary deterrent, but this is confounded by data; during a recession, the number of people attempting to quit smoking actually reduces[78] (and tobacco shares are a well-established defensive investment).

(c) Perhaps retirement saving is different?

We are living increasingly pressured lives, and people under stress experience diminished mental energy to do things that are hard, such as quitting smoking. Horizons are shortened, and focus is placed on day-to-day survival, contrary to what is needed to encourage people to save for retirement. Furthermore, behavioural change is usually catalysed by the immediacy of personal experience but, for many people, retirement is a long way off (a view reinforced by the retreating State Pension Age). It is understandable that no one is claiming that catalysing a savings culture is going to be easy.

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[75] This could be tested by, for example, Chile ending compulsion; would Chileans continue to save for retirement or go on a consumption bonanza, indicating that a savings culture had not been created?

[76] The Future Foundation. Note that the forecast is 18% for 2020, so the rate of reduction is slowing.

[77] Including smoking bans (in places of work, in public buildings and on public transport), restricting points of sale and advertising, education and, perhaps most significantly, price, through taxation.

[78] In pre-recession 2007, 32% of smokers said they had tried to quit within the past three months; this fell to 23% in 2008, 22% in 2009 and 17% in 2010. (Cancer Research UK).

5. Hunting for barriers to consumer engagement

This chapter describes a framework to help the stakeholders in the retirement savings arena (notably the industry and the Government) identify barriers to consumer engagement that they themselves have erected. Once identified, it becomes easier to work how to lower them, with the onus of responsibility lying with the industry rather than the Government (which is already in legislative overwhelm).

Some readers may consider this chapter to be excessively academic. If so, move on to Part III, which considers the role of the state in more detail.

5.1 Understanding motivation

Conventional wisdom has it that rewards and punishment ("stick and carrot") drive motivation. In the context of retirement saving, this has not been properly tested because there is no *immediately* apparent punishment for *not* saving. Tax relief, a lost opportunity, is insufficient encouragement for a growing number of people (particularly Generation Y, further discussed in Chapter 9). One school of thought is that motivation can be summed up in three words; autonomy, mastery and purpose.[79]

(a) Autonomy

People are highly motivated to direct their own lives, retaining control over what tasks they do, and when and how they do them.[80] In the retirement savings context, the desire for autonomy clashes with "the deal"; for many people, the trade off in return for the tax relief incentive is not attractive. The subsequent reward, additional retirement income, is distant and uncertain: pension savings are too inflexible (i.e. no early access). Other forms of incentive should be considered, not necessarily financial, that preserve (or even enhance) individuals' autonomy.

(b) Mastery

Mastering anything is satisfying (and therefore motivational), but it requires engagement and is painful (in this context, foregone consumption). The challenge is to persuade people to start saving; one approach to help them is to provide "Goldilocks" tasks; not too much and not too early.

(c) Purpose

An analysis[81] of traits common to the world's most successful companies found that almost all of them have a clear sense of purpose (a passionate ideology and vision) that transcends purely economic considerations (such as maximising shareholder returns). These organisations (i.e. their workforces) are highly motivated. At an individual level, this could translate into pursuing a cause greater and more enduring than ourselves, such as doing something in the service of others. The desire to pass wealth on to children, for example, strongly resonates with people's emotions.

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[79] *Drive; the surprising truth about what motivates us,* by Daniel Pink, 2009.

[80] This has huge implications for getting the best out of people in the workplace.

[81] *Built to Last; successful habits of visionary companies*; Jim Collins and Jerry Porras, 1994.

5.2 The stakeholders' perspective

Many of the analytical tools available to understand behaviour are excessively academic, but the following approach does lend itself to practical application.[82] The objective is to help stakeholders (notably the industry, the Government, third party service providers and employers) identify the barriers to customer engagement for which *they* are responsible; some will be stakeholder-specific and others, such as short-termism, are common to all stakeholders. Once the main barriers are identified, stakeholders (ideally collaborating) would be in a better position to work out how to lower them; this could form the (behavioural) change agenda necessary to catalyse a savings culture.

There are three distinct steps, starting with encouraging stakeholders to *really* understand themselves, a pre-requisite to dispassionately assessing the quality of their relationships with other stakeholders, *particularly* customers.

Step 1: Stakeholders: understand who you are

Consider the hierarchy of influences on corporates or individuals, ascending in significance up to the key driver, that of possessing a sense of purpose. There are six levels.

(i) At the foot of the ladder is **the environment**, comprising products and their respective regulatory and tax regimes, and tax incentives. This is an influencing force common to all stakeholders.

(ii) Stakeholders' current **behaviour;** *what* do they actually do, i.e. their actions as observed by other stakeholders, and also their actions as perceived by non-stakeholders including, crucially non-savers. Behaviour is dependent upon

(iii) **capabilities;** the stakeholders' knowledge, resources, skills or systems, which drive their behaviour, i.e. *how* they conduct themselves. Capability determines what companies deliver (for example, product and quality of service), the quality of advice, legislation and regulation, and individuals' ability to make personal finance decisions. Capabilities are associated to

(iv) **beliefs**; the principles that guide actions, and **values;** *why* stakeholders do what they do, i.e. what is important to them. For business, shareholder considerations may dominate here, potentially at odds with the interests of customers. It is worth recalling that (customer) relationships are special when values and beliefs are shared. Amongst the financially literate customers, are their beliefs (the motivation, and also the barriers) and values (the "why?" behind motivation) attuned to accepting the self-responsibility required to save? If not, they are unlikely to save enough;

(v) **identity**; in the case of a company, its culture ("*who* we are"). Individuals who do save sufficiently are likely to identify themselves as being responsible for their own financial well-being in retirement. Identity presages a clear sense of

[82] After Robert Dilts and Gregory Bateson.

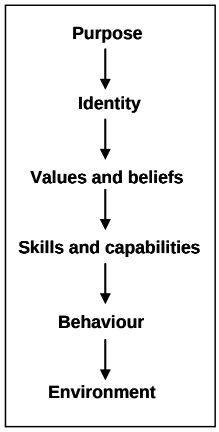
(vi) **purpose.** For individuals, this could be described as vision (which few of us have), perhaps financial self-reliance in retirement. A key aspect of a corporate vision is how it connects with the broader community of which it is a part; companies that enjoy long-term success typically pay considerable attention to their community, through cooperation and communication.

The hierarchy: an illustration

To encourage more saving (*behaviour,* level ii) requires changes to higher levels, for example by addressing people's lack of *capability* (level iii) to make informed financial decisions. Yet almost all government initiatives concerning saving involve tinkering with the *environment* (level i). This has no impact on individuals' capability, and will certainly not catalyse a savings culture. To do that, we have to look beyond simply changing the environment.

Step 2: Look back from the future

The second step is for each stakeholder to leap forward and imagine a time when the UK does have a savings culture. For companies, regulators, service providers and legislators, what would now be their purpose and identity? What are the stakeholders' beliefs, values, skills and capabilities? What are they now doing (activities), what is the senior management team now discussing and, finally, what does the environment look like (regulation, legislation, products and industry participants)?



Step 3: What has changed, and what brought the changes about?

With a savings culture established, the third step is for each stakeholder to identify what has changed within their organisation, compared to when the UK lacked a savings culture? What is different about their company structure, their responsibilities and relationships (internal and external), the product suite and how it is priced, customer service, modes of communication, and the regulatory regime and legislative framework? Once the changes are identified, each stakeholder is in a position to step back into the present and consider what would bring these changes about, and act accordingly.

5.3 Damaging inconsistencies

Stakeholders who conduct the aforementioned exercise are likely to find numerous inconsistencies between themselves and other stakeholders. Some of these **inconsistencies manifest themselves as barriers to customer engagement.** Barriers can be either:

(i) **internal:** for example, a difference between what a company says and what it does (often observed by the public); or

(ii) **external:** i.e. an inconsistency between two different parties, and therefore very visible; for example when a company and individuals (customers and potential customers) do not share a common purpose.

Inconsistencies matter, because they manifest themselves as poorly performing companies (with high costs), irrational regulation and badly crafted legislation (hence the excessive complexity that characterises the industry), slack service, high charges, incompetent advice and some sharp practices. The result is widespread public distrust of the industry, which partly explains why our nation under-saves (on an aggregate basis).

Internal inconsistencies are usually easier to address than external ones, not least because they are less likely to be subject to the attention of other parties, including the media, which loves to feed in the trough of the aggrieved (obsessed with "bad news" stories). External inconsistencies can be the source of ire and bad PR.

5.4 Stakeholder misalignment: a few examples

The industry is riddled with internal and external misaligned interests vis-à-vis its customers, beyond the usual commercial tension between buyer and seller, and the need to satisfy shareholders. This miasma of misalignments contributes to a lack of customer engagement with long-term saving. For example:

- a number of companies in the industry proclaim they put customers "at the centre" (company *identity*). Internally, however, they may be driving their administration teams to cut costs (including R&D) or wrestling with legacy IT systems (a *capability*) that can only provide annual fund statements months after the valuation date. Thus, in practice they lack the *capability* to *behave* how they may wish to, at odds with their own stated *identity.* This is an internal issue with external, adverse, consequences (evident across customer service);

- "trust us" messages (company *identity*) are used as a mechanism to win business. In reality, trust is earned by aligning a company's *purpose* with that of its customers, and then behaving in a manner consistent with that purpose. Instead, the gap between actual behaviour and self-proclaimed identity simply breeds (commercially damaging) cynicism;

- product mis-selling: the cause could be an internal *capability* failing, perhaps through lack of training, or misaligned interests between salesman and customer (external; misaligned *values*);

- consider endowment mortgages. Albeit not guaranteed, they are intended to repay mortgages (a company *belief*). But customer needs are not being met because some endowments fail to produce sufficient returns to repay the mortgage (a company *behavioural* failing); and

- for decades, some advisers have placed their own interests ahead of their customers. The adviser community failed to address this, and consequently surrendered the initiative to the regulator, leading to the Retail Distribution Review (RDR).

The retirement savings industry's stakeholders should proactively seek out barriers to customer engagement, and address them in their own best interests.

5.5 The Behavioural Insight Team

A potential source of inspiration for the industry is the Cabinet Office's Behavioural Insight Team, run by David Halpern, alternatively referred to as the "nudge unit". Its purpose is to harness behavioural economics and market incentives (as opposed to legislation) so that ministers become "choice architects", encouraging people to choose what is best for themselves and society. Currently, its priorities include well-being, public health, the environment and philanthropy but, to date, it has not focused on encouraging people to save more (perhaps because NEST is now on its way). That said, Dr Halpern's summary acronym, "MINDSPACE" (Table 5) is helpful in explaining why people behave the way they do.

Table 5: Explaining behaviour; "MINDSPACE"

M	Messenger	We are heavily influenced by who communicates the information
I	Incentives	Our responses to incentives are shaped by predictable mental shortcuts, such as strongly avoiding losses
N	Norms	We are strongly influence by what others do
D	Defaults	We "go with the flow" of pre-set options
S	Salience	Our attention is drawn to what is novel and seems relevant to us
P	Priming	Our acts are often influenced by sub-conscious cues
A	Affect	Our emotional associations can powerfully shape our actions
C	Commitments	We seek to be consistent with our public promise, and reciprocate acts
E	Ego	We act in ways that make us feel better about ourselves

Dr Halpern: "*Evolution has endowed us with a social brain that predisposes us to reciprocate acts of kindness, not to just blindly help anyone and everyone, regardless of how they treat us*."

What could the industry do to be seen as *kind*?

PART III: THE STATE IS PART OF THE PROBLEM

6. Pushmi-pullyu government: a lack of common purpose

6.1 Internal misalignment, between the Treasury and the DWP

The Government is torn between wanting people to save and spend. There are departmental (i.e. internal) schisms, notably between the Treasury and the DWP. This confused position manifests itself as contradictory policies and ambiguous communication, which does nothing to stimulate a savings culture.

The DWP "owns" social policy, and therefore has an interest in encouraging people to save for retirement. With a workplace focus, it writes the enabling legislation, but it is the Treasury, not the DWP, that controls the tax incentives, and bears the allied cost. Given this, the two departments' interests are not aligned, DWP efforts being thwarted by a recalcitrant Treasury. Hard evidence of this emerged in the autumn of 2009, when a delay in auto-enrolment was announced, the Treasury fearing the increase in tax relief costs that would accompany a few million additional savers. The rolling out of auto-enrolment will not now be completed until 2018-19, more than twelve years after the auto-enrolment proposals were first published.

6.2 External misalignment, between the MPC and savers

The Government is pursuing a fiscal policy that encourages people to save (tax relief; which costs the state nearly £30 billion per year[83]), whilst simultaneously accommodating deeply negative real interest rates. Whilst the implications of these two policies[84] may be a generation apart (retirement income thirty years hence, compared with low rates to stimulate short term demand), to most people they probably appear contradictory.

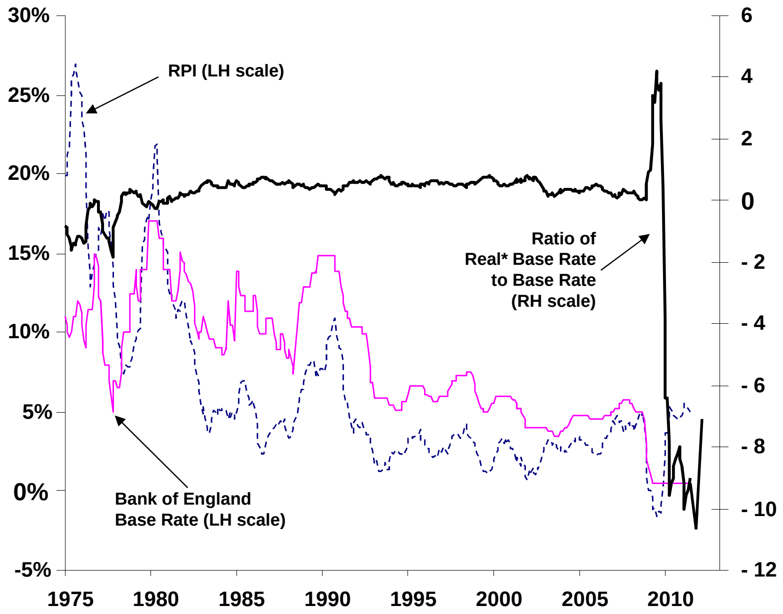
The Bank of England's Monetary Policy Committee (MPC) ostensibly targets inflation with its interest rate decisions. There is mounting evidence to contradict this. Figure 10 compares RPI and the Bank of England Base Rate, and also the ratio of the real Base Rate (i.e. how much it exceeds RPI) to the Base Rate. For the last two years RPI has massively exceeded the Base Rate, to a degree unprecedented in history; RPI, at 4.8% p.a. (end-December 2011), was more than nine times higher than the Base Rate (held at

[83] Up-front relief in 2009-10, which includes £8.3 billion of NICs rebates on employer contributions. ONS, *Table 7.9.*

[84] Given the MPC's independence, it may be deemed unreasonable to describe low interest rates as a government "policy", but quantitative easing is an instrument of government policy.

0.5% p.a. since March 2009).[85] And whilst RPI is expected to fall during 2012, the erosion of savers' capital will continue apace.

Figure 10: Bank of England Base Rate and RPI



** Real Base Rate = Base Rate minus RPI*

Many savings rates are, of course, linked to the Base Rate. Consequently, cash-based savers (i.e. most people[86]) are being crucified, the real value of their capital being seriously eroded by inflation. In addition to bank savings accounts, of the £385 billion invested in ISAs, for example, some £192 billion (50%) is held as cash.[87] The concept of investing in growth assets, such as equities and bonds (let alone the whole gamut of alternative assets classes), is alien to most people, particularly low-income families, who can least afford to lose capital.

Paying down debt, rather than embarking upon positive new saving, is the best form of saving because it produces a *certain high return* (see Table 6), equivalent to whatever rate of interest would have been paid (had there been debt), grossed up by the individual's marginal rate of income tax: negative debt ("negadebt").[88]

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[85] It is acknowledged that, looking forwards, there are downward pressures on inflation, including January 2011's VAT increase (from 17.5% to 20%) falling out of year-on-year comparisons which, on its own, should shave 1% or more off the annual rate. A deteriorating labour market and tightening credit conditions are likely to maintain the downward pressure on consumer spending in 2012, and a third round of quantitative easing (QE) could further subdue inflation. The Bank of England expects inflation to drop below its 2% target by the end of 2012, but its inflation forecast track record has been, in recent years, pretty poor.

[86] Of the 23.6 million ISA account holders, 15.6 million (66%) are invested solely in cash, with a further 4.5 million (19%) holding cash and stocks & shares ISAs. *Source*: ONS, *Table 9.10,* April 2011.

[87] ONS, *Table 9.6*, September 2011.

[88] The energy industry parallel, consuming less energy, results in "negawatts".

Table 6: Post-tax rates of return achieved by avoiding debt

	Basic rate taxpayer (20%)	Higher rate taxpayer (40%)
Mortgage interest at 4% p.a.	**5.0%**	**6.7%**
Consumer credit at 18% APR	**22.5%**	**30.0%**

Thus, a basic rate taxpayer who pays off his consumer credit debt (with a typical consumer credit card APR of 18%) is effectively saving at 22.5% per annum, i.e. many times higher than prevailing cash yields. The Government should be drawing people's attention to the benefits of repaying consumer debt, in particular; it is perhaps naïve to expect the industry to do so.

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*".

This message should be accompanied by a simple comparison of post-tax returns from saving cash and paying down consumer debt. It would also be appropriate to include a warning that by not saving in a workplace pension scheme, employer contributions may be lost.

One can understand people wanting to spend, before prices rise, rather than saving. Low interest rates also encourage (yet more) debt-financed consumption, and it is often a simpler (form filling) process to borrow than to save. All else being equal, and given the choice, most people will opt for the pleasure of immediate consumption. In addition, given that saving dampens consumption, Treasury economists (amongst others) spur us on to spend by telling us that we need to boost consumption to stimulate the economy (and VAT receipts). This is at odds with the DWP's objective of encouraging people to make appropriate provision for their retirement income.

6.3 Debt erosion and bank recapitalisation take precedence

In spite of clearly evident inflationary pressures, ultra-low interest rates could prevail for years (and, in the worst case, for decades, as per Japan?). One school of thought is that this is not unrelated to the Government's strong vested interest in seeing the banks recapitalise (as well as the real depreciation of debt in the two most indebted sectors of the economy; the banks and the Government). The traditional way of recapitalising banks is to widen the spread between deposits and loans; the current interest rate environment facilitates this. A more forgiving interpretation is that low rates are to prevent mortgage default rates from rocketing, but the outcome is the same, the protection of the banks' capital.

Either way, in the current rate environment, the Government cannot legitimately encourage people to save in the form of cash. As an aside, it should be noted that encouraging people to save for retirement is of minimal political value. Savers only reap the benefit in the long term, at odds with our five year electoral cycle.

6.4 Distrust of the Government

Successive governments' lack of common purpose is adding to the public's growing distrust of the state's involvement in the pensions arena. Public confidence in pensions has fallen to a record low, with 54% of all employees not confident in pensions compared to other ways of saving; 37% are confident.[89] Lack of trust in the Government (on pensions) was the third most cited reason for intending to opt out of auto enrolment (23%), after distrust of the pensions industry (40%) and lack of affordability (35%).

This is not just a UK phenomenon. One of the main reasons that people opt out of New Zealand's KiwiSaver is distrust of the Government; in this context, fear of subsequent rule changes, or even the abandonment of KiwiSaver altogether. From a membership of 1.88 million, the opt-out rate was 34% in 2009 and 28% in 2011.

This hints at a fundamental dilemma for all governments. Any attempt to improve the structure of retirement saving involves change, but change sows public suspicion and provides (yet another) reason not to save. Inevitably, those with vested interests, and wishing to defend the *status quo* (to preserve tax relief, for example), gleefully point this out at every opportunity.

6.5 The Government: in risk of legislative overload

The Government is legislating within the pensions and savings arena on multiple fronts, and at a pace unparalleled in decades. There are at least four major initiatives in train, notably the indexation switch from RPI to CPI, simplification of the State Pension (including putting an end to S2P and, with it, the abolition of contracting out), the launch of auto-enrolment (albeit with a timetable of staging dates that has slipped) and, separately, NEST. The State Pension Age is also being ushered into an accelerated retreat[90], and public sector pensions reform rumbles on. Steve Webb is also busy with a myriad of lower profile initiatives, such as banning short service refunds and "Operation Big Fat Pension Pot".

That said, the Government could outsource some of the workload to a standing commission, independent of politics and the financial services industry. Ideally it would encourage the Government to opt for fewer, bolder steps, rather than the frequent fiddling so often seen in the past. Central to its remit would be understand behaviour and, in particular, what motivates people to save. In this context, the effectiveness of tax-based incentives should also be reviewed (further discussed in Chapter 9).

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.

[89] NAPF survey of 2,050 individuals, of which 913 are employees, March 2012.

[90] i.e. quicker than raising it to 68 by mid-2046, as per the Pensions Act 2007.

7. What is the role of the state?

7.1 Introduction

The state has a strong vested interest in the UK having a healthy savings culture, not least because, through the welfare system, it has to field the consequences of under-saving. But a bigger consideration should be the consequences, for investment, of an increasing reliance on foreign capital (as discussed in Chapter 1). And without on-going investment to drive wealth-creation and economic growth, there will be fewer resources available for welfare.

The recent bank nationalisations rekindled the debate about the scope and limits of state involvement in personal finance. To the extent that banks' retail operations perform a crucial societal function akin to that of that of utilities, why is the pensions and savings industry any different? Those who disagree may point out that the bank nationalisations were in response to the immediacy of an economic crisis. But how often do we hear the words "pension" and "crisis" in the same sentence? Perhaps the only difference is that the latter is unfurling less dramatically, over decades rather than days.

7.2 Recent government initiatives

The introduction of auto-enrolment and (separately) NEST are the key components of the state's current intervention in the savings arena.[91] Both initiatives are intended to reverse the decline in employer engagement with retirement saving, essential given the industry's failure to engage the lower mass market with retirement saving.

A less obvious reason for the Government to be concerned about the UK's lack of a savings culture is the retreating State Pension Age (SPA). Ironically, some people may be less inclined to think about long-term saving simply because retirement is further away. The paucity of jobs for those over 60 years old, say, is potentially a bigger concern.

7.3 Auto-enrolment

(a) Guidance required

The DWP's primary on-going initiative is the auto-enrolment of employees into either a qualifying occupational pension scheme or NEST. It is intended to address the problem of workers failing to take up valuable pension benefits offered to them by their employer, and relies on harnessing inertia, i.e. it is hoped that people will not bother to opt out: "soft compulsion". One NAPF survey (March 2012) suggested that one in three eligible for auto-enrolment will opt out, which is not encouraging.

Auto-enrolment is not appropriate for everyone, particularly people with high-cost consumer debt. On average, every UK adult owes more than £11,000 in non-mortgage debt (credit cards, store cards and loans).[92] Unless their employer contributions are significant, those with an enduring exposure to consumer debt should be encouraged to

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[91] See the Pensions Act 2008 and accompanying regulation.

[92] Scottish Widows, *Women and Pensions Report: Pensions for Today and Tomorrow,* October 2009.

initially opt-out and reduce their debt, before being subsequently auto-enrolled. From a relationship perspective, employers are better placed than the Government to provide such guidance, but they are conflicted: employers benefit when people opt out, because they then do not have to make contributions.

This risk of misaligned interests could be mitigated by including a debt-reduction facility within the auto-enrolment legislation. Employees could then choose to either elect to reduce debt or contribute towards a pension. This would, however, be administratively complex. Given this, the Government should provide simple guidelines to help people decide whether to opt out from auto-enrolment, perhaps specifically to reduce their consumer debt, or stay in to benefit from an employer contribution. Any decision should involve a comparison of the cost of debt with the (otherwise foregone) employer contribution.

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

(b) Include ISAs

The auto-enrolment legislation excludes Individual Savings Accounts (ISA). This is a mistake, not least because people *like* ISAs; this is discussed in detail in a sister paper[93]. People place greater value on ISAs' ready access than pensions' upfront tax relief on contributions but, furthermore, ISAs are increasingly considered as a flexible form of retirement saving. In 2010-11, £53.9 billion was subscribed[94] to ISAs, whereas personal pensions attracted only £14.3 billion, marginally less than in the previous year and, for first time, less than was invested in Stocks and Shares ISAs (£15.8 billion, up 26% on the previous year).

Employer contributions and tax relief on employee contributions could go into NEST (or an employer-sponsored pension scheme) to obviate the risk of pre-retirement withdrawal, but it is acknowledged that this would add to administrative complexity. In addition, income replacement rates (in retirement) may be lower than otherwise, but the key objective is to encourage people not to opt out of the auto-enrolment process altogether (in which case replacement rates would then be even lower).

> **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).

(c) The removal of consumer protection; a mis-selling risk?

The introduction of auto-enrolment is being accompanied by the withdrawal of consumer protection legislation related to workplace personal pensions. For trust-based

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[93] Michael Johnson; *Simplification is the key, Section 1.10.* CPS, June 2010.

[94] ONS; *Individual savings accounts Table 9.4,* October 2011.

schemes (including NEST) this does not present an issue; trustees have a legal duty to act in the members' best interests.

Contract-based schemes, however, are overseen by an already over-stretched FSA. One concern is excessive charging, and whilst the FSA does require that the level of fees are disclosed at the point of sale, there is considerable scope for invisible charging, and therefore mis-selling, particularly in respect of smaller scheme sponsors who are more likely to be financially unsophisticated. This raises a question: why is it proposed to remove existing consumer protection legislation when no regulator or Government department is taking responsibility for ensuring that workplace personal pension schemes provide value for money?[95] The reasons are not obvious; it would be better to preserve it as a deterrent to mis-selling?

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.

There are no requirements for workplace pension schemes used for auto-enrolment to have low charges and deductions. This represents a reduction in consumer protection compared to the current requirements for employers to designate a stakeholder scheme or a group personal pension (GPP) with no transfer penalties. The FSA (Financial Services Authority) insists that it is not a "price regulator" and has not acted on our concerns about charging structures and levels. There is too much reliance on "disclosure" of information, even though the majority of consumers will struggle to process and act on any information provided.

If any reminder were needed, mis-selling is expensive. In 2011 a total of £2.7 billion was paid out in redress payments, with more than 90% of all complaints received being related to insurance and pure protection, driven by payment protection insurance (PPI). The total compensation put aside in respect of settling mis-sold PPI is now over £9 billion.[96]

The amount of compensation paid out for mis-sold endowment mortgages also runs into billions (including more than £1 billion from the life assurance industry). This is in addition to the £26 billion (£1,500 per British family) that has been paid out in respect of bank deposit protection since 2001.[97]

[95] See Which? evidence submitted to the Work and Pensions Committee, 14 March 2012.

[96] Including £3.8 billion from Lloyds Banking Group, £1.3 billion from Barclays, £850 million from RBS, £731 million from Santander and up to £745 million from HSBC.

[97] The Financial Services Compensation Scheme (FSCS). It has dealt with around 4.5 million complaints since it was set up in December 2001, notably 3.6 million accounts with Bradford & Bingley, paying out £15.7 billion. Other payments have been in respect of various internet accounts (Kaupthing and Singer and Friedlander Edge), Icesave, Heritable Bank and London Scottish Bank.

7.4 The National Employment Savings Trust (NEST)[98]

NEST, a not-for-profit organisation with trustees, was created primarily for those employers who do not sponsor their own pension scheme. Its target audience comprises moderate earners (up to £35,000 per year, say), perhaps working for small companies. The Government is placing considerable faith in it, the hope being that it will eventually engage millions of the lower paid with long-term saving.[99] NEST faces many challenges, some of them self-made, with assistance from government.

(a) NEST's default fund: flawed?

(i) Risk allocation: controversial

NEST's default fund will comprise a series of "target date" funds[100], each of which will be made up of a blend of five underlying, passively-managed, funds.[101] Asset allocation between the funds will be determined by the NEST trustee board, which will focus on three distinct accumulation phases; "foundation", "growth" and "consolidation".

"Lifestyling" techniques will be used to manage the degree of risk that investors are exposed to. Pension pots need exposure to riskier assets to beat a combination of inflation and charges, and the longer the investment horizon, the more so. Ordinarily, "lifestyle" funds expose younger savers (i.e. decades ahead of their retirement) to "growth" assets, which are riskier (such as equities). Risk is subsequently reduced in the run up to retirement, by progressively shuffling the asset allocation towards "safer" investments, notably bonds and gilts (i.e. fixed income).

NEST's default fund, however, will place an emphasis on *lower* risk investments in the initial (foundation) stage; this is puzzling, as it contradicts received wisdom.

(ii) Reckless caution?

The combination of NEST's 1.8% up-front subscription fee plus today's significantly negative real interest rates will provide a stiff headwind to low risk assets. Indeed, given that interest rates are likely to remain low (relative to inflation) for some time, this strategy offers a significant risk of capital erosion, in real terms (albeit that many people only think in nominal terms, blind to inflation's corrosive influence). Is this a potential case of reckless caution or, at worst, a potential mis-selling scandal in the making?

NEST's explanation for the cautious design of the foundation stage of the default fund is that it is the result of consumer research; people want low risk. Well, given that many people have not cognisant of "risk and return", this is no surprise. Indeed, when it comes

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98 Detailed in Johnson; *Self-sufficiency is the key; addressing the public sector pensions challenge*, CPS, February 2011.

99 NEST auto-enrolment is being phased in over several years, commencing in 2012 with the largest employers. The 2011 Autumn Statement offered small businesses an extra year to prepare for auto-enrolment; the process will not be complete until 2018-19.

100 A series of sub-funds are each managed to a specific target date for retirement; hence the name. There could be separate funds for people who expect to retire in 2045, 2050, 2055, and so on.

101 UBS, State Street Global Investors and BlackRock will manage the default fund's five investment mandates; Passive Global Equities, Passive UK Gilts, Passive UK index-Linked Gilts, Sterling Cash and Diversified Beta (investing in a wide range of asset classes).

to long-term financial decision making, most of us are unsure of what is *most likely* to be in our best interests.

This begs a question: *what is the role of the state in this context*? Should NEST's trustees be leading foundation stage investors in a riskier direction, because they believe that this would be in investors' best long-term interests, but contrary to investors' expressed preference? There are no "correct" answers, but given that the state fields the consequences of small pension pots (through the benefits system), it should have the right to lead on this. But courage is needed.

There is a second important consideration. For some people (particularly amongst NEST's target audience), NEST will be their first experience of investment. But an overly cautious default fund is unlikely to develop their understanding of risk and return; the world is not risk-free.

(iii) The political perspective

One question to consider is whether NEST has attributed too much weight to political considerations. We cannot ignore a key government objective for NEST, to minimise the risk of people experiencing a month or two of losses (perhaps due to volatile equity markets), and then opting out, defeating the purpose of auto-enrolment.[102] Avoiding losses would appear to be at the forefront of the thinking behind the structure of the default fund.

> **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.

This is not to say that the standard of default funds elsewhere is particularly inspiring; many are woefully inadequate, but the industry, with its conflicts of interest, is not motivated to address the issue. In the meantime, the Government has published some guidance, outlining best practice in the design of default funds.[103]

On a more positive note, NEST has elected for passive (rather than active) managed funds within the default fund, which should help keep costs down. Although most people are expected to opt for the default fund,[104] there will be a small range of other funds to choose from.

(b) NEST: countering the opt-out risk

The Treasury is reluctant to issue inflation-linked debt because it is likely to prove to be expensive relative to conventional (fixed coupon) issuance. But the Government may be prepared to pay this price if it meant that the NEST opt-out rate were to be kept low. It should consider the creation of a new inflation-linked savings instrument specific to NEST. It could be described as an inflation-indexed fund (to aid communication; most

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[102] This is an example of an emotional response overwhelming rationale: many people fail to distinguish between *paper* and *actual* losses. This is particularly relevant give the recent stock market turbulence. The average fund in the UK All Companies sector has lost 10.9% over the past year (to 11 February 2011-12). However, the same investment will still have been up 23.8% over the past three years, while the return over five years stands at 95.7%. Morningstar data.

[103] TPR has set out "*Principles for investment governance of work-based DC pension schemes*", and the DWP has published *Guidance for offering a default option for defined contribution automatic enrolment pension schemes* (May 2011).

[104] ATP's experience is that 95% of scheme members choose the default investment strategy.

people (particularly amongst NEST's target audience) are unfamiliar with non-cash savings), but have the risk characteristics of an inflation-linked gilt. This initiative could be combined with a redesigned default fund.

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.

(c) NEST contributions; 8% will not be enough

There will be a statutory minimum of 8% on a band of earnings[105] for all schemes, which many private sector providers are expected to adopt. 8% may be politically pragmatic in the current economic climate, but the Government is unwittingly providing an implicit endorsement that it is enough. In practice, 8% is too low to meet most people's retirement income expectations. This is particularly an issue for the 50% of the working population who currently have no pension entitlement other than the basic State Pension. Australia's Super G scheme currently requires a 9% contribution from employers, now scheduled to increase to 12% by 2020, and an additional 3% contribution from employees has also been mooted. The DWP should express similar aspirations for NEST.

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.

(d) NEST: unable to compete?

(i) Introduction

NEST represents a major challenge to the industry and, inevitably, some competition has emerged (Table 7), notably from:

- the Danish ATP, which has launched a multi-employer, trust-based scheme (branded NOW Pensions)[106]; and
- B&CE, which has launched a super trust (The People's Pension).[107]

In addition, mainstream UK providers, including Standard Life, are extending their master trust pension structures in preparation for auto-enrolment.

NEST's 0.3% AMC is competitive, and represents a welcome challenge to the investment management community, providing additional impetus towards passive management.

However, ATP and B&CE enjoy some major structural advantages over NEST, to the extent that some MPs are questioning how NEST will compete…..and even what its role is.[108] If NEST is to compete, then it must be unshackled from restrictions such as the low contributions limit, the ban on transfers, the high subscription charge and the lack of any

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105 Comprising 4% from employees, 3% from employers and a 1% tax rebate. The earnings band details are yet to be finalised, although the threshold minimum is likely to be £7,475 per annum.

106 NOW Pensions' AMC is 0.3%, with an administrative charge of £1.50p per month won its first customer in December 2011; The Retail Data Partnership, with 19 employees.

107 B&CE won its first customer, Morgan Sindall (2,200 employees), in January 2012.

108 Dame Anne Begg MP, chairman the Work and Pensions Select Committee.

vesting period (which makes it relatively unattractive to employers). NEST cannot wait until 2017, when its restrictions are scheduled to be reviewed.

As an aside, Now Pension's lack of investment choice is particularly striking; the issue of choice is further discussed in Chapter 14.

Table 7: NEST's competition

	NEST	Now Pensions (ATP)	The People's Pension (B&CE)
Charges	0.3% AMC + 1.8% subscription	0.3% AMC + £1.50p per month admin. charge	0.5% AMC
Fund choice	Default fund + c. 10 others to choose from	No investment choice: only one fund available	Default fund (medium risk) plus 2 other profiles to choose from (low and high risk). 7 other funds to choose from including Sharia and SRI options
Investment strategy	Default fund: 5 underlying mandates; Passive Global Equities, Passive UK Gilts, Passive UK index-Linked Gilts, Sterling Cash and Diversified Beta (investing in a wide range of assets)	3 underlying funds: a managed diversified growth fund, a retirement protection fund and a cash protection fund	Default fund: medium risk with 80% allocation to equities. 15 year glide path to retirement
Transfers	No	Transfers in	Transfers in and out
Governance	Trustee-based; fully independent	Trustee-based; not fully independent (CEO a trustee)	Trustee-based; fully independent
Experience	Management experience is mixed	Considerable; ATP services much of the Danish working population	Provides pensions for the construction industry: 500,000 policyholders
Track record	As an institution, none	Strong: 7.4% p.a. return over last decade	30 years; £1.8 billion in assets under management

(ii) NEST's subscription charge; remove it (if possible)

NEST will levy a 1.8% subscription charge, intended to repay a £650 million start-up facility from the DWP. This, combined with the AMC (0.3% of assets) and a twenty year timeframe, translates into an all-in (explicit) cost of some 0.5% per annum.[109] This is a substantial improvement on what is on offer from much of the industry, but many people (rightly or wrongly) will compare 1.8% (up-front) with prevailing cash yields of under 1%. There is a risk that the subscription charge will unwittingly provide people with a ready excuse to opt out of the auto-enrolment process.

The state should write off the loan and remove the subscription charge, consistent with the Treasury's philosophy of "spend to save".[110] Given the long term benefit of having the working population engaged in retirement saving (many for the first time), this could turn out to be a bargain. The downside is that NEST could then no longer claim to be a self-sustaining organisation; it would be exposed to accusations of market distortion, and the industry could approach the European Commission with accusations of state subsidy. But before doing so, it should pause to carefully consider how tax relief could be interpreted.

[109] This does not of course reflect the erosion of capital care of implicit costs; see Chapter 2.

[110] "Spend to save" thinking is encapsulated in both the Treasury's Green Book and the Office of Government Commerce's Common Minimum Standards (OGC is part of the Efficiency and Reform Group of the Cabinet Office). NEST's subscription charge would have to be dropped if compulsory participation were introduced.

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".

The Government could go further, by swallowing the cost to NEST of having to administer a vast volume of micro-interactions. This would not be without precedent; the US Federal Government meets some thrift institutions' (savings and loan associations and credit unions) payroll and collection costs.

An alternative approach would be to give NEST discretion over what it charges. Currently it cannot distinguish between an employer with a centralised payroll and one with numerous different payroll systems; the latter would be much more costly to service.

(iii) NEST contributions cap; remove it

NEST has a cap on annual contributions of £4,200 (rising to £4,400 for 2012 / 2013), which serves no customer purpose. Indeed, some larger employers, in particular, are citing it as a reason not to engage with NEST.[111] Introduced to protect the vested interests of the industry, it should be removed forthwith.

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

(iv) Transfers in and out: permit them

Transfers into and out of NEST are not allowed (except in specific limited circumstances), the official reason being "in order to focus the scheme on its target market". This is nonsensical when pension pot consolidation and portability are being advocated (not least by Steve Webb, the pensions minister); only those with deep-rooted vested interests defend the transfer ban.

The ban originated (contrary to the Pension Commission's recommendation) as a concession to the industry, which was seeking to protect its market position: it is absolutely not in the consumer's interest. Subsequently, as direct competition to NEST has emerged (perhaps unanticipated at the time the ban was introduced), the ban has transmogrified into a serious competitive disadvantage.

Meanwhile, a Government-sponsored report[112] has requested an urgent review to consider how transfers across the pensions industry can be made easier (see Chapter 8). And whilst the Secretary of State is required to review NEST in 2017, as far as transfers are concerned, this is far too late. NEST should be allowed to receive transfers as soon as possible, ideally from 1st October 2012; thereafter, employers will be able, under auto-enrolment legislation, to default people out of group personal pension schemes into qualifying schemes, including NEST.

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).

[111] Tony Filbin, Managing Director, Workplace Savings, L&G (*Professional Pensions*, 1 September 2011).

[112] *Making automatic enrolment work*, October 2010.

(v) Open NEST's administrative platform to other schemes

Once NEST's operations are running smoothly, employers who are sponsoring their own schemes should be permitted to transfer them onto the NEST platform. NEST ought to be able to harness considerable economies of scale and cut (small) employers' administrative costs.

(vi) NEST and the public sector; a missed opportunity[113]

NEST represents a golden opportunity to catalyse a savings culture amongst low earners, many of whom are in the public sector (20% of the total workforce). But NEST excludes them. In addition, there are strong arguments for starting to tip-toe the public sector towards a partially funded pension framework, with a component of DC-based provision.

> **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.

The Treasury would prefer to have the additional contributions for itself, but foregoing this cashflow would be consistent with its own "spend to save" thinking. The long-term benefit of having a significant proportion of the working population engaged in retirement saving (many for the first time) would outweigh the associated costs. Indeed, engagement is a crucial first step to catalysing a savings culture. The Treasury would, however, have to meet the associated cost of tax relief (and employer NICs rebates, whilst the Second State Pension (S2P) remains).

(e) NEST: conclusion

NEST could legitimately claim to already be a "success", because the prospect of its arrival is exerting competitive pressure on the industry. NEST's incarnation has also prompted some private sector providers to launch propositions that are at least as attractive. Consequently, one could argue that NEST has already served its purpose, and that it is no longer required. But only its on-going presence will maintain pressure on the industry, particularly if NEST's less endearing attributes were to be rectified, notably the ban on transfers and the contributions cap (both part of the price of its politically-inspired creation).

One has to have some sympathy for NEST's position. It is hobbled with the disadvantages of being a public sector entity (for example, unlike its private sector competition, it cannot choose its customer base), and it is potentially in play as a political pawn. *In extremis*, if NEST were to "fail" (however defined), this would be portrayed by the Opposition of the day as a political failure, so the Government will do all it can to assist, without being seen to do so (limited by EU regulation and the risk of industry cries about "unfair competition"). Furthermore, abolishing NEST is inconceivable because any subsequent state-sponsored initiative (to encourage saving) would then not be taken seriously.

Meanwhile, NEST is preoccupied with working out how to repay its DWP-furnished start-up loans,[114] whilst simultaneously scaling back its take-up projections, care of mounting

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[113] As more fully detailed in *Self-sufficiency is the key; addressing the public sector pensions challenge*, Michael Johnson, CPS, February 2011.

[114] Which will have to increase, following by Steve Webb's announcement (28 November 2011) of the auto-enrolment delay for small businesses.

competition and the bleak economic outlook. NEST's research had predicted an opt-out rate of about 20%, but this is now viewed as optimistic.[115]

7.5 *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 harness inertia through a panoply of additional default options, 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. If we are to introduce additional default options, we should start with a savings account for all.

7.6 *The Super ISA*

Over 90% of the population have very simple requirements of the industry, but it is not meeting them. This, combined with the state's vested interest in stimulating a savings culture, legitimises a state-sponsored "shove". Today's ISA structure should be enhanced so that it could serve the consumer's two basic needs: discretionary (rainy day) savings *and* retirement savings, thereby rendering many other products redundant.[116] It would need a simple name: the Super ISA ("Super" as in superannuation).

The Super ISA would embody the merger of today's disparate ISA and pension worlds. It should be capable of accepting lump sum and regular savings (including employer contributions), and accessing a range of investment options. It would reinforce the (well understood) simple principle that giving up access would provide a higher return. Changes of employment would be accompanied by the former employer's contributions simply being replaced by contributions from the new employer (along with salary).

All new-borns should be allocated a Super ISA account at a default provider (the Post Office?), identified by their National Insurance number. Parents would be given the option to move it to any other eligible provider. In the meantime, today's ISAs could be linked to future NEST accounts (to become Super ISAs); enhancing NEST's capabilities in this manner would also render it more competitive.

Thus, all UK-born citizens would, in time, have at least one simple, seamless savings vehicle from cradle, via employment and into retirement. In practice, the development of the Super ISA should be conducted jointly by the industry and the Treasury, not least because it would have to be able to automatically differentiate between discretionary and retirement savings for the purpose of allocating tax-based incentives: an IT challenge, but not a "stopper".

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[115] "An opt-out rate of above 50% would concern us." Lawrence Churchill, NEST Chairman, December 2011.

[116] This vision was originally floated in sister paper; *Simplification is the key*, CPS, June 2010.

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).

An alternative name for the account could be the MySavings account (inspired by Australia's MySuper) which, when wedded with a NEST account, could become MySavings NEST.

8. Legislative changes: looking ahead

8.1 The state pension: a change in policy direction?

(a) A flat rate....one day

In April 2011 the DWP launched a green paper[117] outlining plans for a single flat-rate ("universal") state pension, combining today's basic State Pension (BSP) and State Second Pension (S2P) into one single-tier state pension. The paper envisages the new State Pension being set above the Guarantee Credit threshold, to address the savings disincentive provided by means-tested benefits; it posits £140 per week (in 2011 money). The complex S2P would be abolished, and with it, the end of contracting out. Were such proposals to come to fruition, they would represent an important simplification of the pensions arena, as well as providing a bedrock of income certainty (above the poverty line), on which to build personal savings.

> **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*).

(b) Two philosophical U-turns

The introduction of a simplified state pension would mark two policy sea-changes. The direction of government policy has been, over the last 50 years, to increasingly emphasise private provision for post-retirement income. Successive governments have relied on competition to ensure that the hegemonic free markets are efficient. Perhaps the evidence, of insufficient saving, poor investment returns, an overpaid industry and a public sceptical of long-term saving (and the industry), has finally undermined that philosophy.

Secondly, eligibility for the new state pension would no longer be based upon NICs contributions, but some measure of UK residency. Although, in practice, we moved from a contributory system many years ago, care of means-tested benefits, many people will not see it that way, and they may be left questioning the wisdom of their past National Insurance contributions.

(c) Thirty years to fully qualify: not enough?

Given the improvements in life expectancy and the retreating SPA, one could expect that eligibility for a full state pension would require a rising number of qualifying years. But the trend has been in the opposite direction: now 30 years for men and women, when prior to April 2010 it was 39 years for women and 44 years for men. The Treasury may, one day, come to regret this shift (although it could exercise other cost control levers), although the age at which both men and women are leaving the labour market is rising. This suggests that from the perspective of the individual, what matters most is when the state pension is paid, rather than the number of years of contributions.

[117] DWP: *A state pension for the 21st century*, April 2011.

8.2 The State Pension Age (SPA)

In the meantime, the SPA has been sent into retreat, to counter the onslaught of rising longevity, currently legislated to rise to 68 by 2046.[118] Further changes to the SPA are quite likely. The DWP's aforementioned green paper canvasses views on plans for a mechanism to automatically increase the SPA in line with average life expectancy.

But life expectancy is not increasing uniformly across the population; the improvement is skewed towards the better off. A 65-year-old healthy male professional could expect to live to nearly 88, some 11 years longer than a low-earning manual worker retiring in ill-health.[119] Consequently, the fairness of having the same SPA for everyone is in question; suggestions include replacing it with entitlement based on the number of years worked. The rationale is that those who stay in education until their early- to mid-20s are likely to enjoy longer life expectancy *and* could probably afford to work longer. Some actuaries have advocated a link between the SPA and the *individual's* expectation of life.

The end of a fixed SPA would also be consistent with the recent demise of the Default Retirement Age, partly a reflection of people's desire for flexible working. But tailoring the SPA to individual circumstance invites a panoply of moral hazards, as well as being operationally challenging to implement.

8.3 Pensions: a lack of immediate utility

(a) Early access: the lesser of two evils

Unlike almost all other retail decisions, the retirement-savings investor is not buying something for immediate consumption. The "purchase" is a pot of assets at retirement, perhaps 30 or 40 years into the future. It will then be used, typically, to purchase an annuity to provide income until death.

This lack of immediate utility is a huge deterrent to engaging with retirement saving, and is at odds with the trend in how Generation Y[120], in particular, are living their lives. For example, those aged 22 to 34 and falling into auto-enrolment's target market[121] have been increasingly forced to rent, rather than own, their home (41%, up from 31% five years ago).[122] Given this pent up demand to own a home, saving within a pension is looking unattractive to a growing proportion of the population. As Table 8 shows, every age group within auto-enrolment's target audience and without a pension is less inclined to start saving into a pension than they were three years ago.

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[118] As per the Pensions Act 2007.

[119] Oxford Institute of Ageing; *Living longer and prospering*.

[120] Generation Y; born between the mid-1970s and early-1990s, following Generation X (1965 to 1974) and the Baby Boomers (1948 to 1964).

[121] Defined as working full or part-time, (including the self-employed), earning £7,500- £35,000, aged 22 to State Pension Age and not currently contributing to a pension.

[122] GfK Financial; *Financial Research Survey 2012*, period covering January 2007 to January 2012.

Table 8: Saving into a pension has become even less popular[123]

Age Group	January 2009	January 2012
22-34	23%	17%
35-49	13%	5%
50+	2%	1%

This trend is particularly marked amongst those aged 35-49, which should be of real concern to the industry. People want to be in control of their assets; 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.

In December 2010, the Treasury launched a consultation on early access to pension funds, and ruled it out in April 2011. It was subject to intense lobbying from industry vested interests concerned about the erosion of pension assets under management, which is incredibly short-sighted.

There is an understandable concern that early access risks a wave of unwise consumption, leaving people with less income in retirement than otherwise.[124] One approach to addressing this is *controlled* early access, in a manner that resonates with how people think, for example, “my home is my pension”. This should not require a swath of rules, which would be hard to monitor (and there are usually ways round them). A second accommodation could be to allow graduates to use their employers’ auto-enrolment contributions to pay off student debts.[125]

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. The property should be the buyer’s sole property.

There would have to be safeguards to ensure that a home purchased using early accessed retirement savings could not subsequently be used as security for new consumer debt (effectively leveraging what were retirement savings).

(*b*) *Early access raises tax issues*

The introduction of early access does, however, raise tax issues, pension contributions having been topped up by income tax relief, and National Insurance Contributions (NIC) rebates on any employer contributions. The interaction with tax credits also has to be considered. The Treasury would, quite rightly, want to recover its long-term saving incentives, which could be done as follows.[126]

- **Income tax.** The amount withdrawn could be added to taxable income, so relief would be charged back at the prevailing marginal rate. For those who received income tax relief at their current marginal rate it would be the "right" amount. For those who had subsequently become higher rate income taxpayers (perhaps as

123 ibid.

124 As experienced by US savers, in respect of using the loan facility attached to some 401(k) Plans.

125 An idea suggested by Ros Altmann, Director-General of Saga. The issue of whether or not to grant tax relief would have to be resolved.

126 With thanks to Carl Emmerson of the IFS.

a result of making the withdrawal), the state would gain, but it would lose out in the (relatively few) cases where people had received higher rate relief but now pay basic rate income tax. That said, today only one in seven recipients of higher rate relief go one to repay it via higher rate income tax during retirement; the Treasury already loses out.

- **Tax credits** operate in a similar way to income tax, i.e. income is assessed after pension contributions, so individuals are essentially getting relief at a more generous rate if they are on one of the tax credit tapers. Thus, analogous to income tax, withdrawals from pensions should count as income when assessing eligibility for tax credits.

- **Employer NIC rebates** are harder to address; the most simple approach would be for the employer's NIC rebate to be deducted from the withdrawn amount and reimbursed to the Treasury.

An alternative *quid pro quo* for early access could be to reduce eligibility for the 25% tax-free concession on lump sum withdrawal at retirement, but such an arrangement would make it nigh impossible to *subsequently* put an end to the tax-free lump sum (further discussed in Chapter 9).

(*c*) *Early access: conclusion*

Early access is not a straight forward issue, and perhaps boils down to being the lesser of two evils. Whilst associated tax-related calculations are potentially messy (and require historic data), the alternative is to risk many younger adults *never* engaging with retirement saving, due to pensions' inflexibility; the next cohort of pension-purchasing clients could be very thin.

In addition, preventing early access perpetuates an on-going source of financial distress. By not being allowed to borrow from themselves, some people then borrow far more expensively from somewhere else. This creates a vicious circle whereby incomes are squeezed by debt repayments, reducing formal saving.

8.4 Product taxation

(a) An unwitting love of complexity

One of the more damaging contributions that successive governments have made to the savings arena is to impose different tax regimes for different financial products.

Pensions, ISAs, single premium life assurance bonds, life funds and collective direct investment schemes (such as OEICs and Unit Trusts) are each subject to a different tax regime, which again differ in each of the four phases of saving (accumulation, at-retirement, decumulation and post-death). In addition, the products have very different attributes, making meaningful comparison almost impossible; the detail is discussed in a sister paper.[127] This taxation maelstrom guarantees that customers cannot compare costs and "value" across the product spectrum. Furthermore, there are tax treatments for each stage in life; pre-retirement accumulation, at retirement, post-retirement decumulation and post-death.

[127] See Chapter 2 of *Simplification is the key*, Michael Johnson, CPS, June 2010.

Such is the influence of tax regimes on the design of savings products, that the state is effectively the chief designer.[128] Indeed, it would appear that the paramount concern of successive governments is not to lose control over its ability to tax those with savings (which are, furthermore, often created from income that has already been taxed). The Government's purpose is not aligned with that of long-term savers, and until this changes, the UK is unlikely to catalyse a savings culture.

In the meantime, the taxation arrangements reinforce the impression that "the industry" is actually three different industries, albeit largely focused on a common customer base. Each of the pensions, savings and investment, and life insurance businesses have their own trade body[129].

(*b*) *Simplification required*

This paper does not intend to wade into the tax labyrinth, other than to make one simplifying suggestion. 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. Even the product terminology is bewildering; for example, investment bonds (with embedded life insurance) are not taxed as per a conventional (fixed income) corporate bond or gilt.

The Office of Tax Simplification (OTS) is currently reviewing pensioner taxation, but their terms of reference exclude the simplification of the taxation of different financial products. But with many life companies in terminal decline, there is now an opportunity to simplify the tax regimes for different savings products.

> **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.

Many of the products that would be impacted by this proposal are anachronisms from the past, sometimes accompanied by some of the worst excesses of adviser remuneration, including trail commission.

8.5 Pension pot consolidation

(a) Introduction

There is an unholy trinity of forces acting to reduce the size of our pensions:

- adverse market conditions (such as poor investment performance and low annuity rates), which is (largely) beyond the control of the Government;
- the dysfunctional nature of the (rent-extracting) industry, resulting in high costs and the excessive erosion of savings, discussed in Chapter 2; and

[128] Ideally, products should be designed by customers; user-led innovation, in the style of the Lego company, for example.

[129] The ABI (insurers), IMA (investment managers) and NAPF (pension funds). They sometimes have conflicting agendas.

- unnecessary structural barriers that inhibit the consolidation of multiple small pots.

(*b*) *The small pots problem*

Careers are increasingly segmented, with people averaging 11 different employers before retirement. We mix periods of work, training and education, and do a variety of full-time and part-time work, in a manner that was unimaginable thirty years ago. Consequently, at retirement, most people can expect to have a number of separate asset pots, comprising company schemes and personal pensions, such as SIPPs and stakeholder products.

The returns on small pension pots are inferior to those on larger ones, partly because they are proportionally more expensive to administer, a fact that some providers are quite open about. Legal & General, for example, has told clients with less than £15,000 in a pension pot to "review their pensions", a hint that, from L&G's perspective, the business is unsustainable (and that it does not want holders of small pots as customers).

Multiple pots also complicate any analysis of portfolio composition during accumulation. But their most serious consequence is that they reduce the saver's annuity purchasing power at retirement. The smaller the annuity, the larger the pro rata cost, yet most annuities are considered small; 67% of those purchased between 2001 and 2009 were worth less than £20,000 (and 44% were worth less than £10,000).[130]

Pot consolidation should also be of value to providers currently bearing the financial burden of administering millions of inactive ("dead") pots, created when people change their employment. Dead pots are accumulating at a rate of more than one million each year, yet most of them are too small to ever be commercially attractive.[131] Establishing an efficient mechanism for pot consolidation should benefit customers and providers alike; a rare "win-win".

(*c*) *Pension pot consolidation: alternative approaches*

The pensions minister, Steve Webb, is well aware of the inefficiencies of multiple small pots, hence the DWP's initiative termed "Operation Big Fat Pension Pot".[132] This is exploring ways of addressing the problem and, in light of the advent of auto-enrolment (expected to produce millions more small pots), the initiative is accompanied by a welcome sense of urgency. Allied issues include the lack of pot portability (when changing jobs) and how best to determine transfer values, the latter often involving multiple parties, and lots of time-consuming form-filling.

The minister has called upon the industry to come up with a solution to people accumulating multiple DC pension entitlements from different employers. This represents a golden opportunity for the industry to voluntarily demonstrate leadership, whilst acting in consumers' best interests.

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[130] Pensions Policy Institute; *Retirement income and assets: the implications of ending the effective requirement to annuitise by age 75*, April 2011.

[131] Dead pots usually represent negative Value of In Force (VIF) business, eroding the providers' Embedded Value. According to the Unclaimed Assets Register, there are more than £3 billion of assets in unclaimed pensions pots.

[132] The DWP launched a consultation on 15 December 2011; *Meeting future workplace pension challenges: improving transfers and dealing with small pension pots*.

(*i*) *BACs for pensions?*

The industry could, for example, establish a British version of Australia's Small Business Superannuation Clearing House[133]; a not-for-profit "BACs for pensions"[134], perhaps under the joint aegis of the ABI, IMA and NAPF.

By handling contributions on an on-going basis, this could be more than just an industry-wide consolidating platform for DC pension pots. Unlike the Australian model (aimed at businesses with fewer than 20 staff), it should be open to all employers (and the self-employed), enabling them to pay contributions and transfer values to a single location. Cash would then be forwarded to the ultimate destination (including NEST).

> **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.

(*ii*) *Expand Origo?*

An alternative to establishing a new vehicle would be to expand Origo's capabilities. Owned by 18 UK life assurance groups, Origo works with product providers, wrap platforms, financial advisers, portals and software companies. Its aim is to collaborate with the life, pensions and investment sectors to identify and address cost and efficiency issues. Origo's "Options" service (used by more than 20 providers) is focused on "at retirement" transfer issues[135]; it claims to have achieved a dramatic reduction in transfer times (from an average of 51 days to 11 days). A pre-retirement service is in development (Options II), but widespread participation in Origo is not assured, not least because some providers fear a net loss of assets under management.

(*iii*) *The fall-back position: NEST*

If the industry were to fail to act decisively, then NEST becomes the obvious DC pot consolidation vehicle, enabling NEST participants to consolidate their non-NEST DC asset pots into their NEST accounts.

Irrespective of the consolidating vehicle and its sponsors, any potential adverse consequences of pot consolidation would have to be clearly communicated to savers. This includes withdrawal or Market Value Adjuster penalties, or the loss of valuable guarantees on With Profits policies, annuity rates or other significant benefits.

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[133] Operated by the Federal Government.

[134] BACS (originally Bankers' Automated Clearing Services); a UK scheme for the electronic processing of financial transactions.

[135] Covering open market options (OMO), immediate vesting personal pensions (IVPP) and pension to pension transfers.

(d) *Other pot consolidation mechanisms*

(i) *Automatic transfer values*

A simple way of promoting consolidation would be to introduce a default option so that anyone leaving a pension scheme with a pot below a certain size (£5,000?) *automatically* receives a transfer value, either as a payment to their new employer's pension fund or into a NEST account.[136] Employees should be allowed to "opt out", and elect to leave the pot in situ, not least because they may prefer to take advantage of trivial commutation rules.

> **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.

(ii) *Expand the trivial commutation rules*

It is well recognised that forcing people with very small pension pots to turn them into a lifetime retirement income does not make sense for consumers or providers (keen to cut administration costs). Currently, if *all* of someone's pension savings totals less than £18,000, they can "commute" the whole lot, i.e. take it as a tax-free lump sum (75% of which is taxable), with no need to take an income. In addition, anyone aged 60 or over with an occupational scheme pot holding benefits worth less than £2,000 can withdraw them as a cash lump sum. The Finance Bill 2012 will extend this to allow individuals to commute a maximum of two *personal* pension pots (provided the entire pot is less than £2,000).

Whilst the trivial commutation rules do simplify people's pension pot arrangements, they are not necessarily in people's best interests. £2,000 is very small in the context of purchasing an annuity; many providers do not offer annuity products for less than £5,000.

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

(iii) *Link pension pots to the worker*

Once solution being considered by Steve Webb is to link pension pots to the worker. Thus, when someone changes their job, their pension pot goes with them unless they specifically request otherwise. A simple idea, but Webb is aware of potential problems, particularly if the new employer's scheme is not as good as the previous scheme…..exposing the government to legal action.

(d) *Operational considerations*

(i) *The administrative burden*

Irrespective of the mechanics, the process of pot consolidation should follow clear compliance requirements. In respect of transfers between occupational schemes, there

[136] This would, however, incur valuation and transaction costs.

is a whole gamut of considerations, depending on the type of schemes involved (trust- or contract-based, DB or DC), including:

- obtaining trustee and beneficiary consent;
- ensuring that the recipient provider meets the needs of the customer;
- calculating transfer values (with DB schemes, the value being taken from the scheme has to be fair to both the transferee and remaining members) and tax-free cash entitlement;
- confirming the recipient scheme's tax registered status; and
- confirmation of receipt of monies.

It would be hugely beneficial if the industry were to agree to a standardised set of transfer procedures and documentation. This would probably have to be accompanied by some changes to contract law to help simplify, and speed up, the transfer process.

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.

The task force should consider the use of technology to automate the process of information gathering, such as screen-scrapping, not least to tackle the legacy of "dead" pots (pots left behind after people leave an employer and cease contributing).

(ii) Beneficiary protection: an enhanced transfer value (ETV) code of conduct

Transferring some types of pension benefits can be risky because they could accompany the loss of valuable guarantees or benefits. More specifically, ETVs are being used to encourage (i.e. bribe) workers with (typically DB) company pension rights to give them up in return for riskier pensions plus a cash incentive. To be clear, this is about companies wanting to save money and shed risks and responsibilities, so ETV offers are unlikely to be in employees' interests. An exception concerns workers in ill-health. But, *in extremis*, the alternative for employees could be that they lose their jobs, should their employer becomes insolvent.

Steve Webb has "requested" that an ETV code of conduct be established by the industry[137]; a nudge that was accompanied by the threat of legislation, if the industry fails to act. He has also suggested that the code be enforced jointly by the FSA and TPR. Given the dire track record of joint regulatory responsibility, it would be better if the TPR were solely responsible for DB schemes, with the FSA assuming responsibility for DC schemes (further discussed in Chapter 11).

[137] In this case the Association of British Insurers (ABI), Association of Independent Financial Advisers (Aifa) and the National Association of Pension Funds (NAPF). Steve Webb would like employers to offer to pay for independent financial advice whenever they tempt employees with money to leave company pension schemes.

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).

In the meantime, the industry ought to voluntarily suspend the use of ETVs, until the implications for employees are made much clearer.

(iii) In specie transfers (re-registration) should be encouraged

Currently, transferring assets between different pension savings vehicles often requires the sale and subsequent repurchase (in the new vehicle) of the assets. Crossing the bid / offer spread and paying transaction taxes erodes capital, which runs contrary to the Government's objective of pot consolidation. Re-registration should include the ability to transfer assets from an ISA into a pension vehicle, consistent with supporting simpler, more flexible (workplace) saving.

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.

A simple, industry-wide, re-registration service would also assist advisers to consolidate their clients' multiple pension pots with one provider, thereby centralising execution and administration. Analysis of client portfolios would then be easier, assuming that the necessary data and tools are available via websites. This would help catalyse more competition amongst distributor platforms, and make for a more efficient service.

8.6 Short service refunds

A member of a trust-based scheme who leaves employment with less than two years of pensionable service (but more than three months) can elected to have his own contributions (but not his employer's) refunded ("short service refunds", SSR). The employer is, however, required to offer (as an alternative) the transfer of the employee's benefits to a new scheme (perhaps the next employer's). If the employee accepts this option, the transfer value would include both his *and* the employer's contributions.

Clearly, employers have an incentive to encourage people to opt for the cash refund because they can then retain their own contributions, perhaps using them to offset administration costs or future contributions.[138] Thus, SSRs are a deleterious temptation that harness human nature, notably our preference for cash today rather than a distant pension. This obviously conflicts with the objective of encouraging people to accumulate retirement savings.

There is another SSR consideration; from an employer's perspective, NEST (and group personal pensions) is at a competitive disadvantage to many existing pension schemes

[138] This results in schemes in which some members get no benefit from their employer contributions whilst others enjoy lower administration costs, directly at the former group's expense.

because it has no vesting period.[139] Thus, NEST offers no possibility of SSRs, and therefore no possibility for employers to recoup their contributions.

Steve Webb is well aware of these issues, and has quite rightly indicated that a ban on SSRs is inevitable. But he is also aware that addressing the SSR issue is part of a wider debate about how to treat small pension pots and transfers, particularly once automatic enrolment is operative.

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).

Banning SSRs would put an end to employers recouping their contributions (which are really part of employees' remuneration anyway?), and would also address what is essentially a regulatory arbitrage between trust- and contract- based schemes: the latter are ineligible for SSRs.

8.7 Dual charging

The end of SSRs would not address the invidious practice of dual charging, whereby some scheme providers penalise deferred members with significantly higher annual charges. Employees should be made aware of this before deciding between accepting a transfer, or remaining in a scheme as a (non-contributing) deferred member. Ideally, employers should not contract with providers that operate dual charging but, in any event, the practice may die out if automatic pension pot consolidation were to develop (deferred membership would then be in decline).

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.

8.8 Securities issuance to mitigate risk

(a) Longevity bonds?[140]

Some pension schemes have lobbied the Government to issue longevity bonds, enabling them to hedge against rising life expectancy. This would be a serious mistake; the state already has too much exposure to our ageing population, through the State Pension, public sector pensions and the health service budget; it should not be increased.[141] The price would be borne by taxpayers and, as a form of wealth transfer from workers to pensioners, it would exacerbate the on-going perpetration of generational injustice.

[139] I.e. individuals have full vesting rights from the first day of employment (meaning that plan benefits cannot be revoked), rather than having to accumulate the usual two years of pensionable service (as set out in the Pensions Schemes Act 1993).

[140] Longevity risk is the risk of living too long. Conversely, mortality (or morbidity) risk is the risk of dying.

[141] Fortunately, there is no indication from the Financial Secretary to the Treasury (Mark Hoban) that he has any intention to permit longevity bond issuance.

The sensible approach to longevity risk is for it to be assumed by the individual, albeit that the state could facilitate risk pooling for those who wish to participate. But this would be regressive in that it effectively redistributes wealth from the poor to the rich, because the latter tend to live longer.

As an aside, there is no meaningful market-based solution for large-scale longevity hedging. Globally, there is a lack of capital available to assume the risk, buyers of protection hugely outweighing protection sellers. In addition, demand for mortality protection (a natural hedge for longevity risk) is diminishing because people are less worried than in the past about dying "early". Consequently, the price of the certainty created by longevity hedging is rising.

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

(b) Demand for inflation protection

Investors are clamouring for instruments to hedge against inflation, but supply is limited. Indeed, the Debt Management Office (DMO) and National Savings have been reducing the availability of inflation-linked instruments.[142] This suggests that they fear that real interest rates could remain significantly negative over at least the medium term (five years?); if so, index-linked issuance is likely to prove expensive relative to conventional (fixed coupon) issuance. A few private sector issuers[143] have subsequently issued inflation-linked bonds, but demand continues to outstrip supply.

8.9 Pricing capping?

A recent report proposed that the Government should ensure good value for money by capping DC scheme charges, to avoid complaints about "mis-selling".[144] The FSA has repeatedly ruled out price capping, declaring to a House of Lords Select Committee (in 2007) that "*the FSA is not an economic regulator; we do not set prices*".[145] But, more recently, its stance would appear to have changed; "*where competition is impaired, price intervention by the FCA may be one of a number of tools necessary to protect consumers. This would involve the FCA making judgements about the value for money of products.*"[146]

That notwithstanding, state-imposed pricing pressure is on the way, notably via NEST's 1.8% subscription charge plus 0.3% AMC. But price capping is a clumsy way of forcing the industry to cut costs because it sets an arbitrary level to which the industry would converge. This happened with the introduction of the stakeholder pension plan

[142] In July 2010, National Savings withdrew from sale some index-linked savings certificates because sales "far exceeded" the level anticipated.

[143] Notably National Grid (£260m, RPI+1.25%, ten year term) and Tesco Bank (RPI+1%, 8 year term).

[144] Workplace Retirement Income Commission; *Building a strong, stable transparent pensions system*; August 2011.

[145] House of Lords Select Committee on Regulators, *First Report of Session 2006-07, HL paper I89-I*.

[146] The Financial Conduct Authority; *Approach to Regulation*, June 2011.

(admittedly producing some customer benefit), but with the cap's ten year term about to expire, providers are now raising their pricing again.[147]

But price capping does not tackle the core problem of misaligned interests; it is merely symptomatic of a failing regulatory framework. It encourages the industry to extract income though other, more opaque, means and, furthermore, it would deter external capital from entering the industry, as other industries have discovered.[148]

> **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.

8.10 Can private sector DB schemes by resuscitated?

(a) Realism required

There is general consensus that final salary occupational pension schemes are dead (in the private sector, at least).[149] This is neatly demonstrated by considering how the annual funding cost of providing a 2/3rds pension from age 25 to 65 has changed.[150]

In the mid-1970s, contributions typically totalled 11% of pay (5% from the employee, 6% from the employer). Since then, costs have risen substantially, to take account of protection for leavers (add 2%), inflation protection (add 7%), Gordon Brown's removal of the tax rebate on dividends (add 2%), the associated cost of improvements in longevity (add 8%) and, finally, the realisation that a DB pension is a hard *promise* from the sponsor, not an aspiration (add 10% to cover the uncertainty of failing to meet the obligation).

This all takes the base cost to the employer up from 6% to 35% of pay, and this is *before* poor investment performance and past contribution holidays are factored in. Little wonder that DB pensions are now deemed unsustainable.

(b) There are some initiatives to consider

Notwithstanding the aforementioned evidence, many would welcome initiatives from the Government to attempt to resuscitate DB schemes within the private sector. This could include loosening some of the regulatory strictures that have sent private sector schemes into retreat, i.e. reopening some of the "safety valves" that existed twenty years ago, but which were welded shut by subsequent legislation. More specifically, Parliament could:

- unwind the regulations which converted discretionary benefits into onerous, legally hardwired, pension guarantees. Ideally, we should return to a good faith,

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[147] Legal & General has announced (September 2011) price rises in mid-2012 to coincide with the expiry of stakeholder's 1% cap.

[148] The utilities industry, for example. See Professor Dieter Helm's *Utility regulation, the RAB and the cost of capital,* May 6th 2009.

[149] Paul Lewis's Money Box: Pension Special, Radio 4, 30th April 2011 (based upon the opinions of a dozen pensions experts).

[150] Ronnie Bowie (former President of the Institute and Faculty of Actuaries), on Money Box, 30th April 2011.

"best efforts" basis, contingent on investment performance i.e. redress the over-reaction to the Maxwell scandal. In particular, Limited Price Indexing (LPI) should be scrapped (first suggested in the Pickering review of 2002), thereby giving employers more discretion when up-rating pensions in payment and deferred rights[151];

- amend the Companies Act to allow companies, when measuring their pension scheme liabilities, to use a discount rate which more appropriately reflects the individual circumstances (notably, the asset composition and membership demographic) of their pension funds;
- amend employment and pension scheme legislation to remove ancillary benefits that are not directly related to pension provision, such as the need for group life and long-term disability cover; and
- lobby the Accounting Standards Board (ASB) to soften the accounting treatment of pensions, notably FRS17, which requires a scheme's surplus or deficit to be reported on the balance sheet, potentially introducing considerable volatility.[152] IAS19 is also part of the problem, but as an international accounting standard it is harder to tackle. That said, there has been much debate concerning the appropriateness of mark-to-market accounting for pension liabilities, but change is unlikely until a more suitable alternative is proposed…..and that has not been forthcoming.

The spectre of Solvency II is discussed in Chapter 11 (Regulation).

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.

8.11 Financial education

(a) Schools

(i) The current position

The delivery of financial education in the UK is shambolic, there being no coherent national strategy. It comprises a melange of under-funded charities, such as the Personal Finance Education Group (PFEG), and private sector initiatives.

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[151] The 1995 Pensions Act introduced Limited Price Indexing (LPI), which requires pensions to be up-rated by a measure of inflation, up to a limit of 2.5%. Historically RPI has been used as the index; in future this will be CPI. This was the first sensible initiative, in many years, to help resuscitate occupational schemes because it acts to counter the main force that has been driving employer-sponsored schemes into retreat; the cost to the employer.

[152] The volatility usually arises because the reported surplus or deficit is the difference between two very large numbers; assets and liabilities, which are themselves volatile.

PFEG delivers guidance to teachers on how to plan and teach financial capability. Given the lack of curriculum time dedicated to financial education (nil in most schools), it is unclear how PFEG's efforts reach the intended child audience. Only 45% of teachers report that they have *ever* taught the subject.[153] Consequently, PFEG's effectiveness has to be questioned, not least because its income was slashed by 80% (to some £1.3 million) after the FSA ceased its funding in March 2011.

Perhaps the best known private sector initiative is RBS's Money Sense for Schools programme, which inevitably comingles good intentions with a commercial and PR agenda, ticking the corporate and social responsibility (CSR) box in passing.

(ii) The all-party parliamentary group (APPG)

An APPG report makes several recommendations concerning financial education in schools, including that it be made compulsory (see Appendix II).[154] It is sensible to introduce children to concepts such as budgeting, but themes such as pensions are unlikely to grab their attention, not least because pensions are not salient until people are in their 40's. Perhaps more appropriate is Carol Vorderman's proposal for a new-style practical maths GCSE. This could help slower pupils gain a rudimentary understanding of real-life issues, such as managing their finances and data handling.[155]

> **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.

(b) Adult financial education

(i) A waste of money?

Improving adults' financial wherewithal is probably a greater challenge than addressing a captive audience, such as a classroom of children. Evidence[156] (mostly from the US) suggests that financial education amongst adults often increases confidence in respect of decision-making, but not capability. The outcome is emboldened savers who make more decisions….that are bad.

There are at least five almost intractable barriers to contend with:

- misaligned interests between saver and industry; good financial decisions by savers are often less lucrative for many industry participants;
- information asymmetry between provider and saver, in part due to ludicrous product complexity and the speed at which products change;

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[153] All Party Parliamentary Group for Financial Education for Young People report, December 2011.

[154] Ibid.

[155] Carol Vorderman (Chair), Christopher Budd, Richard Dunne, Mahzia Hart, Roger Porkess; *A world-class mathematics education for all our young people*, August 2011.

[156] For example, see *Against Financial-Literacy Education* by Lauren E Willis, Associate Professor, Loyola Law School; 2008.

- poor analytical skills amongst savers (and some in the industry too);
- widespread decision-making biases that impair saving behaviour; and
- those doing the educating (assuming they are not part of the industry) are financial outgunned by the industry; the latter's vested interests are hard to suppress.

This hints at a conundrum: should the Government encourage people to assume more personal responsibility and, with that, more control over their lives, when many people may be better off having *less* control over decisions concerning retirement saving? Consider an example: the sharp drop in US home ownership over the last few years is partly attributable to the Federal Reserve Board's decision not to regulate the sub-prime mortgage market. Consequently people were able to obtain mortgages that they could not afford (as well as borrowing against their homes); they subsequent became bankrupt, lost their homes and ended up with less control over their lives.

(*ii*) *Misdirected*

Historically, adult financial education has focused on enhancing reasoning and technical capability, and avoiding disaster (an "away from"). But percentages and the consequences of compound interest do not resonate with most people's day-to-day experiences. People are more motivated by moving *towards* a specific objective, operating in an intuitive and emotional fashion, following gut instinct.

The "educational" objective should be to increase engagement, thereby raising (financial) awareness which, ideally, then leads to action. Communication (ideally pitched at a personal level, and "showing not telling") should be couched in aspirational terms, emphasising what could be gained by saving (as opposed to what could be lost by *not* saving). This should be coupled with minimising the need to make decisions (for example, by offering default funds, or only very limited choice) and the radical simplification of procedures (application forms, etc.)

In addition, the virtues of saving through negadebt (negative debt), i.e. paying down debt, rather than embarking upon positive new saving, should be espoused, perhaps as part of debt counselling.

> **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.

(iii) Delivery; employers to the fore?

After parents, the workplace is probably the most effective forum for delivering financial education to adults; employers are more trusted than the industry or the state.[157] Furthermore, employers are identified with the pay packet, the source of the ability to save. That said, some (most?) employers, lacking the relevant expertise and / or not wanting the allied distraction and responsibility, sub-contract to industry providers.

[157] Those who not in work are less likely to be capable of saving anyway.

(iv) Basic money hygiene

Australia's approach is to emphasise "basic money hygiene". The objective is not to turn Australians into financial experts, but to help them sense when to go to a doctor (i.e. seek financial advice), not be a doctor. The Australians have also recognised that in a democracy, regulating or legislating for behavioural change is unlikely to work, so they are trying education, whilst not losing sight of what really influences behaviour, including fear. In this context, fear of poverty in retirement (which does somewhat contradict Proposal 31's suggestion to emphasise the benefit of doing something rather than the disadvantage of not doing something).

(c) The Money Advice Service (MAS)

(i) Early turmoil

The MAS, funded by statutory industry levies, was launched in April 2011 to offer free and independent guidance to help people manage their money, and suggest practical steps to improve their situation.[158] Its objectives are laudable, yet within a few months it had embarked upon a radical paring of staff (down from 140 to 80) and a review of its products, services and delivery channels, including potentially scrapping its phone and face-to-face services so that only web-based communication will remain.

MAS also, initially, had an interest in financial education for young people; it seems that this too has been dropped. Mark Hoban, the Treasury Financial Secretary, has expressed his concern about this, not least because in mid-2011 he asked MAS to review provision of financial education in schools. But throughout 2011 there was an all-party parliamentary group looking at this theme, so MAS's efforts would have been a duplication.

For an organisation to plummet into turmoil within a few months of being established begs some serious questions. The adverse publicity over MAS's CEO having to defend his remuneration package to MPs has not helped; in spite of his small staff, his salary is over £100,000 more than the Prime Minister's. Some find this objectionable, but they should blame the people who agreed his terms and conditions, not the CEO.

(ii) A problem with the word "advice"

Predictably, MAS has riled the IFA community, and AIFA complained to the Advertising Standards Authority (ASA) that some of MAS's claims and word-usage (such as "free" and "independent") are misleading. The ASA rejected the complaints. Notwithstanding the nuances concerning the word "advice", the MAS name could give rise to false expectations, and subsequent disengagement; potentially a communications failure *par excellence*?

(iii) Success: impossible to measure

It is hard to envisage how MAS could be held to account when "success" is nigh impossible to measure. The Shadow Treasury Minister, Chris Leslie, has tried to probe MAS's performance and delivery objectives over the next three years. He has been assured of answers in MAS's business plan and budget (to be published in 2012), but it is far too early to attempt any objective assessment. MAS's marketing spend was £4 million in 2011-12; it jumps to £20 million in 2012-13.

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[158] MAS was created as a requirement of the Financial Services Act 2010. The Act refers to the Consumer Financial Education Body (CFEB) that ran Make Money Clear, subsequently renamed MAS.

(*iv*) *A scandal in the making, or a force for good?*
MAS's budget for 2011-12 was £43.7 million, provided by the FSA from the levies it raised across all firms in the financial services sector. Of this, some £13.5 million was earmarked for staff costs; i.e. £168,750 per head, based upon a staff of 80. The 2012-2013 budget is set at £46.3 million (including £20 million set aside for marketing), along with £34.5 million to help fund a new debt advice service (paid for via a FSA levy on banks, building societies and other lenders).

MAS 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 the industry). This, and the recent publicised turmoil, are the hallmarks of a scandal in the making, but there is an alternative interpretation.

It may be that the CEO is ruthlessly changing MAS's skill set to embrace the digital era, so that is can utilise social networks, for example, to broaden its online mass-market appeal (and, in so doing, reducing MAS's cost to the industry). Perhaps MAS is simply accepting the stark economic reality that providing a personal service (be it via telephone or face-to-face) is just too expensive to deliver. If so, it is merely adopting the standard business practice of ignoring people who are unprofitable to service (akin to IFAs moving "up market").

MAS's offering may boil down to:

- providing an online financial health check, in which case it will not reach those who need (and prefer) the benefit of telephone or face-to-face interaction. In addition, given that computer literacy would be a pre-requisite, MAS's clientele may be relatively young (and affluent);
- helping consumers understand the advice *process*, particularly the allocation of responsibility between the giver and receiver of advice; and
- giving people the confidence to act.

It is unclear whether MAS gives "advice", as the word is commonly understood; ideally is should focus on those with simple financial information needs (i.e. not straying into IFA territory). Could it be that MAS is presenting a challenge to the advice-giving cartel, and indeed challenging the meaning of the word "advice"? This is further discussed in Chapter 11.

MAS probably has a couple of years to demonstrate its value-added to both the industry and the FSA. But the real issue concerning MAS is that it is merely a sticking plaster attempting to address an enormous societal problem; woeful education, a lack of common sense in respect of matters financial and our vulnerability to the foibles discussed in Chapter 3.

8.12 The ombudsmen
Ombudsmen[159] investigate complaints and, perhaps confusingly, there are two different bodies empowered to investigate occupational and personal pensions; the Financial

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[159] Ombudsmen are not regulators; they do not make rules.

Ombudsman Service (FOS) and the Pensions Ombudsman (PO). The FOS has a "point of sale" focus, i.e. settling sales- or marketing-related disputes (such as PPI and mortgage endowment mis-selling). The PO considers subsequent administration-related issues (perhaps raised by trustees).

Maladministration complaints are also dealt with by The Pensions Advisory Service (TPAS), a free service manned by volunteers. TPAS has no statutory powers; it can only achieve a resolution through persuasion and conciliation. If none is forthcoming, cases can be taken to the PO, which has powers similar to a court of law; it is normally the final arbiter.

The introduction of auto-enrolment is likely to increase the scope for disputes, particularly concerning pension pot transfers when employees change jobs. Current arrangements should be streamlined and made more robust, by integrating the functions of the PO and FOS, not least because of on-going PO staffing pressures.[160] Such a merger was first proposed by Paul Thornton, but it was not taken forward at the time.[161]

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).

Merging the FOS and PO would require (potentially arduous) primary legislation, which may explain why it has yet to happen. But at the very least, the two organisations should be sitting together, to facilitate open communication.

8.13 Pensions versus long-term care financing

(a) Introduction

The high cost-inflation of long-term residential care (LTC), and the burgeoning population of older pensioners, are diminishing the state's ability to provide LTC, notwithstanding any political posturing to the contrary. Consequently, individuals are increasingly having to consider pre-funding their own LTC, in competition with saving for a pension.

(b) The Dilnot proposals.....to be largely ignored?

The financing of LTC is sometimes considered to be the fourth elephant in the room (after climate change, the nation's deficit and pensions). It has been put under the spotlight, at least temporarily, by last year's Dilnot report,[162] which included two key proposals:

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[160] The Pensions Ombudsman is understaffed by a third due to government restrictions on recruitment.

[161] Paul Thornton; *A Review of Pensions Institutions, an independent report to the DWP*, June 2007.

[162] The Commission on Funding of Care and Support (led by Andrew Dilnot); *Fairer Care Funding*, July 2011 (specific to England).

(i) individuals' contributions to their LTC costs should be capped at about £35,000, regardless of their assets. Above this cap, people would be eligible for full state support; and

(ii) the means-tested threshold, above which people are liable for their full care costs, should be increased from £23,250 to £100,000.[163]

According to Dilnot, the cost of these proposals would be an additional £1.7 billion per annum (on top of the £14 billion that is already spent on LTC by councils). Unsurprisingly, the Treasury has reacted badly, and hopefully the Government is not going to expose taxpayers to the huge risks that accompany LTC financing. Costs could easily rise by 50% as the "baby boom" generation begin to retire.[164] In short, Dilnot’s key proposals are likely to be quietly ignored, particularly if the next Government includes the Labour Party; Dilnot primarily benefits the relatively wealthy (by protecting their estates for inheritance purposes), many of whom, today, could expect to have to sell their homes to pay for LTC.[165]

In the meantime, there are ways of getting round the existing rules concerning the means-tested threshold. For example, the Charging for Residential Accommodation Guide (CRAG) guidelines exclude insurance policies from means tested assets. Investment (or “insurance”) bonds, in particular, are bought for this purpose, the purchase price being excluded from the assessment.[166] This is simply an arbitrage at the taxpayers’ expense, illustrated by the FSA’s action against HSBC’s NHFA subsidiary. Of the 37 sales to people entering care, 35 were of investment bonds, which the FSA viewed as too risky to sell to 87 year olds.

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.

(*c*) *Redeployed tax relief to the rescue?*

The additional cost of Dilnot’s key proposals could be easily met by ending higher rate tax relief, for an annual saving of £7 billion.[167] This would make political, as well as economic, sense; essentially is would represent a redistribution *amongst* the more affluent.

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[163] Currently, council-funded home help and care home places are offered to those with less than £23,250 of assets (including property). Nearly 20% (1.8 million) of the pensioner population receive state funding for home help and care home places.

[164] Over the next 20 years, the number of people in England aged 85 and over is projected to double to 2.4 million. Meanwhile, the average cost of a four-year stay in a nursing home is projected to double to £225,000 by 2028, from the current level of around £112,000.

[165] Today, 17% of people aged over 85 require long-term care and about 40,000 homes are sold each year to pay for this. *Source*: Peter Gatenby, senior actuary of Mazars (accountants).

[166] Investment bonds have an embedded notional death benefit that pays out 100.5% (say) of the asset value on death.

[167] An idea first floated by Baroness Hollis.

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.

(*d*) *Dilnot's legacy: integration of pension and LTC financing?*

Whilst a number of Dilnot's lesser proposals may be implemented[168], the report's main contribution may be to catalyse the debate as to whether LTC self-provision should be incentivised through tax breaks, akin to pension saving. Insurance companies would naturally be in favour, and lobbyists (and Dilnot) have requested favourable taxation rules on disability-linked annuities[169] (which could be used to offset LTC costs), to stimulate product demand. But is the demand really there, given that only 5,000 LTC policies were sold in 2010? Indeed, providers have been pulling out of the LTC insurance market, partly because of the lack of clarity over what the state may provide in the future.

Until it is clear to what extent Dilnot's key proposals are to be implemented, the Government should not commit any taxpayers' funds to incentivising LTC self-provision. If, for example, a £35,000 cap were to be introduced, there would then be a clearly defined market for covering any *potential* care costs below the cap.[170] The contingent nature of this risk suggests scope for an unfunded, insurance-type product. But today's insurance products are expensive, inflexible and offer no rebate for those who eventually do not need long-term care. And they do nothing to help catalyse a savings culture.

An alternative approach would be to permit early access to pension assets specifically to pay for LTC, *should the need arise*, i.e. increased flexibility around the pension drawdown rules. In addition, the use of pension savings could, for example, be permitted to meet the purchase cost of disability-linked annuities. This would avoid the need for any new legislation, regulation or incentives in respect of LTC insurance (which would further complicate the post-retirement financing arena).

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.

At least one provider of LTC insurance is advocating that conventional annuities should include a clause that triggers an income "step up", should the beneficiary enter LTC. The rationale is that once in LTC, life expectancy is limited to roughly four years (if self-funded LTC) or two and a half years (state-funded). This would, however, have implications for the longevity dynamics of the underlying pool of annuitants, changing the insurer's risk profile (with pricing implications for annuities).

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168 Such as standardising the criteria set by local authorities for funding, thereby eliminating the "postcode lottery".

169 Disability-linked annuities are reduced flat-rate annuities which double or treble in income at the point of developing a care need.

170 Note that the wealthy would probably self-insure, and therefore not participate in the risk pool (and nor would those with few assets, because the state would cover any LTC costs).

(e) *LTC and equity release*

Assuming that the state is not going to be drawn into widespread LTC financing, pensioners will have to be self-reliant. In the 1990's, equity release (of wealth tied up in residential property) was viewed as the salvation for LTC financing, but it has never really caught on. Yet, for almost all pensioners, the equity in their home is the only sizeable asset that they have. We need to fully understand why, to date, equity release has not developed into a major market.

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.

The barriers to engagement with equity release could include distrust of market participants (including advisers[171]), excessive pricing, a lack of comprehension of how compound interest grows to erode capital, legal and regulatory issues…….or is it that there is simply a lack of demand for LTC finance? If so, why, and what is the industry forecasting? One explanation concerns emotional attachment; today's pensioners regard their home as different and untouchable, and reserved for their children.

8.14 Conclusion: the state is struggling to catalyse a savings culture

Notwithstanding the current maelstrom of legislative activity in the pensions arena, politicians are struggling with how to catalyse a savings culture. The weak economy is a contributing factor but, more fundamentally, encouraging people to forego consumption today, to save for the long term, is of minimal political value.

In addition, pursuing the traditional approach of more legislation and regulation is likely to merely deliver incremental change in attitudes towards saving, when *transformational* change is required. Consequently, ministers would welcome initiatives from within the industry that do not 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. Part V makes some suggestions as to how it could achieve this.

In the meantime, the Government should not shy away from the inevitable. Given the onslaught of our ageing population, the escalating need for LTC, and the UK's poor economic outlook (potentially for at least the next decade), the state cannot providing pensioners with incomes sufficient to sustain the quality of life that they enjoyed whilst working. However politically unpalatable, government "promises" can only give rise to false expectations; an honest government would step up its communication ("public information broadcasts"?) reiterating personal responsibility for securing an adequate retirement income…..and, potentially, residential care. Incidentally, this would be consistent with the prevailing political ethos.

[171] Consumer research organisation Which?, in a survey of 22 equity release advisors, found a wide variety in the quality of advice (January 2012). It found that less than half of the advisers tested carried out a full discussion of the basic product features, or failed to describe the interest rate and how interest costs grow over time. Six advisers failed to mention that house prices could go down and three failed to discuss their fees.

9. State-funded incentives for retirement saving

9.1 Introduction

Today's incentives to save for retirement are essentially financial, comprising tax relief on contributions, the tax-exempt 25% lump sum at retirement, and NICs relief on employer contributions. They are crude and mis-directed (primarily towards the wealthy), their effectiveness is woefully under-researched and they lack any emotional resonance. Behavioural traits such as loss aversion and hyperbolic discounting, have far more influence on savings behaviour than financial rationale.

The challenge is to design incentives that resonate with what matters to people, not least because the underlying objective is, unwittingly, to move them into the clutches of an industry…..that is widely distrusted. Furthermore, the products are often mind-numbingly complex care of, principally, their multi-various tax treatments. It is no surprise that consumers are bewildered, not least because product pricing signals are almost irrelevant. Unlike almost all other consumer decisions, the outcome of any purchasing decision is typically unknown until perhaps decades later.

Furthermore, the framework of saving incentives (as well as some aspects of the State Pension) is entangled with unrelated objectives (often political), notably wealth redistribution; this adds to complexity. Ideally, wealth redistribution should be confined to the income tax framework.

There is also a moral perspective to consider. We should, for example, question whether tax relief is an incentive (i.e. morally neutral) or a bribe, mindful that the Government would like people to save for retirement to help reduce the social welfare bill. But for the heavily-indebted, saving may not be in their best interests.

9.2 Tax relief

(a) Hugely costly

The state invests a huge amount in tax relief, primarily in the form of up-front income tax relief on employee and employer contributions (at a cost of £26.1 billion in 2010-11). NIC relief on employer contributions totalled a further £13.0 billion.[172] To put this into context, this is equivalent to the UK defence budget (£40 billion), and is 70% more than the Government spent on Transport in 2011-12 (£23 billion).[173] An additional £6.8 billion was spent on tax relief on investment income; the cost of relief in respect of capital gains realised by pension funds is deemed too difficult to estimate.

(*b) What is the purpose of tax relief?*

Before savaging tax relief, its purpose should be debated. The state's main motivation for encouraging savings is to mitigate future social security costs, necessary to alleviate pensioner poverty. Given that the effect of these costs is likely to increase with old age, the state has an incentive to encourage retirement savings ahead of discretionary (rainy day) savings with their ready access. But the current distribution of tax relief is heavily

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[172] HMRC; *Registered pension schemes: cost of tax relief, Table Pen 6,* February 2012.

[173] HM Treasury; *Budget 2011.*

skewed towards the well-off; the 8% of taxpayers who earn more than £50,000 per annum receive almost 50% of all pensions tax relief.[174] Clearly, reducing pensioner poverty is not the result. Indeed, one could conclude that tax relief serves as a reverse form of wealth redistribution (the conventional approach being to favour the poor). Arguably, the wealthy do not need such an incentive to save, and even if it were deemed appropriate to reduce their tax burden, why not democratise the benefit by ending higher rate relief and simply cut the higher rate of income tax?

A thorough reappraisal of up-front tax relief is required (investment income should remain untaxed, and reinstating the 10p rebate is further discussed, below). *In extremis*, it could be abolished, the £26 billion annual saving being used to boost the basic State Pension (BSP, costing some £51 billion) by roughly 50%. Such as approach would be beautifully simple and, crucially, politically appealing, the beneficiaries (future pensioners) outnumbering the recipients of tax relief. Furthermore, such a move would catalyse a virtuous circle, by dramatically reducing the annual bill for Pension Credit (more than £8 billion, annually, including Guarantee Credit). A saving in administration costs would also emerge, releasing yet more funds. Ending tax relief would also represent a significant simplification of our income-in-retirement framework, whilst removing a state-funded pit prop of what is, in parts, an ailing industry.

(*c*) *The Treasury's perspective*

(i) Higher rate tax relief is, usually, <u>not</u> *taxation deferred*

The proponents of higher rate relief (let us not forget that it a major lubricant of the industry) claim that tax is merely being deferred. The data does not support this assertion. The Treasury is effectively co-investing with recipients of higher rate relief, anticipating repayment through post-retirement income tax. But only one in seven of those who pay higher rate tax whilst working, go on to pay higher rate tax in retirement. From the Treasury's perspective, this is a bad deal; higher rate tax relief is a huge cost to the state, not an investment.

In the meantime, standard rate taxpayers are increasingly convinced that the lure of 20% tax relief on pension contributions is insufficient to overcome pensions' lack of flexibility. Immediate access to savings is, for most people, the key influence. Industry surveys[175] confirm people's preference for ISAs over pensions; ISAs are immensely popular (the brand is still trusted). In 2010-11, £53.9 billion was subscribed to more than 14 million ISA accounts, without the bribe of up-front tax relief, whereas some £22.9 billion of employee contributions went into occupational and personal pensions (excluding SIPPs).[176] Whilst ISAs offer ready access, they are increasingly being considered as part of retirement

[174] HMRC; *Survey of Personal Incomes 2009-10*, Table 3.5, Income and deductions, 2012. (It is accepted that this distribution is not surprising given that the wealthy pay more into a pension and their relief is at higher rates of tax.)

[175] For example, more people (38%) view cash savings (including ISAs) as a better route to a reasonable standard of living in retirement than personal pensions (30%). Source: Scottish Widows, *UK Pensions Report 2009,* June 2009.

[176] HMRC; *Individual savings accounts,* Table 9.4, 2011; and *Pension Trends*, Chapter 8, Pension contributions, Table 8.3, 2011.

saving. Furthermore, ISA withdrawals are tax-free (unlike income derived from a pension), and it is in retirement, when incomes are lower, that people need a lower tax burden.

(*ii*) *Tax relief: eroded by industry charges*

The most damning aspect of tax relief is that over time it could be entirely consumed by industry charges. Consider a single contribution of £100 net, paid into a pension fund by a higher rate taxpayer. This is grossed up to £166.67p by 40% tax relief. Assume that the assets subsequently return 2.9% per annum (i.e. the average real annual return of UK pension funds over the last decade[177]), *after* deduction of an AMC of 1.5% per annum (which is typical). Every year thereafter, the industry deducts its AMC from the pension fund. Within 37 years, 40% of the total cumulative AMC exceeds the tax relief initially contributed by the Treasury.

Transaction charges add 0.7% per annum in costs, based upon UK pension funds' average portfolio turnover of 128% each year (i.e. holdings are kept for an average of just nine months).[178] The time required for 40% of the cumulative AMC to erode all of the tax relief then reduces to less than 29 years, i.e. less than the timeframe over which many people save for a pension.

(*iii*) *The industry is failing the Treasury*

Over the last decade, the Treasury has provided tax relief totalling £262 billion (on contributions and investment income), plus another £96.6 billion in NIC relief (i.e. tax foregone) on employer contributions.[179] This will have been funded through gilts issuance, at a real cost, over the last decade, of 3.9% per annum; see Table 9.

Table 9: Real investment returns over different timeframes (% p.a.)[180]

Asset class	2011	10 years	20 years	50 years	112 years
Shares (equities)	-7.8%	1.2%	4.8%	5.3%	4.9%
Gilts	15.8%	3.9%	5.9%	3.1%	1.3%
Corporate bonds	1.6%	1.6%	-	-	-
Index-linked gilts	14.4%	4.0%	5.0%	-	-
Cash	-4.1%	0.2%	2.1%	1.6%	0.9%

Thus, the cost to the Treasury of financing tax relief is 1% *more* than the average annual real return on all UK pension funds over the same period. Table 10 shows how this 1% *per annum* "loss" on its "investment" has accumulated over the last decade, to total £17.5 billion.

[177] TheCityUK; *Pension Markets 2012 report*, March 2012.

[178] SCM Private analysed 1,287 individual pension funds comprising £392.5 billion of assets; see *Research into dealing activity and costs of UK individual pension funds*, November 2011.

[179] HMRC; *Registered pension schemes*, *Table Pen6,* February 2012.

[180] Barclays Capital; *The Barclays Capital Equity Gilt Study 2012.*

Table 10: Tax relief: the cumulative cost to the Treasury (£, billion)

	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10p	2010-11p	Total
Total tax relief	£17.6	£18.6	£20.4	£23.4	£26.9	£30.0	£30.7	£29.7	£31.8	£32.9	**£262.0**
NIC relief	£5.4	£6.2	£7.3	£8.4	£9.8	£10.4	£11.7	£11.5	£12.9	£13.0	**£96.6**
Cumulative total	£23.0	£47.8	£75.5	£107.3	£144.0	£184.4	£226.8	£268.0	£312.7	£358.6	**-**
1% of cumulative total	£0.2	£0.5	£0.8	£1.1	£1.4	£1.8	£2.3	£2.7	£3.1	£3.6	**£17.5**

In other words, over the last decade, 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. This is explained by two principal factors:

(i) pension fund returns have been dragged down by the poor performance of equities; and

(ii) industry charges, evidenced by the fact that many of the gilts issued to finance tax relief are held by pension funds (and increasingly so, in light of the de-risking trend, further discussed in Chapter 11).

Certainly, a significant portion of the £17.5 billion has simply passed from the Treasury to the industry (and a similar conclusion is reached when considering other timeframes). Perhaps this is today's version of Keynesian economics.

(*d*) *Generation Y's perspective*

The word "pension" does not resonate with Generation Y. The lure of tax relief is insufficient to overcome the aspiration to own a home, the need to repay college debt and the financial myopia of the "spend-now" culture, as well as pension products' inflexibility. The Government's stance, opposing early access to pension funds prior to retirement, is regrettable, and the pension industry's support for this is short sighted, and perhaps suicidal. It risks the younger generation never engaging with retirement saving; indeed, the challenge is to encourage them to save at all.

Consequently, the annual contribution limits for tax relief on ISAs and pensions saving should be combined, with the full limit available for saving within an ISA. Furthermore, the annual contribution limit on which relief could be gained (currently £50,000 for pensions, irrelevant to 99.5% of the population) should be reduced, perhaps to £40,000, *including* ISA investment. Note that investment limits for tax-advantaged products should be simple, round numbers, rather than, for example, the ISA limit for the 2012-13 tax year of £11,280.

A combined tax-advantaged investment limit of £40,000 could become a key cost control lever, with adjustments to it (driven by affordability) being a regular feature in the Budget. Any unused allowance could perhaps be "carried forward" on a rolling three year basis.

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.

Subsequently, up-front tax relief could be whittled away entirely (remember mortgage interest relief?) as the next generation places an increasing emphasis on ISAs for their retirement income, ideally built upon a bedrock of income certainty provided by a higher

State Pension (as envisaged in a DWP's green paper[181]). 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.

(*e*) *The end of tax relief: gently does it*

(i) End higher rate tax relief

The immediate abolition of all tax relief on pension contributions would not be politically pragmatic; a multistep process is required, starting with putting an end to higher (and additional) rate relief. Limiting tax relief to 20% would save the Treasury some £7 billion per year; to be clear, this is an annual saving, repeating itself year after year. In return for the removal of higher rate relief, there are a number of *quid pro quos* that the Government could consider offering, including:

- **reinstating the 10p tax rebate on pension assets' dividends and interest income** (at a cost of roughly £4 billion per year); i.e. such income should be *truly* tax-free for pension funds.[182] Retaining additional income within pension pots would ensure that the positive power of compounding benefits the individual, rather than the Treasury; and

- **dramatically increasing the annual ISA subscription cap, to £40,000, say**, as per Proposal 37. The cost to the Treasury would be limited to taxation foregone on dividends and income within the ISA wrapper.

Given that prevailing interest rates and dividend yields are so low, now would be a relatively cheap time to implement both these proposals. Furthermore, although the cost would increase with rising interest rates, this would probably coincide with a strengthening economy; affordability would be less of an issue.

> **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.

A further reason for ending higher rate tax relief is that for many higher earners it is, in reality, an extension of their tax planning arrangements, rather than being primarily considered as an incentive to save.

(*ii*) *A higher flat rate for tax relief?*

A flat rate of tax relief, of 25% or even 30%, irrespective of the saver's marginal rate of income tax, could be considered as an alternative to 20% for everyone, if it were deemed appropriate to further incentivise low earners. Costs could be controlled by adjusting the

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[181] DWP: *A state pension for the 21st century*, April 2011.

[182] In 1997 Gordon Brown scrapped the 10p rebate on dividends, thereby effectively imposing a 10p income tax on what were supposedly non-income tax paying bodies, notably pension funds. Estimates vary as to how much the Treasury has subsequently benefitted, with a corresponding reduction in the value of retirement funds; figures vary between £150 billion and £225 billion, to the detriment of millions of savers and pensioners.

annual contribution limit on which relief could be gained. Irrespective of the level of any flat rate for tax relief, it should not be less than the maximum rate of income tax that pensioners could face, thereby retaining high earners' interest in saving within a pension product.[183]

> **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.

As an aside, it is acknowledged that a flat rate of tax relief in excess of the standard rate of income tax would comingle wealth redistribution with a saving incentive, at the price of additional complexity. There are other permutations for the future of tax relief, which would save the Treasury a lot of money without materially reducing most people's incentive to save for retirement. These are more fully discussed in a prior paper.[184]

(*iii*) *Re-characterise tax relief?*

More than three-quarters of non-pension savers are ignorant of the contribution from tax relief.[185] Given this, tax relief should be re-characterised to aid communication. A number of alternatives have been suggested, including:

- **a matched savings scheme,** whereby for every £1 added to a pension pot, the state puts in a fixed additional amount, irrespective of the saver's marginal rate of income tax.[186] This would be more progressive than the current system, and the state's contribution to each individual could be capped to control the total cost;
- **a "no-lose lottery",** such as guaranteeing people a 50p return (which would then be automatically added to their savings) on their £1 "ticket" (the ticket price being retained within the asset pot)[187]; and
- **a persistency bonus** to tackle short-termism. Initially set at zero, the bonus would grow over time as funds are left *in situ*, thereby encouraging people to save for the long term.

9.3 Other incentives

(a) The 25% tax-free lump sum: replace it with a pre-annuitisation reward

Another tempting target for the Treasury is pension savings' 25% tax-free lump sum (at retirement), costing some £2.5 billion per annum in foregone income tax. Encouraging

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[183] Note that today's savers are making a leap of faith that in future, the basic rate of income tax will remain at 20%, but today's level is a historic low (ignoring the previous Government's very short term dalliance with 10%). Tax relief at 20% and pensioner income tax capped at 20% could be marketed as "20:20 vision".

[184] Michael Johnson; *Simplification is the key,* CPS, June 2010.

[185] A Standard Life survey (March 2012) found that 77% of people aged 18 to 65 who do not currently save for retirement are oblivious that for every £4 they invest in a pension, the government contributes at least another £1 in tax relief.

[186] Proposed in the Social Market Foundation's' report *Savings on a shoestring: a whole new approach to savings policy*, July 2011.

[187] Based on an idea from Ros Altmann, Saga Director-General.

the withdrawal of a tax-free lump sum is a bizarre way of encouraging people to build up a pot of assets to subsequently provide a regular annual pension income. Furthermore, to Generation Y, the prospect of 25% of some distant, uncertain return being free of tax is unlikely to change behaviour in respect of saving within a pensions framework. As an incentive for long-term saving, it is wholly ineffective.

Given that the objective for retirement saving is to supplement the basic State Pension, perhaps the expense of the lump sum tax concession should be reallocated to increasing people's annuities? A 5% pre-annuitisation "reward" (or "top-up") of the pension pot would, for basic rate taxpayers, be equivalent in value to the lump sum tax concession (which today saves them 20% income tax on 25% of the pension pot, i.e. 5%).[188] This would be of much more lasting benefit, to most people, than the 25% lump sum's tax concession.

> **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.

Many would agree that retaining the £2.5 billion per year within people's annuities would be a much better use for it than simply returning it to the Treasury (by simply ending the 25% tax-free concession). Payment of the "top-up" would be delayed if annuitisation were postponed (perhaps because the £20,000 Minimum Income Requirement (MIR) had been exceeded).[189]

(*b*) *The Minimum Income Requirement should be extended to lump sums*

Retaining the 25% lump sum within the pension pot would enable people to buy a larger lifetime annuity, i.e. a 25% larger pension than otherwise. Furthermore, research by Prudential shows that 79% of pensioners drawing a company or private pension in 2011 took a lump sum from their fund at retirement…..and 10% regret doing so. People are increasingly questioning the wisdom of having taken the lump sum and spending it (perhaps frivolously), not appreciating, at the time, the corrosive impact that this would have on their retirement income.

Given this, it would make sense to also apply the MIR to taking income via flexible drawdown.

> **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).

(*c*) *Salary sacrifice: an arbitrage*

Salary sacrifice schemes are offered by employers as a means to save on National Insurance Contributions (NICs), both for employer and employee. Some employers then

188 *Tax by Design (the Mirrlees Review); Chapter 14, Reforming the Taxation of Savings*, September 2011.

189 The MIR is the amount of secured pension income that a member must have for life, to draw an income via flexible drawdown. The £20,000 requirement is to be reviewed by the Government in the 2015-2016 tax year. Income payments that count towards the MIR include the basic State Pension, State Second Pension (S2P), lifetime annuities and scheme pensions.

pay all or part of their NICs saving into the pension plan, thereby increasing contributions. The structure's popularity is rising; 55% of companies offer it, either automatically or as an option for employees (43% in 2009).[190]

Essentially, instead of an employee paying his own contributions, they are paid on his behalf by the employer, the employee's pay being reduced by the same amount. Thus, the employee swaps some of his gross pay for pension contributions; less gross pay means that he (and the employer) pays less NICs and, in addition, some employees will fall into a lower income tax band.

Consequently the Treasury is foregoing NICs and income tax revenue; salary sacrifice schemes should be reported alongside tax relief, to provide a more accurate picture of the cost of incentivising pension saving. Indeed, it would be better if all tax-based retirement savings incentives were consolidated into a single mechanism, the cost of which could then be properly controlled.

> **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.

(d) Employee share ownership schemes

There are four different types of HMRC Approved Share Plans[191] providing tax-efficient savings mechanisms. They encourage medium- and long-term saving amongst many low and middle income earners[192] but, collectively, provide administrators with a minefield of taxation-derived complexity. The Treasury has, quite rightly, requested that the Office of Tax Simplification (OTS) look at simplifying the Share Plan tax arrangements, reporting to ministers in 2012.

(e) Incentives that resonate with behaviour

(i) Acknowledge that people value certainty

Tax relief is a reward for completing an activity, but it does not lead to any certain outcome. Perhaps tax relief should be replaced with an incentive that provides certainty, in what would otherwise be a DC (i.e. uncertain) pension pot? For example, the annual £21 billion currently directed to income tax relief on employee contributions could, instead, be used to subsidise the purchase of deferred annuities from the Treasury, i.e. certain income commencing at retirement. If done on an unfunded basis, the Treasury would enjoy an immediate cashflow benefit; this would also end the erosion of invested tax relief, care of annual industry charges.

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190 *Source*: Punter Southall Group; *DC pensions in the UK workplace: corporate DC survey results*, March 2010.

191 Save as you Earn (SAYE) Savings-Related Share Option Scheme ("Sharesave"), Share Incentive Plans (SIP), Company Share Option Plans (CSOP) and Enterprise Management Incentives (EMI).

192 A third of employees saving in an SAYE scheme, for example, earn less than £21,000. *Source*: ifs ProShare.

(*ii*) *Harness the emotional power of family*

The current spend on tax relief could be redeployed towards incentives that span the generations. Leaving something for children (and grandchildren) is a powerful motivator, so why not permit pension assets to be bequeathed free of Inheritance Tax (IHT) limits and the seven year rule? Provided that the assets could only go into the recipients' pension savings, this would encourage a *controlled* trickle-down of wealth through the generations, and reinforce a sense of personal ownership of pension savings. This would, however, only benefit the relatively rich, i.e. those with estates in excess of the IHT threshold.[193]

A more egalitarian approach to combining a financial incentive with an emotional one would be to extend the current arrangement whereby parents can make contributions to a child's pension, up to £2,880 per year (i.e. below the £3,000 annual gift limit for inheritance tax), topped up by 20% tax relief, to £3,600. The investments then grow free from income and capital gains tax.

Irrespective of the donor's marginal rate of income tax, why not increase the tax relief rate to 30%, say? The additional cost could be easily met by eliminating all higher rate tax relief (as proposed above). This would represent a potentially significant step towards redressing the looming generational injustice, as well as enabling the recipient to harness the positive power of compounding over a very large timeframe (although few children would appreciate this at the time!).

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.

Policy makers interested in cross-generational incentives should consider that Generation Y could be the first generation to experience a deterioration in their quality of life, relative to their parents (baby boomers and Generation X[194]). This trend, acknowledged by the politician David Willetts[195], could be accompanied by the emergence of inter-generational antagonism, as well as disillusionment amongst the young (having grown up adjacent to their (affluent) parents, thinking that all will be well).

Policymakers should bear in mind that when seeking to encourage people to save, the optimal messengers are people they respect; often older family members (rather than politicians, say). In the meantime, we are already seeing a marked increase in grandparents making financial commitments to support Generations Y and Z (people born since the early- to mid-1990s, also known as the Internet Generation).

[193] £325,000 for 2012-13.

[194] Baby boomer were born between 1946 and 1964, Generation X from the early 1960s through to the early 1980s.

[195] David Willetts; *The Pinch: How the Baby Boomers Took Their Children's Future - And How They Can Give it Back,* 2010.

9.4 Employers matter: incentivise them

(a) NICs relief on employers' contributions: retain it

Employers' contributions perform a crucial role in supporting occupational pension schemes, and encouraging people to save. But the biggest source of decline in pension saving, between the early 1980s and 2000, was a contraction in (private sector) employer pension contributions. Subsequent increases were largely due to the need to reduce scheme deficits in respect of benefits already accrued, rather than future accruals.

But, recently, a new impetus for employers to increase their engagement with pensions has emerged. It stems from the growing realisation that employees' lack of future retirement income will become the employers' problem too. The average annual amount paid from DB pension schemes will peak in 2012, at £7,100, but fall thereafter, to £2,400 by 2060, a consequence of only 10% of DB schemes still being open.[196] This decline of DB provision in favour of DC is moving the deleterious consequences of the industry's inefficiencies and conflicts of interest from employer to employee. Consequently, a growing elderly workforce will become unable to retire (and cannot be forced to, the Default Retirement Age having been scrapped). This will exert a financial cost on employers, which could (belatedly) trigger a resurgence in schemes offering more than just pure DC provision. Cash balance pension funds, for example, could become the model for future provision, usually providing an improvement over DC schemes; Morrisons, the supermarket chain, launched such a scheme in early 2012.[197]

There is little doubt that policies which encourage greater employer engagement with pensions will increase employee pension savings. Consequently, NICs relief should be retained; indeed, perhaps employers should be *further* incentivised to support retirement saving?

(b) A distribution reward?

Although employers may be reluctant stakeholders in the retirement savings arena, their engagement is hugely beneficial to society. In 2009 they contributed £36.3 billion to funded occupational pension schemes and £9.7 billion to personal pensions (employees contributed £6.6 billion and £9.3 billion, respectively).[198] Emotionally, however, employers have been disengaging from pensions for decades; witness the demise of DB schemes. But the advent of auto-enrolment moves employers (consciously, or not) into the distribution arena, essentially acting as agents of the state, particularly in respect of those whom the industry finds hard to reach.

Today, the only explicit incentive for employers to participate in pensions is NICs relief on their contributions (£13 billion in 2010-11). It would makes sense for the state to harness the strong relationship between employee and employer (something that the

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[196] DWP; *Evolution of Pensioners' Income from Defined Benefit schemes*, March 2012.

[197] Cash balance schemes accumulate contributions in employees' retirement accounts, the employer providing an assured rate of return until retirement. At retirement, the "cash balance" is passed to the retiree who then, typically, uses it to purchase an annuity at the prevailing market rate. Employees assume their own longevity risk thereafter, arguably the most significant component of the total risk.

[198] ONS; *Pension Trends Chapter 8: Pension contributions*, *Table 8.13*, September 2011.

industry rarely enjoys with consumers), and reward employers who succeed in encouraging their employees to increase their pension contributions.

An initiative such as this requires a cautious approach. It should be focused only on basic rate taxpayers (who are more likely to fall into the category of those who "save something, but not enough"), with the incentive paid in respect of employee contributions above 4% of band earnings, say.

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.

If, for example, such an incentive were to increase by 50% the amount that employees contributed to funded schemes (i.e. an extra £7.9 billion), it would cost an additional £1.58 billion in tax relief (at 20%) and £395 million in reward payments, annually. Contrast this with the £15 billion paid in tax relief to those earning over £50,000 per year: clearly, redistributing higher rate (personal) tax relief in favour of employer incentives would be a much more effective use of Treasury funds. And perhaps some of the more enlightened employers would forward their distribution rewards to their employees' pension pots?

The industry would benefit from such an initiative because it should help it cut its marketing and distribution costs (one advantage of auto-enrolment).

(c) Protecting employers: a "safe harbour"

In the US, a "safe harbour" principle exempts trustees, employers and governance committees from class actions, if it can be demonstrated that they were acting in the best interests of members. Prior to safe harbours being introduced (December 2007), employers were increasingly reluctant to discuss pensions with their employees. Many deemed it too risky (which also provided them with a ready excuse not to do it).

A safe harbour arrangement in the UK is a pre-requisite to increasing employer engagement with pensions. It may also precipitate the use of more appropriate investment options (less defensive, more imaginative). Employers are unlikely to promote saving amongst employees unless they have clear guidelines (*not* regulation) within which they can safely operate. These should include the distinction between "advice" and "information", and what constitutes a "qualified" default fund.

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.

(d) Other initiatives

(i) Scheme membership: flexibility for employers

Employers used to be allowed to make it a condition of employment that employees had to participate in the company pension scheme. Regretfully, this right was revoked in 1988, when the then prevailing political ethos was to encourage personal provision. Well-intentioned employers should be at liberty to require scheme membership, unless the employee can demonstrate that they already have adequate pension arrangements. That said, employers are allowed to write scheme membership into new recruits' contract of employment (occupational schemes and contract-based workplace pension schemes).

(*ii*) *Pressure the management?*

In the US, some senior executives can only receive employer contributions after they can demonstrate "substantial" employee engagement with the company's 401k Plan. The intention is to incentivise management to improve employee engagement with retirement saving.

The UK could amend this approach by denying tax relief to management unless employee engagement in NEST, for example, exceeds 70%. In practice this is unlikely to be productive, and could create resentment. Not all employers will participate in NEST, and it would have no impact on executives whose pension assets have already reached the £1.5 million lifetime allowance.

9.5 Incentives: conclusion

Today's tax-based incentives to save for retirement are hugely expensive and, worse, ineffectively deployed. Skewed towards the wealthy, they do far less than they should to minimise pensioner poverty. Furthermore, they do little to catalyse a savings culture amongst younger workers, thereby exacerbating the looming generational inequality.

The savings incentives framework should be restructured, which will require a preparedness to confront deeply-entrenched vested interests within the savings industry. Prior to that, the Treasury should thoroughly research the effectiveness of tax relief, measured against the objectives of catalysing a savings culture and achieving value for money. The latter could be assessed against expected future tax receipts from pensioners (including consumption-related taxes). In parallel, the Treasury should determine what proportion of tax relief is ultimately captured by the industry, rather than savers. Its findings should be put into the public domain, to facilitate meaningful debate.

PART IV: GOVERNANCE AND REGULATION

10. Governance

10.1 Contract-based or trust-based schemes?

(a) Employees favour trusts, employers favour contracts

The governance of pension schemes is divided between trust- and (FSA regulated) contract-based arrangements. The crucial difference between them is that trust-based schemes are managed by trustees, with a duty to act in members' best interests. The parameters of their role are set by powers and duties, enshrined in the scheme's rules, regulation (notably the Pensions Act 1995) and case law. Trust scheme sponsors usually engage with their schemes; the relationship is one of covenant rather than contract.

Contract schemes typically have no member representation, making it harder for members to influence how their schemes are run. It is no surprise that employees, if given the choice, would almost certainly prefer a trust scheme because it usually provides stronger governance (i.e. better protection) than a contract scheme. Conversely, contract schemes are favoured by employers who, typically, want to avoid the responsibility, cost and complexity associated with appointing their own trustees and running a trustee board.

(b) Trust-based versus contract-based schemes; scope for arbitrage

(i) Short service refunds

In recent years there has been a dramatic shift towards contract-based (DC) schemes, from 89% of NAPF members in 2005, to 49% in 2010.[199] This is in spite of a regulatory arbitrage that favours the members of trust-based schemes: as discussed in Chapter 8, they can elect to have their contributions refunded ("short service refunds") if they leave employment within two years. No such option is available to members of contract-based schemes. That said, this will soon become a moot point; short service refunds are almost certain to be banned.

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

[199] NAPF Annual Survey 2010, NAPF, March 2011.

(ii) Allocation of responsibility

A more serious arbitrage concerns the relevance of *caveat emptor*. Provided the trustees are appropriately diligent, members of trust-based schemes should have little reason to be concerned, unlike members of contract-based schemes.

(c) Master trusts; a governance risk?

Over the last couple of years, a third form of scheme governance has resurfaced[200]; master trusts, which blur the regulatory distinctions between trust-based and contract-based schemes. Whilst trust-based, legally, they offer employers the advantages of contract-based schemes. Their recent resurgence is partly in anticipation of auto-enrolment, employers (particularly in retail, with high staff turnover) fearing a big increase in (administratively expensive) small, dormant pension pots.

Master trusts present a serious issue, concerning the appointment of trustees related to the provider of the master trust. Their interests could be more closely aligned with those of the corporate sponsor (on whose behalf the provider is working), rather than the members' interests. Encouragingly, some firms have taken note of TPR's concerns over conflict of interest; Xafinity, for example has discarded its in-house trustee firm HR Trustees and appointed Bridge Trustees for its master trust. Similarly, Legal & General changed it master trust arrangement, with the appointment of an independent trustee. But the scope for conflicts of interest remains in respect of many multi-employer DC trusts, some of which have distinctly opaque structures and relationships.

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

(d) Vigorous fiduciary duty should close the "governance gap"

FairPensions has identified an emerging "governance gap", a consequence of the demise of DB pension schemes and the rolling out of auto-enrolment. This is accelerating the trend towards contract-based schemes, which lack trustees and any obvious fiduciary obligations and, in workplace schemes, a lack of governance obligations on the employer.[201] Ideally, all pension schemes should be subject to fiduciary-like obligations.

> **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.

Indeed, the ethos of fiduciary duty should be resuscitated across the savings industry, particularly where risk-based decisions are being made on behalf of customers.

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[200] Originally marketed in 1996, the initial enthusiasm for master trusts waned in favour of group personal pension arrangements.

[201] See FairPensions report *"Protecting Our Best Interests: Rediscovering Fiduciary Duty"*, March 2011, by Christine Berry.

10.2 Transparency

(a) Charging structures

(i) Bundling should cease

Trustees should periodically conduct a forensic examination of their supply chain to surface *all* of the charges and other fees incurred by their scheme. They should demand total transparency from fund managers and other service providers, and refuse to transact with those who do not comply.

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

Separate charges for administration, advice and fund management would, for example, ensure that distribution platforms that also offer administration and advice are indifferent to the underlying assets.[202] They would then not be open to any temptation to comingle their services, thereby masking any bias in respect of selling particular products. This would also put an end to clients unwittingly paying, via brokerage commission charged to funds, for fund managers to receive services from brokers that are unrelated to client transactions. These "bundled services" can include preferential access to analysts, research, conferences, equipment and IPOs. They primarily benefit the fund manager, not the individual clients; a typical "agency problem".

Unbundled pricing is not without precedent. Some airlines, for example, use a strategy of incremental pricing, whereby a base seat price is offered and customers can choose to "bolt-on" extras (such as wider seats, more legroom or priority boarding). The public's reaction to this is mixed, but given that these airlines persist, it suggests that for their target audience, such a strategy is popular. However, it matters how such a strategy is executed. Some incremental pricing has attracted interest from the OFT, concerned about it being misleading to consumers; the issue is a lack of transparency. In addition, "mixed bundling", for example, can be anti-competitive.[203]

(ii) Deferred scheme members should be protected

Some 60% of all DC memberships are deferred (they are no longer making contributions), leaving around one million active (contributing) members of occupational DC schemes.[204] As auto-enrolment is rolled out over the next few years, the number of deferred members is likely to increase rapidly, partly because the target audience of low-to-median earners includes frequent job-changers. This could herald an unwarranted bonanza for the providers of contract-based DC schemes who operate dual charging structures.[205] Employees who leave and do not maintain contributions

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[202] Some administrators already adhere to this principle, including Nucleus and some IFA / fund managers firms (such as Towry). Their in-house advisers' pay is unrelated to the products ultimately sold to clients.

[203] Where two or more products are offered together at a price less than the sum of the individual product prices. The Competition Act 1998 prohibits (i) anti-competitive agreements, and (ii) abuse of dominant market positions.

[204] The Pensions Regulator, *DC Trust; a presentation of scheme return data*, 2010.

[205] Including Aegon, Aviva and Scottish Widows.

could find that their annual charges are sharply increased[206] (and employers have little incentive to ensure good terms for their ex-employees).

FSA statistics show that after four years, more than half of pension plans lapse; the most common reason is a change of job. Providers are reluctant to reveal how many high-charging deferred plans they have on their books, but the total is thought to run into tens of thousands.

Dual charging structures also introduce the risk of deferred members effectively subsidising active members, perhaps with some of the subsidy being used by providers to "encourage" advisers in their direction. The industry's PR men describe such dual charging structures as "active member discounts". Which? Magazine, and TPR[207], prefer the term "deferred member penalties".

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

At the time of writing, legislation curtailing charges for deferred members has been announced within an amendment to the Pension Bill 2011. Legislation should be viewed as the last resort; it is preferable that the industry takes initiatives to put its own house in order.

(*b*) *Hidden risks and allied income: stock lending*

Many fund managers source additional income by taking additional risks….without telling their investors. In extremis, this could be more damaging to investors than "hidden" expenses. Stock lending, for example, is commonplace, and the counterparty risks associated with it should be fully disclosed in factsheets and marketing material, detailing (on a daily basis, by fund) the total exposure to stock lending, the names of the largest counterparties and the collateral received. In addition, the allocation of income between investors and fund managers and / or the stock lending agents should be disclosed.[208]

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.

(*c*) *Remuneration: more disclosure required*

Excessive remuneration within the industry is largely at the expense of the industry's customers. If they wanted to, trustees could insist that all counterparties disclose their remuneration policies online, and demonstrate that performance-based remuneration is

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[206] By up to 300% of the benchmark for competitive annual management charges on DC schemes; Which? Money June 2011.

[207] Statement by the TPR; *The role of trustees in DC schemes*, October 2011.

[208] As proposed by Alan Miller, SCM Private.

measured over years, not months. Some banks[209] have already started to do this, partly in response to Vince Cable, the Business Secretary, focusing on "corporate short-termism"; i.e. companies failing to take into account the long-term interests of wider stakeholders.

10.3 Assertive trustees are crucial

(a) The demise of the patrician sponsor

As DC schemes replace DB schemes, the allied transfer of risk from sponsor to members is facilitating employers' emotional withdrawal from the pensions arena.[210] Consequently, their relationship with trustees is waning, primarily because once a DB is closed, the common interest is focused on the endgame, managing down the risk of past accrued liabilities, and little else. From the members' perspective, trustees should then assume a more significant role, filling the gap left by a disengaged employer, as well as monitoring the quality of the employer's covenant (notwithstanding the presence of the PPF).

(b) Trustees: misguided by the law

The legal definition of fiduciary duty is along the lines of "acting in members' interests". This definition is increasingly being questioned, not least because many trustees misunderstand it to mean "the duty to maximise returns".[211] Consequently, pension funds are disregarding the long-term wellbeing of the economy, fixating on short-term results and ignoring environmental, social and governance issues in their investment decisions.

Some within the industry (including Aviva, Jupiter Asset Management, Hermes and the ACCA) are also calling for legal clarification on fiduciary duty. They state[212] that:

> *"As we enter AGM season, all eyes will be on the investor community, as politicians from across the spectrum focus on shareholder oversight as the answer to so-called "crony capitalism". By clarifying that fiduciaries are permitted to consider a wider range of factors, our proposals would bring shareholders' duties into line with company directors' duties, enabling fiduciaries to better serve savers' long-term interests."*

This is eminently sensible.

> **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.

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[209] Morgan Stanley, for example.

[210] At the end of 2009, 1 in 14 DB schemes were closed to future accruals; this was 1 in 5 at the end of 2010; *Source*: NAPF.

[211] See FairPension's *The Enlightened Shareholder; clarifying investors' fiduciary duties*, March 2012.

[212] The Times, Letters, March 2012.

(c) *Trustees: too timid*

Today, governance is a relatively tranquil component of the industry; this needs to change, dramatically. Indeed, trustees are uniquely well positioned to align the industry's interests with those of their customers, notably by tackling the principal-agent problem discussed in Chapter 2. Trustees should be the industry's kingpin.

(d) *Big is beautiful; pension funds, and schemes, must scale up*

There are two aspects to "scaling up": combining people's multiple pension pots[213], discussed in Chapter 8, and fund and scheme consolidation, typically through mergers (perhaps leading to multi-employer schemes). The latter should be being driven by trustees, working in partnership with scheme sponsors and unions.

(i) *The rationale is powerful*

Table 11 shows the membership distribution for the UK's trust- and hybrid-based workplace pension schemes.[214]

Table 11: Pension funds, by membership size[215]

Number of members	Trust-based DC	DB	Total
0 - 100	44,650 (95.9%)	2,568 (37.5%)	47,218
100 - 1,000	1,150 (2.5%)	3,046 (44.5%)	4,196
1,000 - 10,000	610 (1.3%)	1,016 (14.8%)	1,626
10,000+	130 (0.3%)	220 (3.2%)	350
Total number of schemes	**46,540**	**6,850**	**53,390**

Of the 46,540 trust-based DC schemes, 44,000 schemes (90%) have fewer than 12 members, and 38,300 (82%) have only two, three or four members. The average UK scheme size is 2,500 members; contrast this with Australian schemes that average 26,000 members, or Dutch schemes that average 10,500.[216]

The contraction in the number of DC schemes has been particularly marked in Australia. 20 years ago there were over 10,000 schemes: by the end of 2011 there were 362 corporate, industry, public sector and retail schemes of meaningful size, with a shoal of residual, much small ones (3,191) that accounted for only 3% of pension assets.[217]

The NAPF is campaigning for larger schemes (in the guise of "super trusts"), pointing out that sub-scale schemes lead to sub-optimal consumer outcomes. Larger schemes:

- can **harvest economies of scale, or exercise leverage on investment price.** They can exercise their buying power to negotiate down the AMC by perhaps by 75%, and pay no initial charges on funds;

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[213] Steve Webb's "Big Fat Pots".

[214] There are an additional 130,000+ group personal and stakeholder pension schemes and 160,000+ contract-based DC schemes.

[215] The Pensions Regulator, *DC Trust 2010; The Purple Book 2010*.

[216] The Capita Hartshead Pension Administration Survey, 2010.

[217] The Hon Nick Sherry and Peter Downes; *Challenges for UK auto-enrolment from the perspectives of Australia and New Zealand*, TOR Financial Consulting, April 2012.

- are **better positioned to afford the in-house expertise** needed to analyse and research the increasingly complex range of available investments, and **identify the better performing funds**;

- can **more readily afford the best advice** (small schemes are commercially uninteresting to external advisers);

- can more readily **take advantage of co-investment opportunities** (i.e. the ability to buy a share of portfolio companies without fees);

- have **greater reach across asset classes, geographies and** (fixed income) **asset maturities,** resulting in more diversification (thereby reducing risk);

- can better exercise **annuity buying power on behalf of retiring members.** Small schemes' higher costs result in smaller pots at retirement, which are of less commercial interest to annuity providers;

- can **harvest the "governance dividend" attributed to large schemes**, estimated to add 0.5% and 1% to annual returns (to DB and DC schemes, respectively);

- can **accommodate effective risk pooling, (**"collectivisation"), should members wish to participate. Small schemes cannot offer this (to do so requires thousands of members); and

- have **lower administration costs.** A scheme with more than 50,000 members costs £15-£30 per member, compared with £200 for a scheme with fewer than 1,000 members[218].

The justification for scaling up is reinforced by research that shows that the larger a pension scheme is, the better its investment returns are likely to be. This is not, it must be said, without limit, because vast funds can struggle to fully invest, and are tempted to ignore small companies, the research effort not justifying the potential size of investment *relative* to the overall fund. The most extensive analysis ever conducted found that bigger DB schemes outperform smaller ones by as much as 0.43% to 0.50% per year (after costs).[219] This equates to savings 13% larger at retirement, with in-house investment management the largest contributor to the improvement.[220] The potential benefits of scale, and an expert client who can extract best value from providers, are significant.

(*ii*) *Professional trustees are conflicted*

It is patently clear that small pension schemes are deficient, and need to merge if they are to achieve transformational, rather than incremental, improvements in efficiency (measured, in this context, by the annual operating cost per member). Given that it is an

[218] ibid.

[219] *Is Bigger Better? Size and Performance in Pension Plan Management*, Professors Alexander Dyck and Lukasz Pomorski, University of Toronto's Rotman School of Management, September 2011. Results were derived from an analysis of the performance of 842 global pension plans between 1990 and 2008.

[220] The Canada Pension Plan Investment Board (with C$153 billion in assets) claims that by managing its own investments, it pays a tenth of the costs they would have to pay to an outside investment manager.

expressed duty of trustees to act in the beneficiaries' interests, they should be pro-actively pursuing scheme consolidation ("scaling up"). However, it is naïve to expect them to do so with any enthusiasm because, for professional trustees, this 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).

(iii) The state may have to take the initiative

An external catalyst is required, ideally in the form of pressure from scheme members themselves, but they lack the data and collective organisation to act effectively (similarly, consumer groups or the Association of Corporate Trustees). That leaves the state, acting through the regulators, to require the publication of data that should help expose the inefficiencies of small pension schemes, and therefore help beneficiaries hold trustees to account.

> **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.

Improving the availability of information does not guarantee that the necessary widespread scheme consolidation would then happen, but the stakeholders (notably trustees) should be given a window of opportunity (three years?) to act voluntarily. Subsequent regulatory initiatives are discussed in Chapter 11. Public interest (in respect of both public and private sector pension funds) should trump an assumed "right" to privacy.

(iv) The DCLG should lead by example

In the meantime, it is absurd that the Local Government Pension Scheme (LGPS) has not consolidated its 101 separate underlying funds (with over £140 billion in assets) into a few (five?) much larger funds.[221] Each would then have real clout to harness economies of scale, through tough negotiation with the industry, in the interests of their members.[222]

> **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.

In parallel, the LGPS's governance framework is in desperate need of redesign.[223] Today is it an ineffective tripartite of employers and central and local government, with a marked absence of clear accountability and responsibility. This bears all the hallmarks of the now-defunct Bank of England / FSA / HM Treasury oversight of the banks. Evidence of the

[221] Each with £30 billion in assets, they would be on a par with the BT Pension Scheme (£37 billion), the Universities Superannuation Scheme (USS, £32 billion) and the Railways Pension Scheme (£17 billion).

[222] Opposition to merging the funds is usually justified by their varying degrees of health, i.e. funding status. This is a specious argument when they are, ultimately, state-backed.

[223] Further discussed in Chapter 10 of *Self-sufficiency is the key*, Michael Johnson, CPS, February 2011.

consequences of the LGPS's lax governance is furnished by the catastrophic financial condition of a number of the LGPS funds; certainly Hackney, Haringey and Waltham Forest are beyond the point of no return. They are now so under-funded that they are adopting the characteristics of PAYG schemes. In the meantime, their consumption of assets (to meet the cashflow demands of their pensioner membership) is accelerating; these funds are in a death spiral.

(e) Dealing with service providers

(i) Fund managers

Trustees should ensure that the principal beneficiaries of scaling up are the scheme members, not the fund managers. Consequently, they should insist that the fees for actively-managed funds are calculated on the basis of value added, rather than the volume of assets under management (perhaps on top of a small flat fee). Passive funds' fees should diminish with rising participation, giving investors the benefit of economies of scale.

> **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).

If such arrangements were implemented, fees would not increase simply because the market went up. In 2010, for example, fees paid by trustees to fund managers increased by 11% (£300 million), almost exclusively as a result of a recovery in market values.[224]

There is a wide range of other initiatives that trustees should be taking in the interests of scheme beneficiaries, including only appointing fund managers who:

- provide total transparency with respect to their strategies, costs, leverage and trading;
- cap annual turnover of portfolios at 25% per annum (say), to exert some control on transaction costs. Better still, trustees should avoid actively-managed funds; only rarely does fund performance justify the additional costs;
- avoid "structured", untraded or synthetic products; pension schemes should, usually, only invest in assets quoted on a public market (exceptions include property and private equity funds);
- avoid "alternative investing"; there is no clear evidence of any long-term return advantage, and they usually lack illiquidity (i.e. they are difficult to sell, should the need arise);
- invest on the basis of estimated future earnings and dividends. Managers who pursue momentum-based strategies that rely on short-term price changes should be avoided (not least because such an approach is at odds with the long-term nature of pension funds);

[224] LCP; *Investment Management Fees Survey 2011*.

- avoid fund of funds, with their multiple layers of costs and fees;
- have performance fees that align both investors' and managers' interests. Badly structured performance fees can encourage gambling and therefore moral hazard;
- adopt stable benchmarks for fund performance, perhaps economic growth (i.e. GDP). Equity market indices, for example, are inappropriate benchmarks for both passive tracking and active management because their composition, unless regularly reviewed, becomes increasingly redundant over time;[225] and
- use risk management tools that measure risk using dividends or smoothed earnings as inputs, not prices (which are too volatile).

(ii) Administrators

Trustees should be equally tough with administrators, only appointing those who keep their costs low by embracing automation, standardisation (of data format and documentation) and scale (such as by servicing multi-employer schemes rather than huge numbers of individual weekly contributions).[226] In addition, before appointing administrators, trustees should encourage scheme sponsors to package the products together (including pensions, accident insurance, life insurance and holiday pay); the subsequent administration would be cheaper, particularly if the individual products were kept simple (for example, minimising the number of employee-elected options that are embedded in pension schemes).

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

10.4 Not all trustees can be trusted

(a) A code of conduct for trustees

Two academics (Mark Abrahamson and Tim Jenkinson) have raised a crucial question: can all (professional) trustees be trusted? Their research[227] suggests not: some trustees (particularly those of smaller funds) are uninformed because they are not motivated to study the data with the care required to ask the right questions. More serious, however, are conflicts of interest between some trustees and service providers, something that the TPR's Executive Director of DC, governance and administration (June Mulroy) is aware of, and has vowed to address[228].

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[225] For example, Japan accounted for 55% of the global equity index in 1990 and, ten years later, technology stocks represented 45% of the S&P index.

[226] B&CE's workplace pension has an annual policy maintenance cost of less than £5 per policy.

[227] Mark Abrahamson and Tim Jenkinson, Saïd Business School, Oxford University; *Does transparency overcome conflicts of interest? Evidence from investment managers and their brokers*, March 2009.

[228] As quoted in Professional Pensions, 7 July 2011.

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.

The code of contact should include a commitment from trustees to sign the Financial Reporting Council's Stewardship Code[229], which sets out good practice on engagement between institutional investors (including pension funds) and companies. To adhere to the code, signatories have to exercise their voting rights and actively engage with companies in which they invest. Ideally, trustees should also exhibit a working knowledge of the United Nations-backed Principles for Responsible Investment and become an affiliate of the UK Sustainable Investment and Finance Association (UKSIF).

Finally, trustees should eschew "corporate entertainment" which, in many situations, is a soft form of corruption.

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

Strong leadership is required from within the trustee community, because change (i.e. enhanced professionalism) is unlikely to be in the interests of *all* trustees. The code of conduct, perhaps established under the aegis of The Association of Corporate Trustees (TACT), should cover all professional trustees (i.e. companies and sole practitioners). Lay trustees should be invited to participate as well. In the meantime, some independent trustees continue to abuse their "independent" label in a manner similar to some IFAs….which invites regulation akin to the RDR.

(*b*) *Lessons from Australia*[230]

Australia, where DC provision dominates, is perhaps the best example of how the UK pensions arena could look like in a few years' time. Furthermore, it is taking the role of trustees extremely seriously, mindful that trustees are not just "guardians" of an individual's pension outcome, but also of a major and growing tax preferred savings pool that has very significant economic consequences. Australian pension schemes now have A$1.4 trillion in assets, equivalent to the size of the economy.

The Australian Prudential Regulation Authority (APRA) has elevated trustees' fiduciary duties by licensing them. Furthermore, it has issued detailed directives ("Guidance Notes") concerning trustees' duties. Currently, legislation is before parliament to introduce individual trustee legal liability, there is a consultation paper on trustee board membership

[229] Signatories to the Stewardship Code include 176 asset managers, 48 asset owners, 12 service providers and NEST.

[230] See *Challenges for UK auto-enrolment from the perspectives of Australia and New Zealand*, by the Hon Nick Sherry and Peter Downes, TOR Financial Consulting, April 2012. The Superannuation Industry (Supervision) Act 1993 (SIS Act) is the statutory bible for all Australian pension funds.

outstanding and there are plans to empower APRA to require a strategic plan from each pension fund. Ultimately APRA also intends to publish all fund returns including default and other investment options as well as detailed fund costs, fees and charges.

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

In the UK, trustees of corporate schemes already have unlimited liability for their role, and consequently they have pension trustees liability insurance (PTL). But could the existence of such insurance risk some trustees to be any less dutiful?

(*c*) *Mutual status?*

There is a final question concerning professional trusteeship: is it possible to comingle business with genuinely acting in a fiduciary[231] capacity? Given the underling nature of trusteeship, the role of trustee is probably better suited to organisations with an ethos of mutuality.

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

In the meantime, trustees should remind themselves of the Myners principles, a voluntary regime designed to improve trustees' investment decision-making and governance. They were updated and simplified in 2008, the ten principles being consolidated into six, less prescriptive, principles (see Appendix III). In parallel, TPR could sharpen its use of Prohibition Orders to hold trustees to account.[232]

10.5 Four good governance principles

Back in 1976, Peter Drucker suggested that the potential Achilles heel of his vision of "pension fund socialism" was that trustees lacked the motivation to implement "good governance". Drucker's theory has subsequently been supported by research[233], prompting Ronald Capelle[234] to suggest four governance principles for trustee boards.

> **Proposal 61**: Trustee boards should evidence to scheme members that they meet Ronald Capelle's four good governance principles, namely that:
>
> (i) the Board is accountable for ensuring work to further stakeholder interests is done optimally;
> (ii) this work is not conducted by the Board itself (nor related entities or people);
> (iii) Board membership selection criteria are (a) to have appropriate skill and knowledge sets, (b) to value the work, (c) constructive behaviour, and (d) strategic reasoning capability; and
> (iv) the Board has clear self-management and self-evaluation capabilities.

[231] Fiduciary; from the Latin fiducia, meaning "trust".

[232] An order made by TPR effectively prevents someone acting as a trustee.

[233] For example, in 1992 anthropologists William O'Barr and John Conley concluded that the pension fund governance practices they observed were like "*looking into an airliner cockpit at 30,000 feet and finding that there is no-one in there*". Their findings have been reiterated in subsequent work by Keith Ambachtsheer, amongst others.

[234] At the 2004 Rotman International Centre for Pension Management (ICPM) Colloquium.

10.6 Governance: summary

Relative to the financial clout of the industry and its trade bodies, no one is aggressively fighting the pension scheme beneficiaries' corner. Various consumer groups produce high quality research material (including FairPensions, the RSA and Which?), but their funding is sporadic. Consequently, the theme of fiduciary duty is under-researched, and those outside of the industry find that sourcing data is difficult. This could explain why (until recently) fiduciary duty has not been on the ministerial radar.

Contract-based schemes are particularly exposed to the risk of weak governance, partly because with workplace schemes the industry's client is the sponsoring employer, not the employee. Trustees need to become much more assertive, evidenced by pension schemes acting as the principals that they are supposed to be.

In particular, it should be an expressed duty of trustees to address the scale issue. Indeed, they should be catalysts for driving efficiency improvements within the industry, demanding enhanced transparency and fewer, simpler products. Ideally, the resultant lower costs should then lead to lower charges, thereby increasing savers' assets and, subsequently, their pensions.

Ultimately a cultural shift around governance is required, which may have to be brought about by a shove from the DWP.

11. Regulation

11.1 Introduction

The majority of savers 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 (i.e. information asymmetry). For almost all investors, this excludes very little. A less subtle description would be to say that regulation should protect investors from the industry's self-interest, its inefficiencies and, in some cases, its predatory instincts.

Good regulation can be hugely beneficial, promoting competition, limiting tax evasion, ensuring that money laundering requirements are met and that due regard is given to the risks of financial crime. It is necessary where markets fail, for example because of the existence of externalities or the abuse of market power. It may also be justified to protect vulnerable consumers from exploitation. But inefficient regulation imposes a huge cumulative burden of direct and indirect costs, falling initially on the industry but ultimately on its customers. It raises costs, ties-up resources, reduces or distorts investment incentives and stymies innovation. Regulation also has many indirect costs; jobs are lost, taxes rise, customers pay more for worse products and services, and the state expends valuable resources enforcing it. Many of the causes of bad and unnecessary regulation are ingrained in the culture of our politicians, civil servants, the media and, more broadly, our society.

11.2 Some guiding principles

(i) **Government should impose regulation only when the benefits outweigh the costs.** Politicians find it difficult to resist the media's clamour that "something must be done about it", and the result is often a damaging regulatory over-reaction, rather than the pursuit of less burdensome alternatives (including competition, incentive schemes, or self-regulation);

(ii) **the regulation factory houses some damaging self-interests.** The regulators' employees, and third party service providers to the industry (notably accountants, actuaries and lawyers), share a common interest in the introduction of additional regulation. For consultants, change is manna from heaven. Essentially, the industry built around regulation provides livelihoods for those who work within it;

(iii) **it is not possible to live in a risk-free world.** Vain attempts to eliminate all risk often strangle commercial vitality, and undermine individual responsibility;

(iv) **regulation almost inevitably spawns unintended consequences**, such as deterring paternalistic employers from providing good company pension schemes;

(v) before imposing traditional "heavy" regulation, **government should always consider whether the ends could be achieved by less burdensome means**, such as through competition, incentive schemes, or self-regulation;

(vi) regulations can impose **a disproportionate burden on small businesses**. This is unfair, dampens competitive rivalry and reduces productivity;

(vii) **modelling, for risk assessment purposes, should be treated with considerable scepticism.** Most models are excessively complex, and they are fuelled with empirical evidence which, by definition, ignores all the possible (black swan[235]) outcomes that have not happened in the past;

(viii) **European regulations are responsible for a growing share of the regulatory burden:** the UK Government should work harder to improve the quality and implementation of EU legislation where necessary, and ultimately must act to protect and promote the competitiveness of the UK economy. The temptation to gold-plate European directives should be strongly resisted.[236]

11.3 The current regulatory framework

There are two regulators concerned with pensions; the Financial Services Authority (FSA) and The Pensions Regulator (TPR). Those unfamiliar with pensions regulation may wonder whether this is an example of public sector resource duplication; this is not the case. The FSA and TPR regulate different communities in different contexts, and are, consequently, guardians of quite separate "client" relationships.

(a) The Financial Services Authority[237]

The FSA regulates the sales and marketing of personal pensions (including annuities), and is therefore concerned with issues that arise as a result of what is a *business* relationship between industry and customer. Product regulation is not part of the FSA's agenda, so it does not, for example, opine on what a "simplified" product should look like.

The FSA's clientele are licensed firms, its tools are rules-based. The latter can be difficult to apply, for example when guarding against the industry exploiting known consumer behaviours (such as teaser rates on savings that rely on customer inertia). Investment-related issues are also tricky, not least because many consumers will not know whether their "purchase" has "worked" until decades later.

The FSA is being dismantled during 2012. Responsibility for banking supervision will go to the Bank of England (from whence it came, in 1998), under a new brand, the Prudential Regulation Authority (PRA). The remainder of the FSA is to become the Financial Conduct Authority (FCA), which will assume responsibility for consumer regulation and financial products, including the FSA's pensions responsibilities.

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[235] The "black swan theory", developed by Nassim Nicholas Taleb, refers to unexpected events of large magnitude and consequence and their dominant role in history. Such events, considered extreme outliers, collectively play vastly larger roles than regular occurrences.

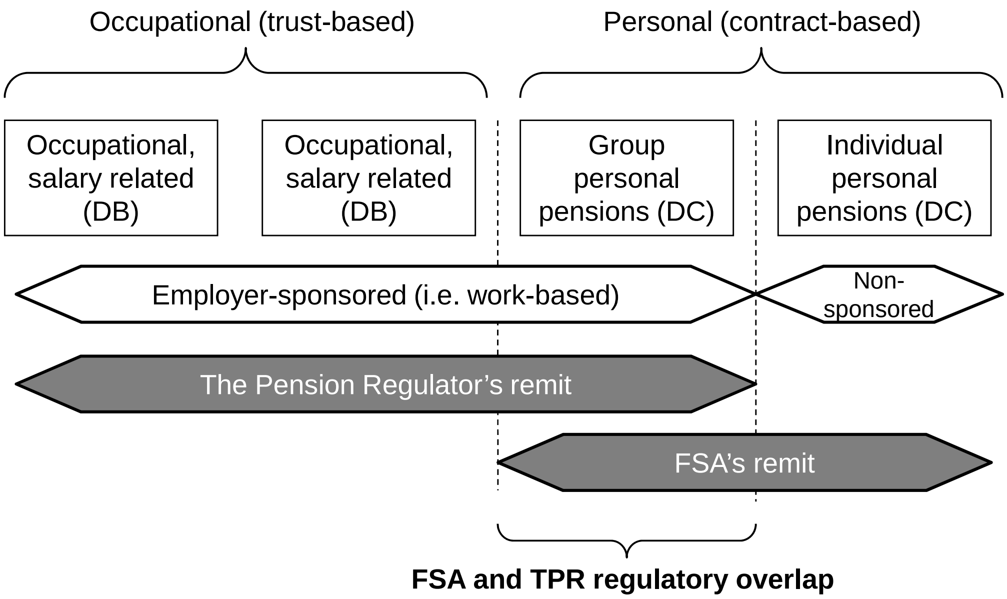
[236] Gold-plating; the practice of tagging additional measures onto the back of European directives which place UK business at a competitive disadvantage in relation to other EU states (where directives are often implemented more literally).

[237] The FSA is a private company limited by guarantee, governed by a board appointed by the Treasury and funded by fees paid by those it regulates.

(*b*) *The Pensions Regulator (TPR)*[238]

TPR regulates work-based pensions schemes, looking after the interests of active and deferred scheme members, as well as pensioners. Its focus is mainly on employers, and scheme trustees and managers; thus the context is one of *voluntary* provision of pensions by employers. TPR typically reviews pension scheme returns, taking action in respect of inadequately funded schemes, for example. It references primary and secondary legislation, and codes of practice that have evidential status. Figure 11 illustrates the current framework for the regulation of pensions.

Figure 11: The regulation of pensions



It is evident that there is some overlap in the regulation of workplace contract-based schemes, which Paul Thornton identified in his 2007 review of pensions institutions.[239]

11.4 Regulatory reviews

(a) An unhealthy fixation with structural change

Getting the regulatory balance right is a perennial struggle for successive governments, irrespective of their political hue. Too much regulation stifles the economy, and too little deprives citizens of the protections which they rightfully expect. The litany of regulatory reviews bears testament to this conundrum.

One review concerning the pensions arena was conducted by Paul Thornton, in 2007. He was asked to "*review how the functions of the organisations set up by the 2004 Pensions Act (TPR and the Pension Protection Fund, PPF) fit with the Government's existing pensions policies, its pension reform proposals, and wider developments in the pensions market*." Appendix IV summarises his main points.

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[238] All TPR board members are appointed by the DWP's Secretary of State.

[239] *A Review of Pensions Institutions; an independent report to the DWP*, Paul Thornton, June 2007.

Encouragingly, early in the report is a reference to how the institutions concerned with pensions regulation are working to a common purpose (i.e. improving co-operation and closer working *between* the regulating institutions). But this theme is taken no further, and there are no recommendations for establishing a common purpose between regulators and consumers. Instead, the focus falls on the reformers' perennial favourite, a fixation with changing *structures.* Past regulatory reviews contain numerous proposals for structural rebranding[240] and reorganisation, often embracing the Hampton Principles.[241]

(*b*) *One less regulator required*

As already mentioned, it would not make sense to fold the TPR into the FSA, notwithstanding their common interest in pensions. Such a move would import into the FSA a new array of unfamiliar relationships, accompanied by over £1 trillion of DB liabilities.

Alternatively, all the DC schemes could go into the FSA's domain, leaving the (withering) DB schemes within the remit of a solely DB-focused TPR. It would then also make sense to fold the Pension Protection Fund (PPF) into TPR; their interests are aligned as they share a common client base, confronting similar issues. Furthermore, TPR could do with access to the PPF's modelling skills.

Given the aforementioned comments concerning past reviews' pre-occupation with structural change, the following proposal is made reluctantly. However, it is justified by the blurring of the regulatory distinctions between contract- and trust-based DC schemes and the shift from DB to DC pension provision. It also creates the potential for rule removal (i.e. simplification) and the regulation of pensions based upon who is taking the risk, i.e. a clear DB / DC dichotomy. The emergence of hybrid structures would complicate the issue but, ultimately, it is likely that a single body will oversee all forms of pension provision (DB having died out).

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.

One other consideration for the regulators is the growth in the transfer of pension schemes' risks (particularly longevity) to insurance companies. This will require closer co-operation between a TPR / PPF combine and the insurance companies' regulators.

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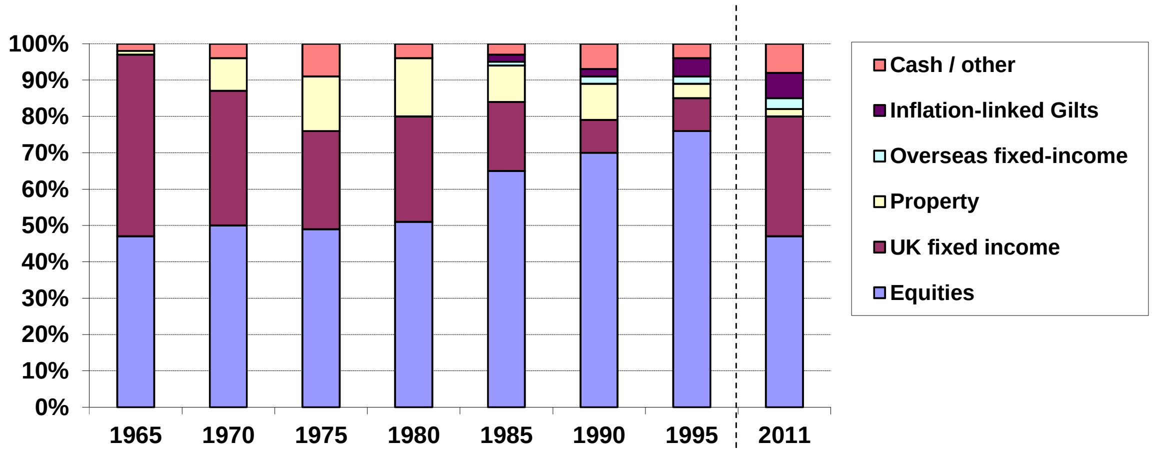
240 For example, LAUTRO became the PIA, to become the SIB before being renamed the FSA in October 1997. The FSA is the amalgam of the Building Societies Commission, the Friendly Societies Commission, IMRO, the Register of Friendly Societies, the Securities and Futures Authority, along with the PIA.

241 Sir Philip Hampton's 2005 review "*Reducing administrative burdens: effective inspection and enforcement*" recommended that the number of regulators that businesses deal with be reduced from thirty-one to seven.

11.5 Regulation: unintended consequences for pension funds

UK pension funds used to invest heavily in equities, to diversify risk and hedge against inflation. Equity allocations peaked in the mid-1990's (at around 75%; see Figure 12), but thereafter UK pension funds have become increasingly risk averse.

Figure 12: UK pension fund asset allocation %, 1965 to 1995, then 2011



Today, the UK pension funds' equity asset allocation is around 47%, down from 50% in 2010 and 67% in 2003.[242] This de-risking was partly in response to the onslaught of new regulation that emerged in the mid-1990s, notably the Pensions Act 1995. This exemplified the political over-reaction to the Maxwell scandal; a clear example of a short-term crisis response producing damaging, long-term, consequences. It increased costs for scheme sponsors and hastened the demise of DB occupational schemes (aided and abetted by overly zealous accounting requirements, notably FRS17 and IAS19).

The contraction in funds' allocation to equities has not been in savers' best interests because, as Table 9 shows, equities have done well (in the *very* long-term) relative to gilts and cash.

11.6 The Retail Distribution Review: what of it?

For the last few years the FSA has been immersed in the Retail Distribution Review (RDR). The RDR is partly a consequence of a minority of advisers abusing their customers' trust; consequently, they have surrendered the initiative to the regulator.

(a) Background

At the 2006 Gleneagles conference, the former FSA chairman Sir Callum McCarthy observed that the retail distribution model was broken and needed reform.

> *"We have a business model that is based on incentives which produce results which are unattractive to reputable providers, unattractive to their customers, and whose benefits to intermediaries are questionable."*

[242] Mercer. Most of the recent reduction in equities has happened within the UK equity portfolio, down from 28% in 2009 to 21% now, fund managers becoming increasingly concerned about the western economies' anaemic growth prospects relative to those of emerging economies.

The launch of the RDR followed. Due for implementation by the end of 2012, it is intended to lead to a change in behaviour of a financial advice business that has been characterised by:

(i) independent financial advisers (IFAs), some poorly trained, servicing a consumer market that has little financial knowledge;

(ii) a sales-driven culture that leaves some clients with poor quality, expensive products which should never have been purchased;

(iii) the pursuit of business volume, rather than quality (leading to excessive product churn); and

(iv) remuneration structures that lead to distorted consumer advice.

Essentially, the RDR is intended to address the conflicts of interest in the UK retail financial services industry, so that advisers *really* behave as their clients' agents, and are appropriately qualified to do so.

(b) The RDR's two key proposals

The RDR proposes two fundamental changes to the advice arena, both intended to put an end to mis-selling.

(i) The banning of commission

Providers will no longer be able to offer commission to secure sales from adviser firms and, consequently, advisers will be unable to recommend products that automatically pay them commission. Commission has, for decades, underpinned many IFAs' livelihoods, as well as providing many life and pension companies with a competitive advantage (because they can finance commission payments with their capital).

In future, clients will only be able to pay their advisers via an up-front fee or, perhaps cosmetically more palatable, to have product providers deduct it from their investment to be concurrently paid to the adviser. Factoring is to be banned (whereby providers advance finance to advisers out of their own funds).

To be clear, the issue around commission is *not* a lack of willingness to pay for professional services. We willingly pay (up-front) fees for professional services (accountants, dentists, lawyers, surveyors, etc.), when it is clear how much we are paying, and what is being received in return. But we object when we receive poor value for money or when the cost is unclear (as it is with commission), only to later discover that we have been ripped off. A significant minority of financial advisers have been proponents of the latter approach to business, and the RDR is intended to address this.

(ii) Additional professionalism

The RDR recognises that many advisers are insufficiently skilled to deal with the immense complexity of financial products available. Consequently, all advisers will be required to meet tougher academic qualifications (to QCF Level 4 (Diploma Standard)) and those wishing to retain the IFA title will also have to meet new requirements for independence. Those electing not to meet the "independence" criteria will become "restricted" advisers, the restriction being in respect of the product range on which they can advise. Restricted advisers will include those who are single- and multi-tied advisers.[243]

Whilst we can measure people's technical competence, what of their moral character? The FSA's professionalism agenda is based upon an ability to pass exams, but professionalism is equally about attitude; a consequence of personal background, experience and values. The RDR ignores these attributes, perhaps in the interests of simplicity. And whilst tougher exams will weed out some weak IFAs, there is little evidence to suggest that academic aptitude and being trustworthy, for example, are closely correlated. That said, post-RDR IFAs (as currently envisaged) are likely to be motivated, educated professionals, effectively having progressed from being packaged product salespeople to providers of valuable "wealth advice". But there will not be many of them.[244]

In the meantime, the Australians have taken the professionalism requirement to an extreme. The draft legislation of their Future of Financial Advice (FoFA) reforms (their equivalent of the RDR) enshrines *in law* that financial advisers should act in their clients' best interests.

(*c*) *Independence; an unattainable ideal*

The FSA has failed to appreciate what many IFAs actually do; they are salesmen rather than advisers. They get paid when they transact. In practice, when selecting assets for their clients, many IFAs simply apply a set of filters, typically comprising past performance (which we know to be almost irrelevant as a guide to future performance), current price, the fund manager's brand and quality of service (directly connected to how much is spent on advertising) and their remuneration (pre-RDR). Product providers ("manufacturers") sell to the IFA community by playing to these filters, whilst ostensibly offering "good value", thereby aligning IFAs' interests away from those of their clients.

Furthermore, IFAs face an impossible task if they attempt to provide personalised, wholly independent, advice. There is no one analytical tool available to help them establish which of the 360+ million UK combinations of retail fund, fund manager and insurance company is best suited to any particular client. In this light, IFAs could be forgiven for concluding that a conscientious application of the FSA's "whole of market" and investment suitability criteria is a ridiculous task. The bar for giving independent advice is therefore unfeasibly high under the RDR; in the context of financial advice, the word "independent" is a misnomer.[245] If any further evidence for this is needed, a large survey[246] of advisers concluded that:

- 85% of their clients do not understand the difference between independent and non-independent advice; and
- 93% do not understand what the RDR is, and the benefits it is meant to bring.

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[243] Advisers who are constrained to products offered by a limited range of providers.

[244] David Barral (marketing director, Norwich Union Life) expects adviser numbers to fall to 10,000, from 21,000 today.

[245] Nucleus Chief Executive David Ferguson: "*the word independent has passed its sell-by-date*" (Money Marketing, 7 May 2009).

[246] A survey from the PanaceaIFA website (January 2012); there were 740 respondents.

Putting an end to the use of the word "independent" would also address the risk of confusion around the distinction between "independent" and "restricted", as well as the perception that "restricted" advisers are second class.

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

(d) Paying for advice

(i) Comingled objectives

The banning of commission is at odds with some people's preference to pay commission rather than fees.[247] Paying commission, spread over time, can be *emotionally* easier than the immediate, highly visible, exercise of writing out a cheque (and commission is not subject to VAT). The FSA would appear to be comingling the mechanism of payment with the laudable objective of improving transparency. The issue is not commission *per se*, but its invisibility to clients.

That said, the FSA is progressively clarifying its thinking concerning fee transparency. It is now clear that product providers that facilitate advisers to be paid, through initial charges or on-going premiums, will have to detail the fees separately from any product costs (along with the allied reduction in yield).[248]

(ii) An unintended consequence

With the end of commission, post-RDR, some advisers will move towards charging on a funds under management (FUM) basis. Naturally, they would then concentrate on pursuing the wealthy, rather than people without existing savings (typically the young)…..but it is primarily the latter who need advice.

(iii) Another consultation….with the wrong audience

The banning of commission, in isolation, fails to address the bigger question; how *should* advice be paid for? Rather than taking an assertive lead, the FSA has defaulted to its usual approach of launching a consultation concerned with how providers will be able to facilitate adviser charging.[249] The proposed guidance leaves providers with a choice[250], but this misses the point. The FSA should be investigating how *customers* want to pay for advice.

> **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.

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[247] Given the choice, between 4% (Capgemini Financial Services Survey, *The World Insurance Report*, 2008).and 10% (Independent Voice, *Perspectives on the IFA Industry,* 2010) of clients would prefer to pay for advice by way of a single, up-front, fee, rather than commission. More recently (January 2012), 690 of 740 respondents (93%) to a PanaceaIFA website survey of advisers said their clients would prefer commission to remain an option so they can choose the remuneration model that best suited them.

[248] FSA; *RDR Newsletter*, 18 November 2011.

[249] FSA; *CP11 / 25 Distribution of retail investments: RDR Adviser Charging and Solvency II disclosures*, November 2011.

[250] Providers can choose between paying adviser fees from the full amount received from the client, or through the initial product fee.

(*iv*) *Recurring advice fees need to be controlled*

Post-RDR, some advisers are likely to try to replace their commission income by (transparently) charging on-going fees to retail clients, based upon the size of clients' assets. The Australians have anticipated this in their draft FoFA legislation by requiring advisers to provide a fee renewal notice every two years; if clients do not opt in, they are automatically opted out (and the fee ceases). But this protective arrangement only covers *new* clients, not existing clients, raising concerns that over time it will create two classes of customer (protected and unprotected).

> **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.

In addition, customers should be sent a fee disclosure statement as frequently as their payments are made. Alternatively, all asset-based advisory fees should be banned or, at the very least, they should be net of leverage (i.e. excluding debt-financed assets).

(*v*) *Unethical trail commission*

Whilst trail commission[251] will be banned (saving consumers £200 million[252] per year), it will remain in place in respect of "undisturbed funds", i.e. those that are not moved by the adviser post-RDR.[253] This is unacceptable because, in effect, it grandfathers (and thereby legitimises) an odious practice, that of not clearly communicating to clients the *on-going* cost of advice (which eats away at assets year after year). People who are not receiving an on-going service from an IFA should not be paying trail commission, irrespective of when the arrangement was put in place.

It is therefore alarming that in the run up to RDR implementation, many advisory firms are moving clients into multi-asset managed funds in an effort to ensure that trail commission is not removed on existing business. The long term performance of managed funds is abysmal, and 82% of managed funds have failed to beat the market over the course of twenty years.[254] Furthermore, this figure only includes funds that survived for the whole period; in the interim, many poorly performing funds would have been shut down or merged into other funds. Almost all clients would be better off with index tracker funds, for example; they have lower annual charges (0.5% compared to 1.5% for a typical managed fund) and lower asset turnover (thereby incurring smaller dealing costs and stamp duty).

Whilst the Government is keen to harness the positive aspects of inertia (via auto-enrolment, for example), it should be equally enthusiastic about tackling its negative consequences. People could sell their assets to break the commission trail, but they rarely do. The difficulty is, what should the Government do? The Australians wrestled with trail

[251] Whereby part of the on-going annual administration charge paid by investors is paid to the adviser who made the original sale (irrespective of whether any on-going advice is given or not).

[252] Christine Farnish, Chair of Consumer Focus, a government body.

[253] If the funds are moved, then new terms have to be agreed and advisers will no longer be entitled to trail commission.

[254] WM Company research.

commission as part of their FoFA reforms. Ultimately, the regulator wilted under a storm of industry protest and reluctantly agreed to “grandfather” the back book of trail commissions, partly because of concerns that it is a contractual right that cannot be removed.

> **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.

In the meantime, clients continue to sign up to pay trail commission to their advisor for the life of the product, which may be decades, without receiving any tangible benefit. In parallel, several FSA-compliant websites are now emerging to offer a trail commission rebate service with, typically, 20% being retained as a fee; opportunism care of the regulator.

(*e*) *The RDR is expensive*

Table 12 shows the FSA’s own cost analysis of the RDR.

Table 12: The cost of the RDR

	2008 cost estimates*	2010 revised cost estimates**
One-off costs	£430m	£605m - £750m
Ongoing costs	£40m	£170m - £205m
Present value of costs for the first 5 years	£600m	£1,400m - £1,700m
Annualised costs for the first 5 years	£135m	£305m - £370m

** FSA Consultation Paper CP09/18; Distribution of retail investments: Delivering the RDR, June 2009.*
*** FSA Consultation Paper CP10/6; The assessment and redress of Payment Protection Insurance complaints. Feedback on CP09/23 and further consultation, March 2010.*

A leap a faith is required to conclude that RDR-derived benefits will outweigh its costs. But compared to the cost of settling previous mis-selling scandals (£11.8 billion in respect of personal pensions and £2.7 billion for mis-sold mortgage endowments), the RDR costs could be presented as a sensible “investment”, albeit ultimately shouldered by savers. Others, however, view it as being one more example of clumsy and expensive regulation.

(*f*) *RDR; the consequences*

(i) The benefits

Implementation of the RDR will produce some benefits to savers, including:

- the creation of clear water between advice and product, making it easier to distinguish between adviser and salesman (essentially the end of the hegemony of the provider-agent relationship);

- improved transparency in respect of charges. Note, however, that almost two-thirds of advisers say that the RDR will not give *enough* transparency on management and transaction fees[255];

- a marked improvement in the quality of advice; and

- a resurgence in "sensible" financial products that have traditionally been ignored by commission-hungry salesmen, including passive funds, investment trusts and National Savings & Investments. Commission-heavy products, such as With Profit endowments and investment bonds, may disappear altogether, through lack of demand.

(*ii)* *The key unintended consequence; less advice*

No one doubts that the RDR will lead to a contraction in the availability of affordable advice, as firms close and some IFAs leave the market care of the exam deterrent.[256] The realistic costs of being an IFA, post-RDR, are likely to become so high that ordinary investors will struggle to meet them. Furthermore, the more qualified and skilled an adviser becomes, the higher the reward demanded. Advisers are already abandoning smaller investors (i.e. 90%+ of the population), and migrating to higher net-worth clients. In the autumn of 2010 Towry, for example, declared that giving financial advice on assets below £100,000 was no longer commercially viable (the average investment case size in the UK is under £20,000). It also unilaterally shut down the accounts of 6,000 of its clients who held less than £5,000.

Furthermore, under the FSA's capital adequacy proposals, all financial adviser firms will be required to hold three months of relevant annual expenditure and a minimum of £20,000, double the current level of £10,000. Given that some 20% of firms are loss-making and a further 24% report profits of less than 5% of turnover, many (smaller) firms are expected to close, or consolidate with others.[257] This would mirror the Australian experience, where a wave of consolidation is now sweeping the financial planning sector.[258]

(*g)* *RDR; conclusion*

The RDR is intended to restore trust and confidence in the financial services industry, a prerequisite to rebuilding a savings culture in the UK. But whenever it is discussed, one detects a sense of disillusionment (and ministerial fatigue?), not least because it has long lost sight of its six original objectives, established in 2006 (see Appendix V). Its focus has progressively narrowed, so the RDR has become a review of advice, rather than distribution. Consequently, the customer interface with execution-only distribution is

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[255] According to a survey of 100 IFAs conducted by SCM Capital, April 2012.

[256] 15% of retail investment advisers (RIA) are expected to leave their roles post-RDR (RS Consulting survey for the FSA, December 2011). 57% of respondents said they will "definitely" remain an RIA and 28% would "likely" to retain their roles.

[257] Ernst & Young suggests that 30% to 40% of IFA firms will disappear care of the RDR (*The outlook of the life and pensions market*, *2009*).

[258] Bank and wealth manager MyState has made a A$68m agreed bid for Queensland's The Rock Building Society (September 2011), and a bidding war (amongst the banks) is expected to erupt for Australia's largest independent financial planning group, Count Financial.

neglected, along with the customer experience with portfolio managers. This is partly due to the rapid turnover in FSA staff[259] dealing with the RDR, as well as a substantial re-ordering of the FSA's regulatory priorities, in light of the recent world financial crisis.

The FSA is likely to deliver on its ambition to increase the professional standards of the industry. High net worth individuals will be well served by professional advisers, but there exists a far bigger prospective customer base that is not really aware of, or interested in, buying financial advice from a new breed of conflict-free IFAs. Unlike continental Europe, where the bancassurers and insurance companies play a big role in serving the market, some UK banks are not interested in replacing the diminishing IFA community. Indeed, some are exiting the advice market completely, possibly deterred by the volume of consumer complaints to the Financial Ombudsman.[260] Thus, on one of the RDR's key objectives, broadening access to advice, it will comprehensively fail. Indeed, its lasting consequences is likely to be the disenfranchisement the "lower mass affluent" from independent advice.

In addition, the RDR invites an arbitrage. It only applies to "advised" sales, so it invites today's advisers to 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.

Furthermore, the RDR (nor any other legislation) cannot ensure that advisers, who will always be their clients' agents, will absolutely align their interests with those of their clients, the principals. But perhaps the biggest issue with the RDR is that it is wholly supply-side focused, when the principal challenge for the savings arena is the lack of demand, reflecting the lack of a savings culture.

11.7 DC regulation

(a) Stimulating a savings culture is key

Today's regulation of pensions reflects the bygone age of DB pensions. But the private sector is rapidly becoming a DB desert, in favour of DC arrangements, with the risks being placed on the saver rather than the employer. The best way for people to counter the risks associated with retirement income is to maximise the amount they save. Consequently, encouraging a savings culture should be an explicit objective for the FSA and TPR.

> **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).

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[259] Sir Callum McCarthy, the leading RDR advocate, left the FSA in 2008, Clive Briault, the FSA's managing director of retail markets, resigned in March 2008, to be followed by two more FSA managing directors of retail markets, before the FSA abolished the post in 2010.

[260] In early 2011, for example, Barclays Bank announced the closure of its financial planning arm, thereby no longer offering branch-based advice. HSBC and the Co-Op bank have also cut back on providing advice.

(*b*) *Focus on industry efficiency*

Hopefully politicians and policy makers will conclude that regulators should change their emphasis from prudential oversight to "shoves" that encourage improvements of the industry, in both its effectiveness (better results; in this context, more people saving more) and its efficiency (better use of resources). Progress should be assessed against quantifiable yardsticks. Political and regulatory nudges could include pressing for:

(i) much more assertive scheme governance, evidenced by funds really acting like the principals that they are. This should include the scaling-up (i.e. merger) of pension schemes (perhaps organised along industry lines), enforced by extending the criteria to meet Qualifying Workplace Pension Scheme (QWPS) status to include minimum thresholds for asset and membership size.[261] The NAPF could assist by allocating a significant weighting to scheme size when kite-marking pension schemes;

(ii) the industry facilitating the consolidation of individuals' multiple pension pots, with regular reports on the rate at which individual pot sizes are increasing. This would be greatly assisted by the industry embracing contract simplicity and standardisation, with peripheral features (concerning widows, disability, etc.) unbundled from core pension provision;

(iii) *total* transparency in respect of charges, costs and fees (and perhaps executive remuneration), not least to expose the inefficiencies of small pension schemes;

(iv) the narrowing of the product range (but, to be clear, regulators cannot ban choice); and

(v) evidence that the industry is investing in process automation and cost cutting, with the benefit of lower costs being passed on to customers.

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.

[261] From 2012 all employers are required to provide a Qualifying Workplace Pension Scheme (QWPS) for their employees. It must meet certain criteria, including an overall contribution of 8% of qualifying earnings.

The justification for assertive state intervention would be that the state (i.e. taxpayers) ultimately fields the consequences of an under-saving nation, a situation for which the industry is partly (not wholly) to blame. But regulating (or legislating) so that the industry *has* to react is the last resort. It would be preferable if the industry were to take the lead and unilaterally make the efficiency improvements. The regulators should provide it with a three year "window of opportunity" (i.e. a notice period) within which to do this.

There is nothing preventing the industry acting today, collaboratively, to bring about these changes……other than entrenched self-interest, camouflaged by protesting consumers' right to free choice. If meaningful change were not apparent within three years, say, the regulators' stance should change gear, to become "require" rather than "encourage".

(c) Standards required

DC schemes need *standards* to protect their members, to include the quality of administration, governance, investment policy and transparency (particularly concerning charges and fees).

The NAPF already awards a Pension Quality Mark ("kitemark") to companies with DC schemes that meet certain minimum standards on contribution levels, communications and scheme management. Whilst the objective is laudable, to help to rebuild and promote public confidence in workplace pensions, the NAPF is perhaps too closely identified with the industry. Only a wholly independent assessment of schemes' quality, to include governance and transparency, would satisfy the public.

> **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.

11.8 Between DC and DB: a regulatory cliff edge

Whilst the regulatory frameworks for pure DB and pure DC pension schemes are distinct, there is no accommodating regulatory "third way". Anything that is not pure DC is deemed to fall under the aegis of full-blooded DB regulation. Thus, schemes that include an element of risk-sharing between employer and employee (such as cash balance schemes) are regulated as DB, yet the employer is only assuming the investment risk until employee retirement. Employees assume their own longevity risk thereafter, arguably the most significant component of the total risk; it seems excessively burdensome on employers to regulate such schemes as pure DB.

The consequence of the DB-DC regulatory cliff edge is to deter innovation, at a time when it is in demand (perhaps even more so in light of the arrival of auto-enrolment, which is prompting some employers to reconsider their pension schemes' structures). A more flexible approach to regulation is required, one which considers in more detail the risk allocation between employer and employee.

> **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.

If the sponsor of a risk-sharing scheme were to default, employees' pensions would be potentially left exposed, depending on the nature of the underlying plan. If there were any DB elements (i.e. an element of certainty provided by the employer), then the Pension Protection Fund (PPF) should stand behind the scheme. In respect of particularly complex hybrid schemes, the PPF could ask the employer to purchase some default insurance (or increase the PPF levy).

Pure CDC schemes would not attract PPF support because the employer would not have a contingent liability to make good any deficits. Following employer default, closed CDC schemes could, however, give rise to issues concerning the distribution of "bonuses" to members (akin to a closed With Profit's fund); fully transparent disclosure then becomes key.

11.9 Regulating for simplicity

As the shape of the RDR has unfurled, discussions about "simplified" products and "simplified" advice, to serve the mass-market, have come to the fore…..again.

(a) "Simplified" products

(i) Remember Sandler?

Ten years ago Ron Sandler's (now long-forgotten) review called for a "simplified" range of low-cost, risk controlled savings ("stakeholder") products.[262] This was followed by a FSA Discussion Paper (DP19) and Feedback Statement[263]. The latter surfaced a host of thorny issues that ultimately stymied Sandler's attempt to roll out simplified products. They are still familiar today, including:

- promoting sales of simplified products, versus ensuring that consumers are given the necessary protection against losses (flagged by the FSA's own Consumer Panel);
- how much "guidance" may be required and whether such "guidance" would be regulated to the same extent as current "regulated advice"; and
- legal issues; for example, who would be left bearing the responsibility if consumers subsequently suffer investment losses on simplified products?

The commentators of the day concluded that the FSA could not answer these questions satisfactorily, and that further consultation on implementing rules for simplified products would "become bogged down by more finger-pointing and competing interests". The FSA subsequently commissioned some consumer research on the effectiveness of a filtered questions approach to guided self-help for consumers. That was in 2003; since then, little progress has been made in respect of product simplification. It is certainly not on the FSA's agenda: its focus is on preventing bad products being sold.

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[262] The Sandler Review, July 2002. It was commissioned by a government worried about the so called savings gap.

[263] See FSA DP19 (April 2003) and FS19; *Options for regulating the sale of "simplified investment products"*; July 2003.

(*ii*) *Caveat emptor: the case is not clear cut*
Many people are of the opinion that product simplification should be accompanied by the resuscitation of *caveat emptor.* This would be consistent with the prevailing political ethos of assuming more personal responsibility, and would also help reverse the burgeoning "blame culture" whereby investors believe they have a case against their adviser or fund manager if investments perform poorly. But the case for advocating *caveat emptor* is weakened if consumers are encouraged to engage with saving through inertia (be it auto-enrolment or compulsion). *Caveat emptor* could not reasonable apply if, for example, product selection were via an employer-set default option.

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. *Plus ça change*.

(*b*) *"Simplified" advice: confusion reigns*

(i) Impossible to define?
Given the difficulties in defining "advice", it is no surprise that, to-date, there is no agreement on what "simplified" advice is, perhaps because a definition for "simplified" products has yet to be agreed.

The FSA's guidance consultation[264] on simplified advice is unaccommodating, placing almost identical regulatory demands on providers of simplified and full advice. For example, simplified advice delivered through an automated system requires "a QCF Level 4 adviser to be on hand" (what does "on hand" mean exactly?). The FSA has rejected ABI and BBA requests for simplified advice to be subject to lower qualification requirements than under the RDR, and refuses to say what products should be available through a simplified advice process (despite industry calls for it to do so). Even the FOS has said that it will judge simplified advice complaints on the same principles as full advice.

(*ii*) *"Simplified" advice; an attempt at a definition*
It may be easier to define "simplified" advice by describing what it is not. Perhaps it should *exclude* anything that could be mis-sold; thus it cannot be investment-, product- nor provider-specific. This would avoid the prospect of any lingering liability inhibiting the well-intentioned. Alternatively, for at least half the population, it could simply be reduced to "forget about saving and focus on reducing your consumer debt". In this context, "simplified" advice is certainly not about investment selection, pensions or other financial products; it more closely resembles common sense.

[264] Published on 15 September 2011.

11.10 Regulation: the European perspective

(a) Europe: the impact on distribution

(i) The UK is different

The biggest long-term impact of European legislation could be on distribution. IFAs' current dominance the savings and investment market is an oddity within the European context, where banks and insurers dominate the mass market. It seems inevitable that post-RDR, independent and restricted advisers (along with private banks) will converge on a small number of wealthier individuals, leaving the UK mass market open to the banks, in particular. But they may not want it, because the RDR's qualifications and adviser charging proposals could demolish the advice model of a retail bank which focuses on volume sales made by junior staff incentivised by commission. In practice, the future of the mass market is more likely to be in online services rather than the branch-based sales model that exists across Europe, unless there is slippage on the qualification standards for restricted advisers or simplified advice.

(ii) MiFID and PRIPS

Whilst the FSA is doggedly ploughing on with the RDR, Brussels is focused on its review of the Markets in Financial Instruments Directive (MiFID), and related work on disclosure requirements for Packaged Retail Investment Products (PRIPs) across the EU. Both the RDR and MiFID set out to legislate for the protection of investors' rights, and to improve transparency amongst product providers. Whether PRIPs disrupts the implementation of the RDR remains to be seen, but they do share a number of common objectives (including the banning of commission). That notwithstanding, there is a growing concern within the UK that the impact of European regulation is quietly shaping the fundamental structure of the UK's financial services market. For example, the FSA initially intended for a clear demarcation between sales and advice in the earlier versions of the RDR, but was forced to back down because this would hamper the competitiveness of firms operating in Europe.

Previous European initiatives have not fully embraced at least one of the essential principles for rebuilding confidence and trust in the industry. For example, the UCITs IV regulations[265] (effective from July 2011) do not mandate the separation of the cost of advice and the cost of the product. Brussels cannot be relied upon to sort out the industry's ills.

> **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.

[265] Undertakings for Collective Investment in Transferable Securities Directive; the latest incarnation of legislation to harmonise the distribution of retail investment products across Europe.

(*iii)* *An opportunity beckons*

If the UK's pension industry were to embrace MiFID and PRIPs, as well as placing the saver's interests at the heart of what it does, it could build a very successful export sector, based upon them. Certainly, a positive approach towards Europe would help counter the European perception that the Anglo-Saxon finance model led to the financial crisis. Indeed, today this is pre-requisite to UK companies being able to compete internationally.

(*b)* *Solvency II and pensions do not mix*

Solvency II concerns a fundamental review of the capital adequacy regime, and risk management standards, for the European insurance industry. Allied to this, the European Commission is seeking to treat pensions in the same way that it deals with insurance schemes. Its proposed changes to the Institutions of Retirement Provision (IORP) Directive would apply insurance-style funding solvency rules to DB pension schemes, modelled on Solvency II.[266] This is nonsensical because whilst insurers could suddenly face large, unexpected demands on their capital, pension schemes are not exposed to "shock" risks; they pay out over time in a more predictable manner.

The introduction of Solvency II-style measures would lead to significantly higher funding targets and shorter deficit recovery periods for many UK firms. The CBI claims that a typical pension fund liability would be about 10% higher under Solvency II than IAS19, leading to British companies having to inject many £ billions of additional cash into their DB pension schemes. Estimates range from £100 billion (Steve Webb) to £1,000 billion (JLT Pension Capital Strategies), with NAPF (£300 billion), PWC (£500 billion) and JP Morgan Asset Management (£600 billion) somewhere in between. Inevitably, many schemes would close. The Government is well aware of the dire consequences that these proposals would have on DB schemes in the private sector, and is opposing them.

A long transition period for new solvency regulations would provide companies with time to achieve an orderly exit from their DB pension obligations, with limited damage to the UK economy.

> **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.

(*c)* *Solvency II: bad news for annuities*

The introduction of Solvency II-style measures is likely to lead to higher capital requirements on the assets that back annuities, as well as a more stringent stress test for mortality (life expectancy) risk (leading to a higher reserve requirement). Together, these two proposals are likely to push (already very low) annuity rates down, perhaps by 10%, (i.e. 10% lower retirement incomes). The EU gender directive (single sex pricing) and continuing increases in life expectancy are likely to exacerbate the downward trend of the last decade.

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[266] European Commission, Green Paper: *Towards adequate, sustainable and safe European pension systems,* 7 July 2010.

This could prompt the industry to lobby for the state to assume longevity "long tail" risk, i.e. longevity risk above a certain age. This should be resisted for the same reasons that longevity bonds should not be issued (as discussed in Chapter 8).

> **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.

11.11 Conclusion: a new regulatory approach is required

The regulators' traditional focus on regulating the industry, thereby protecting its customers, has patently failed. Regulators need to progress beyond consumer protection, through the stage of consumer understanding and on to the final state of consumer engagement.[267] That requires consumers to trust the industry, but the blunt instrument that is (an ever-increasing volume of) classical regulation is totally unsuited to engendering trust (which is not created *through* regulation).

Furthermore, tinkering with the regulatory environment and structures will not catalyse a savings culture. There is no evidence, for example, that the RDR will increase the mass market's inclination to save. There is, however, abundant evidence that rules do not work; they have failed, for example, to prevent the recent banking crisis.

A new approach to regulation is required, to usher in a period of regulatory enlightenment and innovation. Prudential oversight should be de-emphasised; the industry is drowning under a Niagara of hugely complex rules, at customers' expense: regulators should be prepared to experiment and take risks. Unfortunately, today's regulators are not equipped, neither operationally or culturally, to do this: it would represent a major departure from their traditional (classic public sector) behaviour, which is overly-influenced by self-preservation.

The regulators' role should be redefined, to include a responsibility to proactively ensure that markets work; today the approach is to passively set rules and assume that the market takes care of itself. Regulators should be proactively driving the industry to dramatically improve its efficiency and customer service, pre-requisites for establishing a savings culture.

And if this is not forthcoming, within three years, say, it should be demanded. Either way, the industry needs to evidence a transformational, not incremental, change in its behaviour, in a manner that encourages people to increase the amount they save.

There are three specific themes that the regulators should pursue, all consistent with the pension minister's direction of travel:

(i) much more assertive pension scheme governance, by exerting pressure on trustees to, for example, scale-up their pension schemes;

(ii) the consolidation of individuals' multiple pension pots; and

[267] Consider Maslow's Hierarchy of Needs, progressing from the need for safety and security (akin to consumer protection) through to self-actualisation (i.e. engagement).

(iii) substantially enhanced transparency (across the whole industry, particularly in respect of charges, costs and fees).

Improvements in each of these areas would initiate a virtuous circle, *provided* that lower costs are passed on to customers via lower charges. Savers' assets would then increase, encouraging them to save more, and they would become less cynical of the industry. This would enable it to rebuild trust, and then negotiate down the regulatory burden.

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?"

PART V: THE INDUSTRY

12. The industry should ask itself some tough questions

12.1 Introduction

The industry's high cost base is the consequence of:

(i) opacity and moral hazard (all enshrined in the principal-agent problem);

(ii) its abuse of asymmetric information; and

(iii) ludicrous complexity (notably, products and their allied taxation regimes).

The combination of inefficiency and greed explains the high cost of purchasing financial products. This discourages new saving, as well as excessively eroding existing savings through the compounding of annual charges.

The industry has to dramatically improve the efficiency with which is serves its customers, enabling it to reduce its charges whilst also making a sensible return on capital. This means putting the customer at the centre of everything that it does.

EFAMA[268] has made a start, by asking governments to address the savings challenge implied by demographics (see Appendix VI), but to some extent their appeal is self-serving. Calling for the introduction of compulsory long-term saving schemes would, for example, help cut marketing costs, but there is no guarantee that lower costs would lead to lower charges, as opposed to bigger profits. Furthermore, in requesting help from the state, the industry risks the state taking something in return……such as curtailing tax relief (a form of industry subsidy).

Ideally the initiatives for the necessary reshaping of the industry will come from within; they are more likely to secure industry buy-in and meaningful action. It could make a start by asking itself a few big questions, to help identify misaligned interests (i.e. barriers) between the industry and consumers.

12.2 What is the purpose of the industry?

Companies operating within the retirement savings arena should be encouraged to ask themselves "*why do we exist?*" and "*how do we add value to society, and is this*

[268] European Fund and Asset Management Association (EFAMA); *Revisiting the landscape of European long-term savings – A call for action from the asset management industry*, March 2010.

consistent with our long-term business plan"? Whilst pondering the answers to these questions, companies should bear in mind:

(i) **pension funds' poor** *collective* **real return** (over RPI) to savers over the first decade of this millennium, averaging 1.7% per year.[269] The corresponding figure for the period 1963 to 2010 is 4.3%. Managed funds were particularly bad performers; investors would have been better off staying in cash. Over the same period, money market funds returned 40%, and the average investment trust returned 92%;

(ii) **investors' lack of geographic diversification.** Of the £200 billion held in mainstream unit-linked pension funds, some 85% was invested in the UK. Over the last decade, the developed nations' equity markets delivered a zero real return. Conversely, Asia Pacific and Emerging Markets assets produced an average return of 97% and 233.5% respectively. Together, these two star performers, along with commodities, accounted for only some 1.5% of investors' money; and

(iii) **the poor outlook for western economies**, increasingly burdened by ageing populations.

What if the industry were to define its purpose as being to catalyse a savings culture? This would clearly in its interests (more business), but could have major implications for its identity, values and beliefs (recall Chapter 5). But the real challenge concerns translating any such (new found) purpose into action, notably the pursuit of simplicity, transparency and flexibility, and delivering value. Some people would add "fairness" to this list, but this is perhaps too nebulous a concept to gain traction.[270] That notwithstanding, customers' core values have to be reflected back to them when they interact with the industry.

12.3 What could the industry do to demonstrate that its shares a common purpose with its customers?

The two most substantial answers to this question concern transparency and giving consumers what they want. These are discussed in Chapters 13 and 14, respectively. Industry ownership, personal risk and remuneration are discussed here.

(a) Change the ownership structure?

The retirement savings industry is different to many other commercial activities, because its performance has major implications for the wider community. Excessive charging and prolonged bad investment performance deter people from saving (with adverse implications for investment and UK plc.), as well as contributing to pensioner poverty.

Given this, it is reasonable to question whether the traditional model of shareholder ownership is the most appropriate for some components of the industry. Can the

[269] *IFSL Pensions Markets 2011*; Chart 9.

[270] Dr Andrew Lilico; *On Fairness*, Policy Exchange, February 2011, suggests that "being fair is a special kind of being proportionate, with particular application in respect of equality, proportionality, and desert…Fairness is a technical concept and an ethical consideration."

competing interests of both consumers and shareholders be accommodated without deleterious consequences for the national interest?

(*i*) *Partnerships......personal risk to mollify moral hazard*

Employees are rarely at personal risk, a key characteristic of an industry replete with moral hazard. This could be (partly) tackled by pairing individuals' potential income upside with meaningful potential downside. Traditional partnership structures used to operate on this basis; perhaps they should be resuscitated?

Businesses that are owned by the employees would be highly motivated to address the industry's ills. To be effective, they would have to span the whole value chain, including fund management, distribution and advice, so that employees can pursue quality on behalf of the customers. An obvious model to consider is the John Lewis Partnership's (JLP) ownership structure, an integral component to its success.

Furthermore, partnerships can also be a demonstration of commitment to business continuity. Currently, too many of the younger financial institutions (notably hedge funds and owner-founded boutiques) are solely focused on maximising wealth creation for the founding generation, rather than building a multi-generational business focused first and foremost on the saver.

(*ii*) *Low-profit, limited liability, corporations*

Some industry participants may like to consider the merits of shifting their primary purpose from profit-maximisation to offering social benefits. This is not a new approach; low-profit limited liability corporations are well established in the USA[271] (where they are dubbed "L3C"; the UK-equivalent is the Community Interest Company, CIC[272]).

L3Cs remain for-profit businesses and are economically self-sustaining and animated by a public purpose. Variants of the L3C are "for-benefit" organisations (such as Mozilla, behind Firefox) and the "B corporation". The latter requires the company to amend its bylaws so that it is incentivised to favour long-term value creation with a positive social impact, instead of short-term economic gain; a "not only for profit" business. In the context of the retirement savings industry, this could be very much in the national interest.

(*iii*) *Mutual organisations*

Within the retirement savings arena, Nationwide and Vanguard[273] are probably the best known mutual organisations. They put pressure on the industry but, as independent, competitive and economically self-sustaining organisations, they cannot be legitimately accused of unfairly distorting the market (unlike National Savings for example). But mutuals lack the employee ownership of a partnership, which drives the customer-friendly employee behaviour that is so evident at JLP.

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[271] Vermont recognised L3C corporate status in April 2008, and other states have followed.

[272] A CIC is a legal structure for businesses designed to benefit communities. It is a limited company, not a charity, conducting a social activity; it can have a large membership, pay dividends (subject to a cap) and be floated on the stock market. CICs have to generate surpluses to support their activities, and maintain their assets to be able to continue to make a contribution to the community.

[273] Investor-owned, i.e. it is owned by the funds that are owned by its investors.

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).

With hindsight, the demutualisations of the last twenty years were probably a mistake; it would have been better to convert to partnerships. However, at the time, the rationale for demutualisation and flotation was to unlock value for With Profits investors and provide access to additional external equity capital. The former was a one-off windfall, of no lasting benefit to the broader community; the latter is now achievable without sacrificing mutual status.[274] That said, raising start-up capital for a mutual is not easy, being limited to either the state or philanthropy and endowment.[275]

NEST could be viewed as a state-sponsored mutual, its right to compete with the private sector legitimised by its obligation to repay its start-up loans. If it were to prove successful, NEST could catalyse a drive towards mass mutualisation by expanding its in-house capabilities (notably, investment management). Essentially, by collapsing principal and agent into one, mutuals could cut out some of the intermediary "rentier" agents. Perhaps mutualisation is the only way to genuinely align the interests of principal and agent…..by merging them.

John Swensen's[276] perspective sums up many people's opinion concerning fund management ownership: *"investors fare best with funds managed by not-for-profit organisations, because the management firm focuses exclusively on serving investor interests".*

(*b*) *Performance and reward: wholly misaligned*

Many people are attracted to working in the financial services industry to enrich themselves, not their customers. This mirrors the common perception amongst consumers that the industry epitomises "heads I win, tails you lose", its employees being on a "one-way ticket". The recent bank bail-outs have done nothing to assuage people of this impression (particularly when followed by bonus announcements). Central to this disquiet is the perceived dichotomy between the performance of employees (and businesses), and their remuneration.

(*i*) *Bankers' pay*

Whilst this paper is not fundamentally about the banks, they are a significant part of the financial services industry. In 2009, the *average* pay of investment banking employees at JPMorgan Chase, Morgan Stanley and Goldman Sachs[277] was over $340,000 (up 27% on 2008). Whilst investment bankers are at the top end of the industry's income

[274] For example, by issuing Mutual Ordinary Deferred Shares (MODS) or Profit Participating Deferred Shares (PPDS). MODS count as equity on a mutual's balance sheet but act like bonds. Societies reserve the right not to pay out on them if trading is bad; they can therefore absorb losses. PPDSs convert debt to equity.

[275] Examples include TIAA-CREF (endowed by the Carnegie Foundation) and Commonfund (Ford Foundation).

[276] Chief Investment Officer of Yale University's pension scheme.

[277] In 2009, nearly one thousand Goldman Sachs employees received bonuses in excess of one million dollars.

distribution, in the public's perception they are indistinguishable from the rest of the industry. Indeed, wages in the financial sector as a whole are 60% higher than in any other industry on the planet (US data[278], but mirrored in most countries with major financial centres). How have bankers achieved this, whilst performing activities described as "socially useless" by Lord Turner (since toned down to "economically useless")? People struggle for an explanation, but one is relativity; fees are small when compared to the size of transactions.[279]

Investment bankers' remuneration comes at the expense of their clients, which includes parts of the pensions and savings industry, and consequently *its* customers: millions of retail investors.

(*ii*) *Asset management's rewards*

Some asset managers' ludicrously asymmetrical reward structures suggest that they have forgotten that the customer is providing the scarce resource upon which their business (and livelihood) relies: their savings capital.

Hedge funds and private equity

The managers of hedge funds and private equity funds, in particular, are renowned for taking disproportionately large profits for themselves (as agents), at the expense of their investors (the principals), who are assuming all of the risks. Within the US private equity arena, for example, managers reward themselves with half of the excess returns (profits that exceed a comparable investment in the S&P 500 index).[280] The SEC has now initiated investigations into illiquid asset pricing, and how fees are charged by private equity firms.

Within the hedge fund arena, some investors continue to go along with the traditional "2 and 20" fee structure[281], but they are becoming more demanding about performance. The investor base is increasingly institutionalised, accounting for 65% of hedge fund assets (it was less than 20% in 2003), which is driving consolidation. And although 51% of the investor entities claim to have renegotiated their fees within the last 12 months, the pie is vast. According to investors, hedge funds (globally) can expect a net inflow of $140 billion in assets in 2012, taking total AUM to an all-time high of $2.26 trillion.[282]

Mainstream asset management

The average manager of an active fund earns many multiples of national average earnings (30 times has been suggested), yet the industry receives a tax subsidy of over £30 billion per year. The sheer volume of evidence of systemic market failure, leading to

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[278] US Bureau of Labor Statistics.

[279] For example, a 0.2% fee on a $5 billion bond issue is $10 million. Merger and acquisition (M&A) fees are much larger.

[280] From 1980 to 2004, US buy-out groups distributed to investors $194.2 billion in excess returns, whilst retaining $189.9 billion from fees and profit sharing schemes. *Source*: Chris Higson (London Business School) and Rüdiger Stucke (University of Oxford); *The Performance of Private Equity*, February 2012.

[281] A management fee of 2% of total asset value, plus 20% of any profits earned (usually over a benchmark).

[282] Deutsche Bank; *Alternative Investment Survey*, February 2012.

poor returns for clients and excess rewards to industry participants, justifies a more assertive approach towards controlling remuneration.

(c) *Asset managers' fees should reflect the value added*

Historically, industry has never presented ex-ante to consumers what they can expect; the emphasis has always been on past performance, the proposition being focused on price rather than value. Price is "point in time", whereas value concerns what is delivered in the future.

The asset manager's "value added" is the return he provides in excess of his benchmark. The providers of savings capital should expect to receive the bulk of this, and not pay any fees for returns below it, other than a small "access" price[283], 0.25% say, to cover the cost of the basic service being provided, primarily administration and safe custody of the assets (both are pretty commoditised and automated services).

Currently, the asset-weighted target return in excess of the benchmark, across all asset classes in the UK, is about 2%. Adding the access price raises this to 2.25%. Given that the weighted Total Expense Ratio (TER) for active funds is around 1.56%[284] (assuming no initial charges, which is often not the case), this suggests that nearly 70% of the ex-ante target excess return is being taken in fees. No sensible provider of risk capital should be prepared to accept only 30% of the ex-ante target excess return (and that is *before* factoring in the possibility of the target return not being achieved). But collectively, we do, which suggests that this is a case of market failure (and that consumer behaviour does not drive price).

Dividing the target excess return as 65% to the investor and 35% to the asset manager (via a performance fee) would provide a far higher correlation between price and value added. On this basis, the weighted TER should be reduced to roughly 0.8%, i.e. by around 50%. This implies a halving of asset managers' income, based upon an asset-weighted excess target return of 2.25%.

> **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).

(d) *How will it happen?*

In simple terms, if the industry is serious about quelling public opprobrium, it will have to pay itself a lot less (as well as improve its performance, but lower costs will contribute to achieving just that). Ideally this will happen voluntarily, but failing that, consumer groups, trustees, advisers and scheme sponsors will exert sufficient pressure to bring it about. And, failing *that*, state intervention may be required, but only as an absolute last resort, and notwithstanding that the case for price capping has already been dismissed (Section 8.9).

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[283] Determined as the blended average of 0.3% for equity funds and 0.15% for fixed income funds, biased towards equities as the UK retail market is more equity oriented.

[284] Average TER of 1.56% for active funds. *Source*: IMA Press Release, *IMA analysis challenges accusations of 'hidden' charges,* 27 January 2012.

12.4 Does reputation matter?[285]

(a) Historically, of paramount importance

For most of the last two centuries, a good reputation was a critical asset in finance. It informed those participating in financial transactions, often hard to quantify and characterised by asymmetries of information, of what to expect from their counterparties. Reputation maintenance was of paramount importance, good reputations being hard to acquire and easy to break (and *vice versa* for bad reputations).

The advent of computers meant that much of what had previously been tacit and relationship-based became capable of measurement (as well as creating economies of scale). And as transactional, codified, trading-room businesses became the dominate source of income, bankers (in particular) forgot about the relevance of reputation (the advisory business excepted[286]). Today, many (within the industry) believe that the only real sanctions are legal and regulatory; reputational issues hardly appear to concern them.

(b) It matters to the nation

The industry's reputational decline has contributed to the UK's lack of a savings culture because most people only very reluctantly interact with it. If the experience were enjoyable, it is likely that more people would save more (just as the enjoyment of shopping encourages some people to spend more). That said, some would say that ISAs represent a breakthrough.

Less saving means less investment, as well as lower income replacement rates upon retirement, both of which are economically damaging, and of real concern to UK plc. Thus, the industry's reputation perhaps matters more to the state that to the industry itself. Given that a better reputation would mean more business, one would expect that an industry so driven by self-interest would recognise this, and act accordingly. But this rationale is compromised by the industry's inherent short-termism; reputational redemption would be expensive, and perhaps take a decade to achieve. The prospect of enhanced business a decade hence is insufficient to counter income foregone today.

Leadership from within the industry is required, not least to save the industry from itself. If assertive action (not the mere platitudes seen to date) is not forthcoming, then state intervention (well beyond NEST) becomes an imperative.

Chapter 14 described a series of measures that the industry could take towards restoring its reputation.

12.5 What would make the industry's employees proud to come to work?

Beyond remuneration, what makes people happy at work? Happy employees make for good service, leading to happy customers, so it is worthwhile for stakeholders to understand the drivers behind "proud" employees.

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[285] Based upon an essay by Alan Morrison, William Wilhelm and Rupert Younger; *Investing in Change: The reform of Europe's financial markets,* afme, 2012.

[286] This explains the rise of boutique investment banks, free from the risk of trading room reputational contamination.

Industry participants may like to consider what it is that makes the John Lewis Partnership (JLP) special. Revered as a paragon of retailing, JLP is highly trusted by its customers. The JLP ethos is built around three themes:[287]

(i) **rights and responsibility**. *Every* employee is a partner in the JLP and a beneficiary of a trust. Consequently, employees enjoy a sense of ownership, and care about the wellbeing of the business; they assume a responsibility to improve it. In return, they earn the right to sharing the rewards of success, through bonuses, so they are directly connected to the welfare of the business;

(ii) **relationships.** JLP's purpose is described in its (written) Constitution; "*the happiness of its members is the Partnership's ultimate purpose*". At first sight, one may wonder where the customers fit in, but JLP looks *through* its employees, having realised that a by-product of a happy staff is good customer service. And that makes for a successful business. The JLP culture is one of caring about relationships, both internally and externally (with suppliers, for example); and

(iii) **influence.** Employees are able to influence what JLP does, and management strives to push influence down the organisation via determined internal communication. There is an internal network of branch forums which discuss local issues at every store and then provides feedback through representatives (elected by staff) to the Partners' Counsellor, who sits on the board. Every employee therefore has a possibility to influence the business.

JLP is very good at resonating with people's values and beliefs, and evidence of its brand power was provided in March 2011. Customers and staff were invited to invest in a five year bond issue paying interest at 4.5%, along with a 2% John Lewis voucher. The bonds are not covered by the Financial Services Compensation Scheme (FSCS), are not tradable on a stock exchange and cannot be sheltered from tax in an ISA. Originally intending to sell £50 million, the issue was closed at £100 million.

There are other British examples, including the Unipart Group. In 1987, when Unipart was launched as a private company[288], all employees were invited to participate as shareholders, to ensure that they had an opportunity to shape and share in their own destinies.[289]

12.6 Which parts of the industry are worth keeping?

This question is intended to really challenge industry thinking, and the status quo. The Treasury "invests" (through tax relief) nearly £30 billion each year in promoting retirement saving, and the industry benefits enormously from this. It receives transaction-derived income when tax relief is invested, and subsequently accrues on-

[287] Author interview with Patrick Lewis, Partners' Counsellor, John Lewis Partnership.

[288] Unipart was formerly part of British Leyland, a state-run business notorious for conflict with its employees.

[289] Learning and personal development are now at the heart of Unipart's culture. Unipart runs Unipart U, one of Europe's first corporate universities, offering employees the chance to learn continuously within the workplace.

going annual management charges on the assets purchased with tax relief. Yet the UK is seriously under-saving for retirement, so one could conclude that either the industry is failing to deliver, or the incentives are ineffectively deployed (or, more likely, a combination thereof).

Furthermore, there is little point in 650 parliamentarians, supported by the apparatus of government, legislating to raise tax revenue whilst a significant part of the financial services industry is working against them. To be clear, tax planning is largely about avoiding tax, through arbitrage and exploiting loopholes. It benefits the rich, at the expense of the poor, and is wholly unproductive from the perspective of UK plc. It is very much part of the "socially useless" cohort to whom Lord Turner was referring (although he may not have had them specifically in mind).

12.7 What could the industry learn from Peter Drucker?[290]

Drucker believed that pension schemes should address two key challenges:

(i) they should be designed so that workers are not left to make complex savings and investment decisions on their own; and

(ii) they should be structured so that decisions are made solely in the best interests of plan participants, by arms-length, "expert" organisations.

He identified three requirements for schemes to reduce agency-derived costs (as described in Chapter 2) and Keith Ambachtsheer[291] subsequently added three features to address human foibles (Chapter 3), terming the package The Optimum Super Scheme (TOSS).

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.

TOSS, an idealistic pension scheme structure, combines some of the best features of traditional DC and DB schemes, but without their historical baggage. For example, whilst individual participants have their own investment accounts, TOSS also has a collective element related to the pooling of longevity risk. In addition, there would be an automatic, dynamic, age-based, transparent process of accumulating a portfolio of deferred

[290] The influential writer on management theory and practice, management consultant, and self-described "social ecologist".

[291] Director and Adjunct Professor of Finance, Rotman International Centre for Pension Management (Rotman ICPM). See *The Ambachtsheer Letter # 238; Peter Drucker's pension legacy: a vision of what could be*, November 2005.

annuities over time. As a single-purpose mutual organisation, TOSS would be large enough to enjoy significant scale economies.

12.8 Where is the industry headed: British wire houses?

The biggest challenges facing the industry (after regaining the public's trust in it) are probably cutting costs, and identifying the optimum model for distribution.

One logical response to the RDR would be to integrate asset management, product manufacture and distribution, akin to today's wire house[292] brokerage model which dominates retail financial services in the US.[293] The emergence of (post-RDR) British wire houses, distributing through restricted (rather than independent) tied advisers, is increasingly likely, not least because IFA firms are realising that to control their ultimate source of income, they need to get close to assets and charge on a funds under management (FUM) basis. Indeed, some have already re-branded themselves as wealth managers (the corollary being that they will only offer restricted advice).

The final step could be for these (former IFA) firms to merge with asset managers and product manufacturers. This could result in a leaner retail-focused industry, former IFAs becoming locally-focused "community distributors", i.e. working within their own communities. Such an arrangement should strengthen product quality control and limit the product range, but the latter could give rise to two conflicting effects. Whilst less choice provides less opportunity for consumer procrastination, it could also deter those potential customers who associate lots of choice with healthy competition and transparent value.

It is conceivable that within a decade, distribution will no longer be a major issue, care of auto-enrolment (or compulsion, particularly if auto-enrolment opt-out rates were to reach an "unacceptable" level). The industry's primary focus could then be on the last remaining parts of the value chain: administration, product manufacture, fund management and the provision of annuities (notably the absorption of longevity risk).

[292] The "wire house" term refers to a business ("house") that provides its branches with the same level of high-speed access to information, irrespective of location, using computers. Originally, wire houses offered tied brokers access to proprietary investment products, research and technology, the brokers providing investment advice and order execution (and perhaps research too). More recently some wire houses have merged with their tied brokers, and some brokers have broken away to become independent, led by Charles Schwab with $600 billion of outside investments under custody, and a network of 6,000 independent advisers.

[293] For example, Morgan Stanley Smith Barney generates about $14 billion in net revenue, has 18,500 financial advisers, 1,000 locations worldwide and serves about 6.8 million households.

13. Transparency

13.1 Transparency: in the industry's interests

Many of us are naturally inclined to blame others for our own shortcomings. Consequently, when we wake up to the silent erosion of our capital (often years after a purchase is made), we may feel ripped off. Whether, or not, our sentiments are justified, the industry's reputation is damaged. Certainly, some providers appear to operate business models that rely on customers remaining unaware of the annual compounding of costs and charges.

It is in the industry's interests to help customers fully understand the price choices available to them *early* in the sales process. The key is to improve transparency (i.e. more disclosure), particularly concerning one-off and recurring costs and expenses, accompanied by clear and simple communication.

13.2 Pricing: standardised terminology required

The industry should embrace pricing standardisation, not only to help customers compare prices, but also to help itself; simplification would help lower its own cost base.

(*a*) *"On the road" pricing*

It is currently nigh impossible for retail investors to access a single measure of the all-in ("on the road") price of purchasing and holding financial products. Lack of transparency is part of the problem, as is the challenge of having to comingle annual and one-off costs and charges. Furthermore, calculations of all-in costs involving actively managed funds require an assumption for trading frequency. A standardised method is required, to be adopted across the industry.

(*b*) *The Total Expense Ratio: misleading and inadequate*

Many fund managers refer to their Total Expense Ratio (TER)[294] as a guide to their charges. But the TER only captures explicit expenses charged directly to the fund, principally the manager's annual charge (AMC), plus the annual costs of allied service providers, such as the fees paid to the trustee or depositary, custodian, auditors and registrar. The average TER for active funds invested in UK shares is quoted between 1.56% and 1.66%[295], tracker funds' TERs being about half this.

The TER excludes trading (i.e. transaction) costs, both implicit (primarily the bid-offer spread and perhaps a market impact cost[296]) 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.[297]

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294 The average TER for funds invested in UK shares is 1.66%; *source*: Lipper (a fund data service).

295 IMA press release, 27 January 2012.

296 If, for example, a fund wants to sell a very large volume of a stock, brokers may widen the bid-offer spread, reducing the price achieved. Mere rumours of big sellers create "market overhangs", again forcing prices down. Similarly, a potential large buyer could prompt a price rise prior to any transaction occurring.

297 Calculated as 1.8% (comprising trading costs of 1.35% plus allied administrative charges of 0.45%) on the £406 billion invested that year. *Sources*: FSA and Financial Express, as reported in The Daily Telegraph, 30 July 2010.

The average annual trading costs of an investment fund is quoted at between 1.25% and 1.4%;[298] this, added to the average TER for a retail UK equity fund (1.66%), takes the holding cost to circa 3% p.a. This is two thirds of the 4.5% equity risk premium usually associated with investing in equities rather than UK government bonds, equivalent to nearly £60 billion based on the £1.9 trillion of pension assets under management in the UK.[299]

Clearly the TER is a woefully inadequate indication of the total cost of investing, and a misnomer at the very least; the word "total" takes advantage of most consumers' lack of familiarity with financial products. All the costs and charges that are not charged directly by funds (implicit and explicit) should also be disclosed, perhaps as the Total Cost of Investment (TCI), calculated on the same basis across the industry.

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.

It is acknowledged that determining the TCI of less liquid asset classes and funds is not easy because their bid-offer spreads vary with market conditions. Consequently, such investments should be accompanied by a health warning to this effect.

Any conditional charges, notably performance fees, should also be communicated to investors prior to asset purchase, calculated for a range of standardised (i.e. industry-wide) annual return scenarios (negative return, zero, 5%, 10% etc.).[300]

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.

(*c*) *Multi-layered charges: funds of funds*

Some funds invest in other funds, compounding the annual charges that investors ultimately have to pay. Such "funds of funds" should disclose *all* the charging layers, not just the top one, which could be cosmetically low to attract the unwary.

(*d*) *A few industry initiatives are emerging*

Could it be that the tide is starting to turn? One major company has called for greater transparency on charges, suggesting that all the costs of fund ownership should be included in a new charge, termed the total cost of ownership (TCO).[301] The TOC would include fund, distribution and stock dealing costs, as well as platform administration

[298] Morningstar (1.25%) and Christopher Sier et al; *Complexity and intermediation in equity fund management*, October 2011.

[299] Funds under management in the UK totalled £4.8 trillion (end-2010), including £1.6 trillion of overseas money. *ThisCityUK annual fund management report*, October 2011.

[300] As suggested by Matthew Vincent; *A manifesto for the reform of fund fees*, Financial Times, 13 November 2009.

[301] Gary Shaughnessy, then Fidelity's UK Managing Director, on BBC Radio 4's The Today Programme, 31 January 2012.

charges, so that funds could be compared on a like-for-like basis. Simultaneously, SCM Private launched a similar campaign ("The True and Fair Campaign"), aimed at raising awareness of fund charges

13.3 Disclosure

(a) IMA Disclosure Tables: woefully inadequate

Regulatory changes[302], introduced in 2006, led to more transparency via enhanced IMA Disclosure Tables. The tables enable trustees to analyse *some* of the costs associated with executing trades, the sources and uses of commission payments, sell-side research and other bundled services provided to fund managers by brokers. However, they omit crucial information that is required to determine the full cost of operating a pension scheme, such as the bid-offer spreads on transactions and transaction costs drive by portfolio turnover.

> **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.

(b) Disclosure of fund income, expenditure and risk

(i) Standardisation required

Fund managers should inform their investors of *all* of their sources of income and expenditure derived from the funds in which they are invested, including income from stock lending and portfolio trading profits. The allocation of this income, between investors and fund manager, should also be disclosed, along with any allied risks to which investors are exposed (notably counterparty risk via stock lending).

> **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.

(ii) Volume rebates

Trustees should insist that volume rebates paid by fund managers to distributors (including platforms) are disclosed[303] and, ideally, passed on *in totality* to customers (via their advisers if necessary), who are already paying other distribution charges.

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[302] FSA rules (Policy Statement PS05/9 (July 2005) introduced two important changes: they limited the services that may be bundled into brokerage commissions (only execution and research) and they mandated that fund managers should report the source of these commissions to their clients, i.e. how commissions have been split between execution and research.

[303] Some distributors already disclose the rebates they receives out of fund managers' AMCs, including Fidelity FundsNetwork, which posts the data on its website.

But a bigger question needs to be addressed: given their opacity, should rebates be permitted at all? The FSA is procrastinating on this issue, having originally proposed a ban on fund manager rebates in a March 2010 discussion paper, which was followed by a policy paper[304] announcing a delay (a victim of industry lobbying?), pending more research….and perhaps heralding RDR Mark II. Subsequently (October 2011), the FSA (sensibly) extended its consultation on rebates to life insurers, pension managers and Sipp providers, having realised that banning fund manager rebates in isolation would have led to a market distortion.

Rebates complicate the consumer's experience when interacting with the industry. They introduce opacity and, for example, make it difficult to compare, on a like-for-like basis, the costs of mutual funds with life and pension funds. And they provide an opportunity for less scrupulous advisers to augment their advice fees (or trail).

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.

Some industry participants have already anticipated the end of rebates by introducing platform fees. Hargreaves Lansdown's announcement (November 2011) of new charges surfaced the opacity of rebates because many customers were clearly under the impression that they were getting access to the funds platform for nothing. Whilst not popular with investors, at least the platform fees are transparent.

(c) Publication of Disclosure Tables

All occupational pension schemes (including the public sector's funded schemes, notably the Local Government Pension Scheme, LGPS) should utilise enhanced IMA Disclosure Tables to assess the value for money provided by their fund managers. They should then publish, at least annually, a standard disclosure template detailing *all* the income and costs associated with their schemes, along with portfolio turnover. This would enable scheme members to evaluate trustee (or contractor) performance.

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.

(d) Focus on the future, not on the past

(i) Informing customers

Savers are very interested in the answer to the question "*how much will I get back?*" But the industry never presents an *ex-ante* perspective to its customers; information it is always based upon observations of past performance. Consequently, customers have no yardstick by which they can determine success, so the focus shifts to price, rather than value.

[304] FSA; *Platforms: Delivering the RDR and other issues for platforms and nominee-related services*, August 2011.

The industry should outline what it is aiming to deliver in return terms, on a fund by fund basis, perhaps as follows:

(i) the return it is aiming to deliver after charges (either in absolute terms or relative to a benchmark), and over what timescale; and

(ii) the track record of having met past target returns? If there is none, the firm should be required to state "*we do not yet have a track record of having achieved our target return for customers, and therefore cannot yet give you any evidence that we can achieve our target.*"

This approach could be augmented by enforced comparative disclosure, perhaps presented in graphical format. The percentage achievement data could be akin to a "food labelling" red-amber-green system.

(*ii*) *Industry modelling*

Many within the industry, notably actuaries, are fixated with building over-engineered models, reflecting both their own, and the regulators', misguided love of complexity. These models are almost always parameterised using observations from the past: this data ignores all the possible outcomes that did not happen. Nassim Nicholas Taleb's seminal *Fooled by Randomness* makes much of this point, and his subsequent *The Black Swan: The Impact of the Highly Improbable* elaborates, to demonstrate why risk models have historically failed to foretell many financial crises.

Scenario generators are sometimes employed to counter the bias towards empirical evidence, but this form of (non-empirical) intervention is only as good as the actuaries' imagination.[305] Perhaps a definition of a black swan is anything the actuary missed?

(*e*) *Disclosure for all investors*[306]

There are two broad groups of investors: "retail" (the man in the street) and "sophisticated" (i.e. "qualified", "professional" or "institutional", including pension funds). Regulation offers the latter less protection than the former, on the premise that those working for sophisticated investors are less in need of it. But this misses the point; the people who are actually at risk (the principals), such as pension fund beneficiaries, *do* need protection; they are as vulnerable to information asymmetries as retail investors. Industry employees are agents (pension fund managers, trustees etc.), part of the insider group with vested interests that are not necessarily aligned with those of their underlying clients'. Principals need to be able to hold their agents to account.

Opacity is a particular characteristic of alternative asset-based funds (an area of focus for an increasing number of sophisticated investors), including commodities, hedge funds, private equity and esoteric assets such as forestry, wine and agricultural land. Furthermore, these funds are rarely traded, so market pricing is not as robust as the more conventional bond and equity markets. Transparency, in respect of asset allocation and trading strategies, is resisted by citing "competitive advantage" and "proprietary expertise".

[305] Not something that all actuaries are particularly renowned for. (This risks the wrath of Mrs. Johnson, a lapsed actuary.)

[306] Peter Morris; *So much for sophistication*, Financial World magazine, October 2011.

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

13.4 The labelling of funds

(a) A brief case study: Arch Cru

(i) A personal tale

In September 2007 the author was invited to a "research look-see" (it went no further), on an unpaid basis, at a small fund, but rapidly growing, management company, Arch Financial Products. Arch's business proposition seemed sensible: to focus on "real economy" assets[307], the view being that they are less prone to the vagaries (i.e. price volatility) of mainstream financial markets, as well as the ravages of inflation. Their principal UK distribution route was via Cru Investment Management, which in turn was heavily reliant on IFAs distributing to their own *retail* clients.

Out of curiosity, the author (new to retail financial services) observed one of Cru's marketing events, where a gathering of IFAs (almost exclusively male and aged over 45) were plied with food and drink by pretty girls, in a style akin to a wedding reception. Cru's dangerously exuberant Jon Maguire then exhorted the audience to the virtues of his wares. This was seductive entertainment, this was fun!.......and Cautiously Managed at that, care of the IMA's fund labelling. Perhaps this was soft corruption (*we have given you something, now you give us something back*), as well as an attempt at financial alchemy.

Maguire is a skilful salesman, and many IFAs, no doubt incentivised by the sizeable commission on offer, subsequently persuaded their hapless clients to invest. In total, Cru attracted £400 million of retail money.

(ii) So, what went wrong?

Once the financial crisis began to unfold, in late-2008, nervous investors sought the safety of cash, but found that they could not get their money out of the Arch funds (illiquidity forced their suspension in March 2009).

Serious *cultural* differences is one of the root causes of what became a financial debacle. Culturally, Arch (predominately staffed by mathematicians, physicists, economists and computer scientists) and Cru were clearly unsuitable partners, and this probably hindered communication between the management teams. But equally serious, Arch's staff had backgrounds in wholesale, not retail, markets. Consequently they probably failed to anticipate the volume of investors' exit demands *relative* to their ability to liquidate the funds' underlying assets.

Essentially, Arch's wholesale proposition was naïvely hitched to Cru's retail mind-set, and the combination was unable to accommodate 2008-2009's unprecedented market conditions (Arch was not alone in this regard). In the aftermath of the global financial

[307] Such as agricultural land, asset-backed loans (bridging finance, leases, royalty interests and trade receivables), energy infrastructure, forestry, water and wine.

crisis, the liquidity characteristics of many of the underlying assets changed fundamentally, rendering them inappropriate for retail distribution. This was subsequently confirmed by the FSA, which found that only 12% of Cru's sales were "suitable".[308]

(*iii*) *Compensation*

In mid-2011, a £54 million compensation package was agreed between the FSA and the institutional counterparties that lent (i.e. sold) their names to Arch Cru. These include BNY Mellon and HSBC Bank (acting as depositaries), and Capita Financial Managers. Capita were the Authorised Corporate Director for the funds, responsible for administration and oversight, thereby guarding investors' interests. Unfortunately, the latter are likely to be left nursing significant losses, not to mention unquantifiable angst. Mr Maguire subsequently went on to sell fish and chips in Bristol.

Meanwhile, the Arch Cru saga continues. Although Capita is regulated and authorised by the FSA, it has not been declared in default, so investors cannot claim on the Financial Services Compensation Scheme. Furthermore, investors cannot readily pursue some of the IFA firms for redress, as they are no longer trading. As for all the IFAs involved, they should be asking themselves why the Arch Cru funds were marketed in the UK as Cautious Managed, whilst they were marketed in Guernsey as "only suitable for sophisticated investors".

Arch Cru has, ultimately, damaged the reputation of every stakeholder in the savings business, including administrators, advisers, auditors, distributors, fund managers, regulators, trade bodies and…..investors themselves. The FSA is, at best, complicit through its inaction, and the whole affair has done nothing to advance the cause of self-regulation.

(*iv*) *The bigger picture*

Only a minority of IFAs succumbed to Cru's charms: at around the same time the author raised his Cru concerns with several senior IFAs and received a very clear message: avoid.

But the Arch Cru story raises much bigger questions than those specific to the behaviour of either Arch or Cru. Many remain unanswered today, notably concerning the culture and independence of IFAs (further discussed in Chapter 14), the extent to which advisers are responsible for what they sell (or does *caveat emptor* apply?*)*, who is standing up for the interests of the end investor, and whether the IMA bears *any* responsibility for the plight of Cru's ultimate clients, the IFAs' clients?

Indeed, the All Party Parliamentary Group looking into Arch Cru has picked up on this, as has the FSA: *"IFAs who gave "unsuitable" advice on Arch Cru often relied too heavily on Investment Management Association categorisations to determine if the funds were suitable for clients".*[309]

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[308] After reviewing 179 files from 24 firms, the FSA found only 22 sales which it considered suitable. One in ten sales were "unclear" and 140 sales were the result of "unsuitable" advice. Of the latter, 93% had mismatched the consumer's risk appetite and the risks of the fund itself.

[309] Clive Adamson, Director in the FSA's supervision division, interview with FTAdviser, 9 May 2012.

(*b*) *The IMA: unwitting partner?*

(i) Labels: open to mis-interpretation

Many of the Arch Cru funds (and others) carried the IMA label of “Cautious Managed”. 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” to imply “low risk”. And Cru’s marketing machine (and other distributors’, including IFAs) harnessed this to maximum effect, thereby rendering the IMA unwittingly complicit in the predicament that Cru’s investors find themselves in today.

Following widespread complaints, in mid-2011 the IMA scrapped its Active, Balanced and Cautious Managed fund sectors and re-labelled them A, B and C. The IMA’s website stated that the sectors are designed to help distributors find the best funds to meet their clients’ investment objectives. How “A, B and C” were intended to achieve this is a mystery; they did not even describe the assets in the funds. In late-2011 the IMA finally woke up to just how meaningless their ABC sector differentiation was, and moved in line with the ABI on Managed sectors.

Table 13: Evolution of IMA sector labels

Old label	Interim label	Label from January 2012
Active Managed	A	Flexible Investment
Balanced Managed	B	Mixed Investment 40-85 per cent Shares
Cautious Managed	C	Mixed Investment 20-60 per cent Shares
-	D	Mixed Investment 0-35 per cent Shares

It has been suggested that the IMA changed its labelling because of litigation fears[310]; it is certainly extraordinary that the IMA has not been labelled “culpable” in respect of the Arch Cru saga. That notwithstanding, the latest labels are, to the layman (i.e. almost everyone), utterly confusing. 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).[311]

(*ii*) *The IMA should not be labelling funds*

The labels can be debated, but the key issue is whether the IMA should be involved *at all* in the categorisation of funds. This is a role extension well beyond what is ordinarily considered a conventional remit for a trade body, which is to represent the interests of its members. Given that the industry’s interests are not always aligned with savers’ and investors’, the IMA’s involvement is contentious because it is financed by the industry. The most prudent position for the IMA to adopt would be to disengage from labelling funds.

310 John Chatfeild-Roberts of Jupiter Asset Management, speaking at a roundtable event, London, 22 February 2012.

311 Based upon analysis by Money Marketing magazine.

(*iii*) *The future of fund labelling*

Before deciding *who* should label funds, a body representing consumers' interests, and independent of the industry, should seek to answer some key questions, including: what are fund labels for?; who is the intended audience?; and (fundamental), who should pay? Considerations should include what consumers and advisers really want to know about a given fund, and an assessment of how other countries address the issue.

Given that some technical capability is likely to be required (particularly if an assessment of risk is involved), candidates (for at least facilitating the process) could include a professional body such as the Institute and Faculty of Actuaries. The rating agencies would not be appropriate, not least because they risk being perceived as quasi-regulators (and over the recent financial crisis their record has been poor).

> **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.

13.5 The value of analysis

(a) Public sector funded schemes

Historically it has proved very difficult to obtain sufficient information to analyse pension schemes in detail, including schemes in the public sector, as Mark Abrahamson and Professor Tim Jenkinson have discovered. They experienced years of obstruction (their Freedom of Information requests for IMA Tables were denied), and finally resorted to appealing (successfully) to the Information Commissioners. Access to private sector schemes' data is perhaps even more difficult, because they are not even subject to the Freedom of Information Act.

Abrahamson and Jenkinson found that whilst average commission rates have fallen, this apparent consumer triumph was extinguished by the revelation that trading volumes had increased significantly. Total commission payments to brokers more than doubled between 2003 and 2007, care of boosted portfolio turnover, which *tripled* over the four year period.[312] If nothing else, this suggests a huge failure of governance (and the governance of the LGPS is certainly shambolic).[313]

Others have quantified the cost of excessive trading by funds in which UK private sector pensions schemes are invested. One report suggests that UK pension funds have an average portfolio turnover of 128% each year (i.e. holdings are kept for an average of just nine months). This adds 0.7% per annum in undisclosed costs, totalling £3.1 billion in

[312] Based upon analysis of 1178 IMA Disclosure Tables relating to public sector pension funds. See Mark Abrahamson and Tim Jenkinson, Saïd Business School, Oxford University; *Does transparency overcome conflicts of interest? Evidence from investment managers and their brokers*, March 2009.

[313] See Chapter 10 of *Self-sufficiency is the key: addressing the public sector pensions challenge*, Michael Johnson, CPS, February 2011.

hidden annual charges.[314] The cumulative effect of this, over 20 years, would be to shrink retirement pots by up to 15%.

(*b*) *Reduction in Yield: misleading*

Fund managers also provide the Reduction in Yield (RIY), which includes upfront charges, but this omits the implicit transaction costs and assumes that investments are held for ten years and return 6% per annum. In practice, few investors hold the same assets for that long; the average holding period on the major stock markets is about eight months. Furthermore, the return assumption is excessive (particularly in the context of the last decade). Consequently, declared RIYs are often far lower than what investors actually experience (which is typically 2% per annum, and higher for those who "churn" their assets, i.e. exhibit low persistency).

(*c*) *Data analysis is just the beginning*

Data analysis can allude to a comprehensive governance failure, but it has its limitations. It does not, for example, surface in our consciousness the innocuous nature of the AMC charging mechanism, which compounds over decades to do so much damage to the size of pension funds (at retirement). This is primarily because the AMC is deducted directly from the funds. If it were to be charged directly to scheme members' bank accounts, so they experience the cash outflow, they would probably become more aware of it, and then exert pressure on pension schemes to negotiate lower fund management charges.

[314] SCM Private analysed 1,287 individual pension funds comprising £392.5 billion of assets; see *Research into dealing activity and costs of UK individual pension funds*, November 2011.

14. Give customers what they want

14.1 Mutual trust

(a) Important, but not paramount

Many in the industry believe that rebuilding trust as the key to revitalising customer engagement. This is important, but not fundamental. There is evidence to suggest that trust is not a motivator when "purchase" decisions are being made; for example, in the aftermath of the UK's 2008 banking crisis, the number of deposit accounts at RBS *increased*. This was in spite of the bank's plummeting share price and the adverse publicity surrounding its former CEO (and before state intervention).

One explanation for RBS's deposit inflow is that many people trust companies purely because of their size.[315] Amongst insurers, Aviva (including Norwich Union) is relatively well trusted, but those surveyed are unable to identify why they favour Aviva, other than it is very big. This is not surprising; most people know absolutely nothing about insurance companies. Within the financial services arena, mutual organisations and co-operatives, which one might expect to do well in the trust stakes, are disadvantaged by their relatively small size.

To many people, this surprising, and it contradicts a survey of "net favourability" of 31 players in the financial services sector.[316] This concluded that when it comes to engendering trust, personal contact is viewed very positively. Small businesses came out top (+77%), with the European Parliament at the bottom (at negative 53%, perhaps reflecting its remoteness from people's day-to-day experience), investment banks (negative 46%) being in penultimate place.

Research also shows that what people say impacts their assessment of trust is often different to what actually drives their opinion. Bank bonuses are highly discussed, but they have not shaped opinions. The drivers of trust in the financial sector are associated with security (perceived as linked to size) and peace of mind. Perhaps, in respect of winning trust, the ideal position for a financial institution is to be big and offering a personalised service, preferably face-to-face….which is expensive to deliver.

(b) Catalysing demand is the key

Resurrecting trust between the industry and consumers will not, by itself, rectify our lack of a savings culture; the bigger issue is consumers' lack of *demand* for retirement savings products. In practice, companies try to harness trust as a mechanism to gain competitive advantage over rivals, targeting consumers who have *already decided* they want to buy something.

Widespread customer demand would indicate the existence of a savings culture. It would obviously benefit the industry, not least because pro-active engagement from customers would enable the industry to reduce its marketing costs.

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[315] Future Foundation research into purchase decision-making.

[316] TheCityUK asked people to indicate the extent to which they have a favourable or unfavourable view of people and organisations.

14.2 Less choice please

(a) Too much choice helps no one

In the UK there are some 6,000 retail funds (including some 2,000 unit trusts and OEICs), more than 200 fund managers and more than 300 insurance companies vying for investors' attention. Savers are therefore faced with over 360,000,000 combinations to choose from; effectively an infinite universe. It is little wonder that they are confused, which provides a ready excuse to procrastinate….and do nothing.

This helps no one, not least the industry, because excessive choice is expensive to provide. It leads to high marketing costs as distributors vie for investors' attention, ultimately hitting investors' returns, as well as adding to operational complexity. But we cannot legislate to reduce choice.

Providers have to be encouraged to reduce their product range through other means, perhaps starting with reminding them that Tesco sold a lot more jam after narrowing its range. Across Europe large distribution businesses (mainly banks) have aggressively sought to manage complexity (thereby cost), and risk, by restricting the range of products they sell. Santander, for example, shut down its open architecture platform in favour of just 18 fund managers across Europe. Denmark's ATP, which is behind NOW Pensions (a NEST competitor), takes choice to an extreme, by offering its customers only one fund[317], i.e. no choice….which certainly has the merit of simplicity. ATP justifies this by referring to their experience elsewhere, that 95% of pension scheme members choose the scheme's default investment strategy. Many other providers have yet to recognise that if choice were narrowed, they could sell more. A leap of faith is required.

(b) Default funds

Default funds reduce the need for decision making (which invites procrastination), by receiving contributions without employees having to select a specific fund. Usually this is done by the employer (with third party advice), but some schemes allow employees to opt-out and choose for themselves. The underlying objective is to select benevolent outcomes for passive citizens (perhaps exemplified by the organ donation scheme).

Thus default funds serve employees who appreciate that retirement saving is important, but who may have no idea what to then do. They can also be used for complete non-engagers; irrespective of the efforts of government, industry and corporate scheme sponsors, some people will not engage with retirement saving, even if employer contributions are on offer.

(i) Australia leads the field: MySuper

Australia is a well-known exponent of default funds. Of the 12 million Australians who hold a superannuation account, some 80% have their employers' compulsory superannuation contributions paid into a default fund. This system was reviewed[318] in

[317] This has three underlying funds (a managed diversified growth fund, a retirement protection fund and a cash protection fund); asset allocation between them is adjusted as individuals approach retirement ("lifestyling").

[318] The Super System Review (chaired by Jeremy Cooper, report dated 30 June 2010), looked at the governance, efficiency, structure and operation of Australia's superannuation system. The Review examined measures to remove unnecessary costs and better safeguard the retirement savings.

2009-10, resulting in a resolve to replace the current default fund arrangements with "MySuper" (from July 2013). This is a simpler default product offering a single, diversified investment strategy at a standard set of fees. Costs will be lower, partly because of the attention paid to making the processing of everyday transactions easier, cheaper and faster (using "SuperStream", further discussed in Section 14.3b).

MySuper reflects the Australian Government's recognition of reality, that "most consumers do not have the interest, information or expertise required to make informed choices about their superannuation".[319] In the UK, 70% of schemes have at least 70% of members in the default investment option.[320] With the onset of auto-enrolment, the DWP has issued guidance for default funds, recognising the likely increase in their popularity, and the importance of getting right their design, governance and communication.[321] NEST could become the leading exponent of a default fund in the UK (NEST is discussed in Section 7.2.2).

Default funds do have their limitations, not least because they are vulnerable to endless debate concerning the "ideal" asset composition, there being, of course, no correct answer. Default funds could be interpreted by some employees as a recommendation of suitability (hence the need for Proposal 45 concerning a safe harbour for sponsoring employers). And if the FSA were to define a set of default fund criteria, this would further help protect employers, essentially giving them "permission" to act.

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.

(*ii*) *Target-date funds*[322]

Most consumers are unlikely to be *demanding* target-date funds, not knowing what they are, but they may appeal given that they reduce the need to make decisions. American corporate sponsors, in particular, direct their employees to target-date funds, as does NEST's default fund. One downside of target-date funds is that they are inflexible so, for example, they could not accommodate an individual who subsequently changes his mind about his target retirement date. In addition, they can give rise to false expectations if, for example, the target date were to coincide with weak market conditions.

(*iii*) *"Lifestyling"*

The default option in DC pension plans often uses a "lifestyle" investment structure. Savings are initially invested in higher volatility, riskier "growth" assets (such as equities)

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[319] ibid.

[320] Punter Southall Group; *DC pensions in the UK workplace: corporate DC survey results,* March 2010.

[321] DWP; *Guidance for offering a default option for defined contribution automatic enrolment pension schemes,* May 2011.

[322] Funds are managed to a specific target date for retirement, contributions initially being fixed. Periodic checks are made to ensure that the saver is on track to accumulate the target asset pool by the specific future date, and contributions are amended accordingly.

to mitigate inflation and longevity risk. Subsequently, perhaps five to seven years prior to planned retirement (and anticipated annuitisation), the asset allocation gravitates towards liability-matching (following a "glide path"). Investment risk is then progressively reduced by switching out of equities into less volatile cash and bonds.

"Lifestyling" is not, however, without its drawbacks:

- de-risking, via equity divestment, is triggered automatically, irrespective of prevailing market conditions;
- it fails to take into account members' "human capital": their career salary profile, attitude to risk, and preference for current versus future consumption, as well as their financial wealth; and
- it operates under the assumption of a predetermined retirement date, which is increasingly unlikely to reflect reality (not least because of the abandonment of the Default Retirement Age (DRA) and the relaxation of the rules concerning annuitisation).

Fund managers (ideally encouraged by trustees and paternalistic employers) should recognise that the optimal default strategy no longer resembles today's one-size-fits-all "lifestyle" structure; it needs to be modernised. The switch to low-growth assets could be delayed until well after "normal" retirement age, and by being invested for longer (i.e. delaying the pension), retirement incomes would, of course, then be larger.

Lifestyle funds could also become more tailored to individual circumstance. They could take into account "human capital", behavioural biases (such as loss aversion) and prevailing market conditions, albeit all at the price of additional complexity.

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.

(c) An industry insight concerning choice

The industry's perspective on choice is confusing. Whilst Hargreaves Lansdown trumpets the virtues of providing its SIPP investors with more than 2,000 funds to choose from, two of the world's leading investment banks take precisely the opposite view when it comes to the retirement savings of their own employees. A reduction in choice, and a preference for passive management (further discussed below), are their key messages.

(i) Morgan Stanley

In late 2011 Morgan Stanley sent its DC pension scheme members a letter in which it referred to as *"one of the most significant amendments to the range of options in a number of years. The Trustee has made these changes after careful consideration."* The letter tells members that the number of funds available to choose from is to be reduced to 16 (globally). In addition, it strongly nudges (shoves?) members towards passive funds (8 of the 16 are index-tracking funds). The letter reflects two main initiatives: *"the Trustee believes that in developed markets, low cost passive funds may be more appropriate for members than higher cost active funds......The Trustee also believes that this will make the investment choice simpler for members...."*

(*ii*) Goldman Sachs

Goldman's employee DC scheme *offers a total of 29 funds, well over half of which (18) are passive, with an average Total Expense Ratio (TER) of only 0.24%. The 11 actively managed funds have an average TER of 0.9%.*

(*iii*) Conclusion: hypocrisy?

Morgan Stanley and Goldman Sachs preach to their clients the virtues of greater choice and customisation, i.e. greater cost and complexity. Yet, when it comes to the *pension plans of the*ir own employees, these "virtues" are eschewed, the trend (now well established in the US) is very much towards offering employees fewer funds to choose from, with a preference for passive management (i.e. index funds).

14.3 Lower costs

(a) Favour passive fund management

(i) Introduction

John Bogle, the founder of Vanguard Asset Management and doyen of passive fund management, has a mantra: "costs matter". But, as he points out, mutual fund fees in the US have increased from 0.54% (1960) to 0.86% (2009), in spite of the advent of labour-saving technology.[323] In the meantime, Vanguard has become the world's largest exponent of (low cost) passive funds, and is now making inroads into the UK market.[324]

In the UK, at the inception of the unit trust sector (in the 1930s), annual fees were fixed by regulation at 0.5%. They are now typically 1.25%[325], yet the funds are far larger today. Given that the costs of managing them should reduce, not increase, *pro rata,* this suggests that the benefit of scale economies are not being passed on to customers. To-date, the industry has "got away with it", partly because the erosion of capital, care of compounding costs, happens slowly and over a long timeframe. It is also hard to quantify something that is missing and unobserved.

(*ii*) *Few active fund managers consistently beat their own benchmark*

Active management of a fund relies on the belief that through investment research, a fund manager can identify the securities that will subsequently outperform a benchmark index, after deducting his fees and the extra trading costs. Data suggests that the probability of the average active equity fund manager outperforming his own benchmark over three successive years is around 5% (Figure 13). Thus there is a 95% chance that he will not beat his own benchmark for three successive years.[326]

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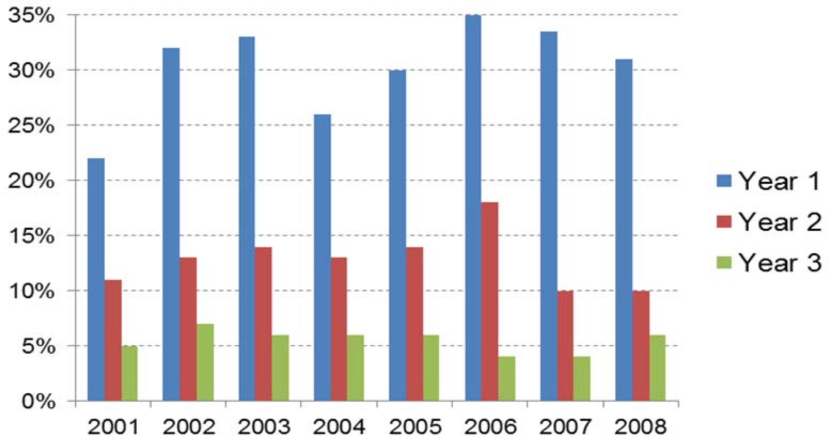
[323] John C. Bogle; *Don't count on it*, 2010.

[324] In December 2011, twelve Vanguard trackers (equity, fixed-income and blended sectors) became available to retail investors via Hargreaves Lansdown's Vantage platform.

[325] *Costs and charges in unit trusts*, Alistair Blair, RSA 2008.

[326] Source: Morningstar, Bloomberg, BlackRock. Data as at 31 December 2010. With thanks to Gina Miller of SCM Private.

Figure 13: Probability of a fund manager outperforming his own benchmark over 1, 2 and 3 years



Certainly, no one is able to accurately predict *which* fund managers will perform best over future decades (the timeframe for retirement saving). Thus, an investor looking to benefit from active management requires an ability to periodically switch managers: consistently getting the timing right is nigh impossible.

The average UK investor in actively-managed funds has to be satisfied with doing worse than the market, the difference being the charges paid to the industry. The marketers reframe this reality by adopting the lottery language of conditionality, the suggestion being that you *could* be amongst the winners. This is supported by “evidence” pertaining to past performance, usually expressed over whatever time period best suits the purpose, and the “star quality” of the fund manager. Hedge funds, for example, sell themselves on their ability to outperform markets, facilitated by their smarter investment strategies and superior modelling skills, and accompanied by a self-manufactured aura of guile and mystic. Suave addresses are intended to hint at success but, by and large, the evidence does not support these subtle suggestions.

As an aside, Peter Drucker, and Keynes before him, was profoundly sceptical of the institutional investment processes he observed, notably the futility of fund managers trying to outperform each other in a giant zero sum investment game.

(iii) Asset class performance: inconsistent

Aside from the challenges of selecting fund managers, investors have to choose which asset classes to opt for. Indeed, over the long term, this is likely to have a larger impact on returns than specific manager or fund selection. Table 14 shows the annual returns on mainstream indices.

Given that it is not obvious which assets classes (or indices) to pick, nor exactly when, diversification is key. Consequently, actively switching from one asset class to another is likely to be a futile exercise (as well as racking up transaction costs); there is little point in paying for an active manager to do this. This suggests opting for passive funds, spread across a range of asset classes.

Table 14: Mainstream indices: £ returns, % p.a.[327]

Index	2006	2007	2008	2009	2010
FTSE All Share	16.8%	5.3%	-30.0%	30.1%	14.5%
FTSE British Government All Stocks	0.7%	5.3%	12.8%	-1.2%	7.2%
FTSE World Europe EX UK Index	20.1%	15.7%	-24.0%	20.1%	5.8%
IPD UK all property	18.1%	-5.5%	-23.0%	2.2%	14.5%
MSCI Emerging Market	15.9%	37.0%	-35.0%	58.9%	22.6%
S&P 500	0.9%	3.1%	-13.0%	11.8%	17.9%

(iv) Portfolio turnover erodes returns

Analysts[328] are increasingly comparing the post-costs performance of active and passive funds by taking into account the impact on returns of different Portfolio Turnover Rates (PTR).[329] Many are concluding that, usually, active fund management is not worth paying for, relative to investing in passively-managed funds. The damage (to a fund's value at retirement) is caused by years of annual compounding of the higher costs of active management….leading to significantly smaller retirement incomes. Table 15 illustrates the reduction in return ("performance drag") of different rates of fund turnover, for a variety of investment strategies.

Table 15: Performance drag due to portfolio turnover (% p.a.)[330]

Turnover	UK Large Cap	Balanced fund	Global Equities	Emerging Markets	Multi-Manager
10%	0.2%	0.1%	0.2%	0.8%	0.3%
50%	0.9%	0.5%	0.8%	3.8%	1.3%
100%	1.8%	1.0%	1.7%	7.6%	2.7%
200%	3.1%	1.9%	3.0%	11.0%	4.9%

Thus, for example, an emerging markets portfolio that is turned over completely in one year (i.e. 100% turnover) typically experiences a reduction in return of 7.6%. A Lipper survey found that the median turnover for actively managed equity funds was 58%, reducing the annual return by between 0.55% and 0.75%. US research has shown a positive correlation between high turnover and poor performance; less UK data is available to investigate this relationship, but there is growing evidence of a similar correlation. The UK has £2.1 trillion of assets invested in funds and other investment portfolios. With an estimated average turnover of 60% per annum, the resulting drag on performance is costing those funds and portfolios a staggering £29.4 billion per year (1.4% of assets).[331]

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327 *Source*: Financial Express Analytics.

328 Notably Roger Ibbotson, Professor of Finance at Yale School of Management.

329 The PTR of a fund measures the amount of trading activity within the fund over the 12-month accounting period. It is an indicator of the level of trading costs that a fund is incurring. The FSA requires collective investment schemes to calculate their PTR.

330 Data (pertaining to 2009) sourced from Frontier Investment Management.

331 Siers et al; *Complexity and intermediation in equity fund management*, October 2011.

Alarmingly, turnover rates are increasing, which may, or may not, be correlated to any downward pressure on commission rates. For example, the average holding period of US equities fell from seven years in 1940, to two years in 1987, and seven months in 2007.[332] We have already seen that the turnover of the UK's LGPS funds *tripled* between 2003 and 2007.

It is time that savers and pension fund beneficiaries exerted some control on portfolio turnover, to limited the allied transaction costs. The question is how. *In extremis*, trustees could, for example, insist that fund managers cap annual portfolio turnover at 25% (say). It is accepted, however, that any limit on turnover would be, at best, arbitrary. A perhaps more palatable alternative would be that trustees demand that fund managers be completely transparent about what they are aiming to deliver and how much the

> **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.

(v) Tracker funds

Since 1990, the average fund within the UK All Companies sector has underperformed the FTSE All-Share trackers (i.e. passive funds) by around 0.75% a year. The difference is explained by comparing the sector's typical AMC of 1.25% with the cost of tackers (which can be as little as 0.1% a year). Ignoring funds' typical initial charge of 4% to 5% (trackers have no initial charges), they still have to outperform by up to 1.15% to cover the cost difference.[333]

That said, some institutional investors use their buying power to negotiate the AMC down to perhaps 0.625% (and no initial charge). This leaves the average active manager outperforming the FTSE All-Share Index by around 0.07% a year, i.e. no meaningful benefit relative to tracker funds.[334]

Furthermore, unlike active funds, there is significant price competition amongst the providers of passive funds. Low cost FTSE All-Share trackers include HSBC's, with a Total Expense Ratio (TER) of 0.28% and Fidelity's MoneyBuilder UK Index fund with a TER of 0.3% (including a 0.1% AMC). Hargreaves Lansdown's SWIP FTSE All-Share index fund has a TER of 0.11% per annum, but once the £2 per month platform charge is added, the cost rises to 0.59% for a £5,000 investment (illustrating just how mis-leading the TER is to the layman). This is four times the cost of some US trackers, where low-cost passive fund management, led by Vanguard, dominates the market. Within the equity sector, funds boasting TERs of 0.1% or less attracted $311 billion (83%) of the $376 billion of total positive inflows over the last decade.[335]

[332] Bank of England.

[333] Analysis by Equilibrium Asset Management, as reported by Citywire, 31 December 2011.

[334] It is different in some other sectors; for example, in Japan and Europe the average active fund seems to outperform.

[335] Morningstar data.

(*vi*) *Active versus passive management: conclusion*

In most cases, fund managers do not consistently beat their benchmark indices, once all the costs derived from active management have been deducted. And because it is very difficult to identify when to switch between fund managers (ahead of them doing well, relative to other fund managers), private investors are better off using passive funds, including "index trackers".

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

Perhaps the last word should go to Warren Buffett. *"By periodically investing in an index fund, the know-nothing investor can actually out-perform most investment professionals".*

(b) Industry collaboration, to reduce costs

If every industry participant were to identify which of their activities did not enjoy some form of competitive advantage, they would quickly discover areas where collaboration with competitors could be mutually beneficial.[336]

Administration is an obvious area to look at, perhaps by an industry-wide forum with consumer representation. It could start by considering all facets of scaling up (including multi-employer shared services) and administering products in packages (including different types of insurance, holiday pay, contribution processing, etc.), rather than individually. Any review should also take a hard look at the Australians' SuperStream proposals, a package of measures designed to enhance the "back office".[337] The review started by identifying significant costs imposed by existing administrative processes, including the excessive costs and complexity arising from manual processing of both money transfers and data, the lack of standardised formats, and poor and incomplete data. It went on to make proposals to:

- improve the quality of data, introducing common data sets for contributions, rollovers between funds and benefit payments, and standardising the manner in which absent data is addressed;
- standardise forms;
- allow the use of tax file numbers (TFNs) as the primary account identifier (the UK could use National Insurance Numbers). The key is to ensure there is a robust identification method in place;
- encourage the use of technology to improve processing efficiency, with an view to making electronic transactions mandatory; and
- improve how fund-to-fund rollovers are processed, and the way contributions are made.

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336 As an aside, if a business were to discover that it has few areas of competitive advantage, it is likely that either its customers are not receiving value for money, or that its shareholders' expectations are not being met (or a combination thereof).

337 SuperStream emerged from the Super System (Cooper) Review, 30 June 2010.

Crucially, the benefit of the administration savings should flow through to scheme members, in the form of lower fees and charges. The Australians expect the industry to save up to A$1 billion per year.[338]

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

14.4 Simple products

(a) In everyone's interests

For decades, the industry has been producing increasingly over-engineered and complex products, the demand for which is often imagined. The motive is higher fees, but in practice, sales have suffered as the industry has become disconnected from the needs of the mass market (i.e. most people). Pensions, for example, have not been a consumer-led product, not least because, in what was a DB world, many scheme members were simply not interested. But with DC now dominant, this is changing, and people increasingly want to understand their pension arrangements.

The pursuit of simplification (and standardisation) runs contrary to the industry's natural instincts but, contrary to perception, not necessarily its interests. Simplification also requires overcoming man's innate talent to over-complicate (albeit perhaps intellectually satisfying). Recently, however, industry chatter about "simplified" products has become louder, but it is still unclear what a "simplified" retirement savings product looks like.[339] This is partly because the industry feels conflicted, fearing simplification to be a precursor to lower charges. But it could result in a higher volume of sales; perhaps a leap of faith is required?

Furthermore, product simplification lessens the need for financial education; indeed, simplicity trumps education. If the industry were to place an emphasis on simple products, in essence selling benefits rather than complex products, it could then spend far more on advice and client follow-up.

In the meantime, the FSA has been of little help; its focus is on preventing bad products being sold. If simple pensions products were to be formally defined, perhaps they could be eligible for a nudge from the state, in the form of additional tax relief, at the expense of more complex products?

(b) Accept that ISAs make sense

ISA are hugely popular, not least because pension products' inflexibility renders them of little interest to Generation Y. In addition, the ISA brand enjoys a trust advantage over pension products and, unlike pension income, ISA draw-downs are free of income tax. In 2010-11, £53.9 billion was subscribed[340] to ISAs, taking the accumulated total to £385

[338] An Ernst & Young estimate.

[339] One suggestion is that a simple product has a single premium with a small initial £ charge. Something with a % initial charge plus an annual charge in £ (rather than %) with a limited range of investment options and no guarantees is *not* a simple product.

[340] ONS; *Individual savings accounts Table 9.4*, October 2011.

billion.[341] Personal pensions only attracted £14.3 billion, marginally less than the previous year and, for the first time, less than was invested in Stocks and Shares ISAs (£15.8 billion, up 26% on the previous year).

Although ISAs are not explicitly sold as a retirement savings product, many savers, particularly basic rate taxpayers, retain their ISA assets for many years, and come to consider them as a flexible form of retirement saving.

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.

(*c*) *Mortgage offset current accounts*

Offset current accounts remain one of the very few "good" retail financial products. Any credit balance is automatically used to reduce mortgage debt, thereby reducing the interest paid. The effect is to reward positive cash balances with an interest rate equivalent to the mortgage rate, paid gross (i.e. free of interest income tax): a far better return than that offered by any conventional bank account. If mortgage lenders want to meaningfully demonstrate that they are putting their customers first, they should offer to credit their borrowers' current and savings account balances against any outstanding mortgage. Such an initiative would, however, reduce industry profits.

14.5 Saving: it should be convenient

Weak distribution is the Achilles heel of much of an industry that is struggling to reach, efficiently, an audience fragmented by age, income and communication preference. The highly PC-literate, younger generation (with relatively small sums to invest) are comfortable with online distribution. But most older consumers prefer face-to-face contact, particularly when purchasing a complex product…..but this is expensive to deliver. Successive reorganisations of distribution have been driven by cost cutting objectives, rather than meeting customer need, and direct sales forces have come and gone. That said, a few life insurers (including Aviva[342]) are now rebuilding their direct sales forces.

Many consumers would like to see the emergence of nimble new entrants to the distribution arena, unencumbered with expensive legacy issues.[343]

(*a*) *Supermarkets*

Supermarkets are conveniently located, more trusted than banks, and keen to enter the financial services arena. If they were to offer deposit accounts, they could, for example,

[341] ONS; *Individual savings accounts, Table 9.6*, September 2011.

[342] Reportedly to service middle-market clients following (an anticipated) sharp drop in IFA numbers, post-RDR.

[343] Akin to the advantage enjoyed by the so called "budget" airlines over the traditional flag carriers.

link incentives (such as what we today call "interest") to in-store spending.[344] Many have fledgling operations, but their growth ambitions are being frustrated by three particular barriers to effective competition and market entry (which advantage the large incumbent players).[345] These are:

(i) **barriers to switching.** Personal current accounts are fundamental to building a relationship between banks and their customers. However, consumers rarely switch due to the perception (often borne out) that to do so would be difficult, time-consuming and costly. They can also find it difficult to compare different product offers, particularly given the often complex charging structures. There are cultural and systemic reasons for this inertia. But the result is reduced competition;

(ii) **lack of access to information.** Banks have to capture and validate detailed information on a customer's overall financial position, to ensure responsible lending. This favours the large current account holding banks who have access to such data, and the network to meet the customer face-to-face. Furthermore, the established banks routinely share current account data through a closed user group, which puts smaller players at a disadvantage; and

(iii) **regulation**. There is a clear need for a proper and robust regulatory system. However the current regulatory framework is complex, lacks transparency and is subject to constant change. This makes it difficult for smaller banks, in particular, to navigate.

Furthermore, the time (two-and-a-half years) and cost (between £25 million and £35 million) of going through the regulatory process to start a bank presents a major barrier to aspiring new entrants.[346] The FSA is unwittingly reinforcing the *status quo,* which is not in consumers' interests.

Some aspiring new entrants have been forced to delay the launch of new mortgage and current account offerings as a result of new rules and regulations implemented by the FSA. If 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 little chance.

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

In the meantime, ministers should monitor closely the progress made (or otherwise) on the switching of primary current accounts.

344 Some supermarkets already offer variants of this, but not linked with savings deposits. Sainsbury Finance's SaveBack scheme allows customers to round up their grocery bill, transferring the balance into their SaveBack account.

345 As described in Tesco Personal Finance's submission to the Treasury Select Committee inquiry into competition and choice in the banking sector.

346 According to Baroness Kramer, during the second reading of the Financial Services Bill in the House of Lords, 11 June 2012.

(*b*) *Access through social media networks*

(i) Fidor Bank

With lifestyles becoming increasingly digital, Generation Y, in particular, is looking to social media for many of their service needs, including financial services. But the industry is struggling to facilitate this, perhaps hampered by a lack of visionary thinking. A rare example is provided by Germany's Fidor Bank, which retains a focus on the core competencies of a bank ("old values") whilst serving people through a new medium. Fidor seeks to integrate people's financial affairs into their digital lives, providing a platform for social interaction through finance ("banking with friends").

Fidor combines an internet payments service with a fully regulated bank, offering an e.wallet (cash account), savings account and the ability to buy currencies and precious metals via the web or iphone applications. Customers can choose whether to meet their financial needs via the bank or from other users (including peer-to-peer lending). Fidor claims a number of competitive advantages, including:

- customers exchanging opinions, advice (more trusted than had it come from financial institutions) and *immediate* feedback about their experience of dealing with Fidor. Thus, customers are integrated into brand management (which helps to water down the image of a monolithic institution) and service delivery, making for high-quality customer service;

- a bonus / reward system for customers who deliver value to the bank, perhaps by contributing ideas that reduce Fidor's costs or improve a product, or who participate in Fidor's YouTube channel;

- user-led innovation, whereby Fidor designs products together with its customers. It is essentially outsourcing product R&D (not unheard of; almost all Lego products are designed by Lego fans, for example); and

- instant feedback (including via highly visible Twitter accounts), which encourages Fidor to prioritise their service efforts.

(*ii*) *Customer engagement is key*

Customer engagement is central to Fidor's ethos. Customers are persuaded to establish goals, and the bank helps to meet them by, for example, setting a series of visible stepping stones towards a savings target. The bank facilitates saving competitions to help people reach a savings goal, harnessing customers' competitive instincts (and perhaps creating a "buzz" around saving so that it becomes a social norm?). Contestants are encouraged to blog about their progress, and attainment rewards are used to retain customer interest. Online voting influences who wins prizes……and helps create brand awareness.

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. Fidor is laying out its identity and true purpose, along with the underpinning values and beliefs (as discussed in Chapter 5).

By harnessing social networks, Fidor is "crowd sourcing" and, by adopting the personality of the people it serves, it is getting far closer to customers than any conventional bank. The idea could be extended into other aspects of personal finance. For example, a trusted arbitrator could facilitate property insurance amongst a social network "crowd", everyone contributing £10 per month and undercutting the industry. They would also be by-passing the regulatory regime…..and foregoing the allied protections. 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.

14.6 Simple, common sense advice

(a) Advice: a confession

This paper contains the word "advice" over 140 times, but the author remains unclear what it actually means. Being a nebulous concept, perhaps "advice" is impossible to define, and with it, "simplified" advice (as discussed in Section 11.9). Furthermore, to some people, product-focused "simplified" advice is a tautological riddle, because if a product were deemed to be "simple", perhaps it should be so self-explanatory as to not require advice (and certainly not product-specific advice)?

If "simplified" advice were ever fully defined, it is likely to be of low value relative to "full" regulated advice, and herein lies a conundrum. Given that providing it one-on-one is unlikely to be commercially viable, "simplified" advice would either have to be made available via an automated process, or delivered to groups of people, simultaneously. But low earners, in particular, need advice, and research shows that that is best delivered on an individual basis, and face-to-face…..which is expensive.

(b) Even the Money Advice Service does not know

In late 2011, the Money Advice Service (MAS) said that "*MAS is moving from information towards advice-type activity"* whilst insisting that it will not enter the regulated advice area.[347] This prompted a request for MAS to define "advice-type activity", to which it responded: *"advice is more directional, more assertive, more personal, than simply information and education-type activity which is why we are moving from doing information and education towards advice-type activity."* MAS went on to say that *"we continue to offer people advice but we do not provide regulated advice or sell anything and we never recommend specific financial service products"…..by "advice" we mean encouraging consumers to act on issues such as debt*. Any layman (and many industry professionals) would be perplexed by this.

(c) Guidance?

A new front has opened up in the advice debate: "guidance". The Pensions Administration Standards Authority (PASA) wants pensions administrators to be able to give guidance to scheme members without fear of breaching the regulated advice boundary. PASA claims that "*giving people information and guidance is not regulated advice – it is member engagement*." PASA wants a "safe harbour" for administrators where they can talk to individuals about the advantages of paying into a workplace pension without being deemed as giving financial advice.

[347] Francis McGee, Head of Policy, MAS, speaking at a Marketforce conference, London, December 2011.

It would appear that the "advice" conundrum (or is it simply rebranded "information"?) is set to rumble on. That said, one pithy summary of what constitutes "good advice" comes from Jeremy Goford, a senior actuary: identify the customer's financial needs / prioritise those needs / identify the benefits that meet those needs / show the cost / add the cost of advice / close the sale / deliver the benefits.

(*d*) *What advice is worth paying for?*

Figure 13 illustrates the probability of the average active equity fund manager outperforming his own benchmark over three successive years: around 5%. Thus, there is a 95% chance that he will not beat his own benchmark for three successive years. Given that there is no reliable way of selecting above-average fund managers in advance, and nobody can reliably forecast the short-term outlook for economies or stock markets, then paying for advice in respect of individual stocks (or funds), with anything other than a very long-term view, is a waste of money.

Ideally, the purchase of advice should be limited to being steered away from fraudulent schemes à la Bernie Madoff, and being made aware of the benefits of diversification, and of the effect of tax rules and regulations on portfolios. But such advice is rarely required, limiting the potential for fees.

(*e*) *Forget about "advice" and focus on "planning"?*

The RDR fails to grapple with a central issue: what constitutes "good" advice, when it is impossible to measure and its consequences may not be felt until perhaps decades later? Usually provided at a specific point in time, it should (ideally) be provided as a continuum, responding to the vagaries of markets and changing personal circumstance.

This suggests that today's advisers should be encouraged to think about "personal financial planning" rather than "advice". This should not simply be a relabeling exercise; it would require them to embrace, for example, disciplined, precautionary forward thinking that includes contingency planning (some of the better IFAs do this already).

> **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.

Furthermore, the IFA label represents an irretrievably damaged brand and should be consigned to history.[348] Indeed, as advisers embark upon moving their business models to being service-led rather than transactional, many will stop calling themselves IFAs anyway, perhaps adopting the generic title "financial planner". Admittedly somewhat vague, this could spawn a sub-strata of titles that provide customers with a basic description of the planner's specific role or area of product expertise.

> **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.

[348] This is a view shared by an increasingly number *within* the industry, including Capital Asset Management Managing Director Alan Smith. Quoted in Money Marketing (7 May 2009), he said: "*IFA is a tarnished brand in my opinion. We will do anything we can to disengage with that brand.*"

Some companies are already increasing their focus on planning. Equilibrium Asset Management (which dropped its IFA label in 2009), for example, uses teams of "paraplanners" to support its advisers. (The company has also abandoned commission-based charging in favour of a pure fee, discretionary management model.)

(*f*) *The professionalism agenda; aim higher, with more flexibility*

If financial advisers want to be treated as true professionals, respected on a par with accountants and lawyers, they should attain QCF Level 6, rather than settle for the FSA's QCF (post-RDR) Level 4 minimum standard.

> **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.

The industry could establish additional classifications (below Level 6), perhaps to accommodate the less ambitious advisers, as well as older IFAs caught out by the RDR's January 2013 deadline. Advisers could, for example, only be qualified to advise on specific products (investment, mortgage, tax, etc.) or themes (such as intergenerational planning, marketing or product design). In addition, a category of "Facilitator" could be created, which would qualify someone to take clients through a process that culminates in them making their own decisions.

> **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.

(g) Embrace technology

To survive, most IFA firms will have to embrace technology to cut costs, as well as broadening their distribution. Offshore back offices may become *de rigueur*, and middle market advice could be reduced to web-based decision trees with "kick outs"; personal service is just too expensive to deliver. But providing advice online raises a fundamental issue: how would advisers get paid for it?

14.7 Simple, fair and transparent pricing

(a) An example: annuities

(i) Reputation in decline

Consumers naturally want to "shop around" and compare product prices, but they are thwarted by the lack of product standardisation. The annuity market illustrates this perfectly. Every year in the UK some 650,000 people turn 65 and, for most of them, it is sensible to then buy a lifetime annuity using their DC pension pots. Indeed, if they were not to do so, they would be "playing chicken" with their life expectancy.

But, in most cases, buying an annuity is an irreversible decision which, as the concept of a fixed retirement age wanes, could become a major deterrent to annuitisation. In 1991, some 95% of American retirees chose to annuitise; today it is less than 40%.[349] The lack of annuity standardisation (rendering price comparison websites useless) is prompting a growing disillusionment with annuities (not helped by the prevailing very low annuity rates, care of low interest rates and poor investment returns (over the last decade). But, perhaps more seriously, there is a growing awareness that the annuity market is "opaque and unfair" and "toxic", depriving retirees of up to £1 billion of income each year.[350]

(*ii*) *The Open Market Option does not work*

The Open Market Option (OMO) allows retirees to shop around for the best annuity rate, and the most appropriate product, but data suggests that it is ineffective. One third of the over-55's have "never heard" of the OMO, a problem componded by 70% not fully understanding what an annuity is.[351] There are two deleterious consequences:

- in 2011, only 46% of retirees purchased their annuities from providers other than their incumbent pension scheme provider.[352] The majority therefore went for the "default" option, i.e. sticking with the incumbent. This resulted in many people receiving smaller annuities than had they shopped around; and
- only 10% of annuities purchased are enhanced (for those in ill-health, paying a higher income than standard annuities), yet up to two-thirds of annuitants are eligible for one. For a 65 year old man with a £50,000 pension pot, the difference between the top enhanced rate and bottom standard rate is up to 54%.[353]

There is nothing to prevent annuity providers helping their customers find the best annuities but, instead, many have chosen to profit via an "ignorance arbitrage". The industry needs to seize the initiative to restore fairness and trust in the annuity market, before a regulator steps in.

(*iii*) *Industry initiatives*

The are some tools available to compare annuities (such as the Annuity Exchange), and annuity advice services help consumers shop around for best rates.[354] But, inevitably, they are linked to only a limited number of providers, and rely on consumers being proactive……when many are not.

(*iv*) *An ABI code of practice: conflicted?*

The ABI has produced a compulsory code of practice for its members, to encourage consumers to shop around for an appropriate annuity when they approach retirement. Few believe that this goes far enough, the ABI being seriously hindered by its members' vested interests (and the code does not, of course, apply to non-members of the ABI). This is tinkering; much more assertive action is needed.

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[349] *Source*: TIAA-CREF Financial Services.

[350] A joint report by the NAPF and the Pensions Institute; *Treating DC scheme members fairly in retirement?* February 2012.

[351] Based on research conducted by MGM Advantage.

[352] ABI; the figure was 35% in 2008.

[353] ibid.

[354] For example, Nationwide Building Society launched an annuity advice service in March 2012.

(*v)* *An efficient annuity clearing house is required*

Bombarding confused customers with more information about the virtues of shopping around for an annuity, however well intentioned, is unlikely to overcome their inertia, nor their fear and distrust of the industry. The most simple solution would be to make the exercise of the OMO mandatory (i.e. no longer an option). This could be achieved via a new annuities clearing house; essentially, a marketplace in which all annuity providers participate (perhaps through the purchase of a tradeable licence).

Pre-retirement (three months?), a standard form would be submitted to the clearing house, via the provider, detailing any ill health (confirming eligibility for an enhanced annuity) and the type of annuity required (guaranteed, index-linked, joint life, etc.). Many people will not know the answer to this, so the information pack should include details of how to obtain independent advice.

Providers could then bid, daily, for annuity business, with unsold annuities being retendered the following day (and an end-of-week "sweep" may be required). This process should introduce pricing tension and, with all transaction prices being published at the end of the day, transparency that is currently lacking.

Additional features of the clearing house would help overcome particular problems facing today's aspiring annuitants, including:

- **pre-auction aggregation to achieve scale.** The average size of DC pots being annuitised is roughly £25,000, and 80% of savers have pots of less than £50,000;[355] too small to appeal to some providers. Consequently the clearing house should package together, ahead of bidding, DC pots being converted into standard annuities, to encourage stonger bids;
- a **tailored market**, specifically for enhanced annuities, with public guidelines as to how different enhanced annuities are priced; and
- publication of annuity rate band "cliff-edges", listed by provider.

Safe-guards would be required to ensure that successful bidders are credit-worthy institutions, and annuitants should be permitted to specify any preferred annuity providers. In such cases, they should receive the details of the winning bid as well as those of their preferred provider's bid, if different.

(*vi)* *Contract standardisation, to improve transparency*

The clearing house should only offer a limited number of simple, standardised annuity contracts, plus a more-tailored suite of enhanced annuities. The templates should be created in collaboration with the industry and consumer representatives. The industry's usual clamour of complaint, concerning the inequity of limiting choice, should be given short shrift.

In addition, the industry could provide an annuity "best practice" guidebook, emphasising common sense. For example, people should be encouraged to phase their annuity purchases over a decade, say, to avoid the precarious point-in-time risk at

[355] *Source*: ABI (2009).

retirement (when rates may be very low). *In extremis*, why not offer pre-paid annuity gift cards producing £100 per month from age 65, index-linked (perhaps purchased by grandparents for grandparents)?

(*vii*) *A role for the state?*

The Government could simply step into the vacuum and facilitate a low-cost national annuity support and brokerage service.[356] It should certainly seize the initiative if the industry were to establish an annuity clearing house that failed to deliver value for money. Indeed, the Treasury would probably be keen to participate in such a market, as an alternative source of funds to the Gilts market. The state could lay off its longevity risk through the reinsurance market, consistent with continuing to ignore industry requests that it assume longevity "tail" risk. The state should not be underwriting the risk of people living beyond 90, say.

> **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.

(*viii*) *A note about annuity pricing*

In future, the dynamics of annuity pricing are likely to change, for several reasons. Today the so called "mortality subsidy"[357] for older annuitants is a key feature in the pricing of an annuity book, but as the normal (fixed) retirement age becomes less relevant, people will demand annuities that are more flexible (i.e. starting later). In addition, if the market share of enhanced annuities were to increase, the subsidy gained from early deaths would reduce (enhanced annuities not being part of the general annuity pool).

(*b*) *Fairer pricing: ISAs*

Cash ISAs are a good example of where the power of inertia has worked against savers. The industry has persistently given abusively low returns (down to 0.2% per annum in recent years), well aware that most savers do not actively managed their accounts. Indeed, some companies have paid lower returns on ISA cash bonds than on their non-ISA cash bonds, thereby subsidising their income with a share of Cash ISAs' income tax exemption on interest, intended to benefit the saver. This has to be addressed, not least to ensure that the associated cost of tax exemption is an effective "cost" to the Treasury.

> **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.

If such a commitment were not forthcoming from the industry, then the Government should introduce a default requirement on the payment of interest on Cash ISAs to achieve than same consumer-favouring outcome.

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[356] David Mowat MP aired such a possibility during a Commons debate on 21 February 2012.

[357] Those within an annuity book who die early relative to mortality expectations effectively subsidise those who die relatively late (as they draw an income for longer).

(*c*) *Fairer pricing; pharmaceuticals: an alternative model?*

As per the pensions industry, the pharmaceutical industry has long been subject to criticism about product pricing. In mid-2011, one of the industry's leaders (GSK) announced that it would cut the price of some basic drugs and vaccines by 95%.....but only in the developing world. Notwithstanding the PR exercise, GSK is acknowledging that it is the richer countries that demand innovative drugs, and this is where their R&D spend is concentrated. Consequently the rich should pay the R&D cost through higher retail prices, benefiting the poor.

GSK claim that this is not an act of charity, because a funding pool from the Gates Foundation and UNICEF is providing assured sales in developing countries, in return for lower prices. There is a clear parallel with the pensions industry. Not only is it the wealthier clients who generally utilise the more sophisticated products, but auto-enrolment is akin to the Gates / UNICEF sales boost (at the lower end of the market).

In the retirement savings context, auto-enrolment provides the industry with an opportunity to reduce its marketing spend; this saving should be passed on to customers.

> **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).

If this approach to pricing were to be adopted, the subsidy of small pots should be highly transparent.

14.8 Risk reduction through pooling: the jury is out

Hedging risk as an individual is more expensive than doing so collectively, so risk pooling[358] makes sense within DC pension arrangements, in both the accumulation and decumulation phases (including purchasing annuities). Indeed, DB pension schemes are attractive partly because they channel the benefits of acting collectively to their individual members. Unfortunately, within the DC arena, the With Profits brand for risk pooling is tarnished, so the industry has been advocating Collective DC (CDC); essentially, re-branded With Profits.

The DWP is vacillating about CDC. Initially unenthusiastic[359], concerned, quite reasonably, about the inter-generational transfer of risk (i.e. pyramid schemes in the making), it has subsequently re-looked at CDC, egged on by the industry. The DWP's reservations could probably be mitigated by appropriate governance mechanisms (and many lessons have been learnt from the With Profits scandal), along with schemes having some capital backing, akin to how a bank supports risk. Furthermore, there is evidence[360] to suggest that CDC schemes' socialisation of risk does provide better average outcomes than standard DC schemes, not least because of the scope for the pooling of purchasing power.

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[358] As opposed to risk *sharing*, between an employer and employee, say.

[359] See DWP Research Report No 623, *Employer attitudes to collective defined contribution pension schemes,* December 2009.

[360] Ignis Asset Management; *Sharing the Pensions Challenge. What role for risk-sharing arrangements in workplace pensions?* 2010.

If risk pooling (within company-sponsored DC schemes, for example) does finally gain DWP acceptance, it will come at the price of complexity, making communication with members that much more challenging. Particular attention will have to be paid to ensuring that there are adequate cost control levers to protect younger cohorts. That said, it is hard to dispel concerns over whether even sophisticated risk management can really ensure generational equality.

> **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.

14.9 Clear communication

(a) The challenge

(i) Pensions are not "demanded": they have to be "sold"

The pensions and savings arena is a blizzard of complexity, jargon and meaningless terminology; perfect material for obfuscation and bamboozlement. Even people within the industry cannot agree on the meaning of terms such as "wrap" and "platform". 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", heightening the communication challenge.

In addition, with the State Pension Age in retreat, the industry has to counter opinions such as *"why save for a pension if I am being told I need to work until I'm 70?"* Consequently, it has to be increasingly imaginative in how it encourages people to engage with retirement saving.

(ii) Generational differences

The industry has to sell to four distinct age groups (baby boomers, and Generations X, Y and Z[361]), each with their own preferred modes of communication (as well as different product needs). Generation Z are "digital natives", highly connected via the web, instant messaging, text messaging, MP3 players, mobile phones and YouTube. Generation Y, unlike Generation Z, remember life before the take-off of mass media technology, whereas many baby boomers (now in their 50s and 60s) find some modern media alien (and not to be trusted).

The industry has to significantly improve how it attunes its media selection to each specific target audience. The younger generations' service quality expectations are for highly personalised "messages", relevant to them at an *individual* level. The industry currently lacks the personal data to deliver this (IFAs have some of it). In the meantime, it could focus on selling particular lifestyle(s) to its (younger) prospective customers, many of whom it ignores.

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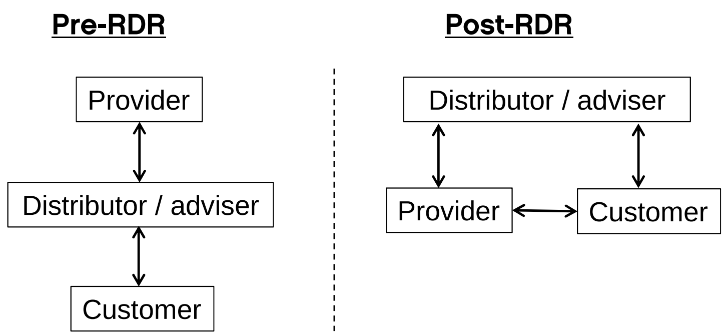
[361] Baby boomers were born between 1946 and 1964, Generation X from the early 1960s through to the mid / late 1970s, then Generation Y (to the early 1990s), followed by Generation Z, also known as Generation M (for multitasking) or the Net Generation.

(*iii*) *Different income brackets*
Furthermore, communication is divided by consumers' income. The wealthy are more inclined to think about "investing", whereas most people consider "saving". The former is an alien concept to them, and they perceive it to require skills that they do not possess. Consequently, 70% of all ISA subscriptions go into cash ISAs.[362]

The word "retirement" has high meaning to those with middle or upper incomes; indeed some consider it to be voluntary. Conversely, for career-long low earners, it can simply mean the point in time when they are no longer capable of working; it is involuntary.

(*iv*) *Pensions: complex and of no interest*
A NEST survey into people's attitudes to pensions has shown that 6% of people think that they are "straightforward", 4% "easy to understand" and just 3% agree that pensions are "simple". In addition, only 5% of respondents found pensions "interesting" and 2% agreed they are "engaging". The words people most frequently associate with pensions are "confusing" (putting off 39% of NEST's target audience from thinking about saving for retirement), "complicated" (only 15% of respondents find the language used to describe pensions straightforward and easy to understand), "boring", "difficult" and "off-putting".

(*v*) *The RDR: implications for communication*
Providers have been (increasingly) communicating with their customers via distributors and advisers. Post-RDR, we could expect significant changes to the industry's communication channels, with some providers reverting to the pursuit of direct customer contact. This is being partly being triggered by the prospect of some IFAs departing the industry, providing an opportunity to harvest legacy relationships.



(*b*) *The state should partner with the industry*

(*i*) *The "p" word*
Mis-communication is not entirely the preserve of the industry. The word "pension" is widely misused by the state, notably by NEST which repeatedly refers to the word "pension" in its literature. To be clear, NEST is the provider of a DC savings vehicle, *not* a pension, a word which comes from late Middle English, meaning "payment, tax or *regular sum* paid". This implies certainty, but DC savings vehicles do not lead to any certainty in respect of income in retirement. Indeed, we have a "pensions and savings" industry, the implication being that "pensions" and "savings" are different.

[362] £38 billion of the £53.9 billion subscribed to ISAs in 2010-11 went into cash ISAs. *Source*: ONS; *Table 9.4, Individual Savings Accounts,* October 2011.

(*ii)* *DWP's "jargon" buster*

In mid-2011 the DWP released a guide aimed at cutting through the pension industry's unintelligible language and confusing jargon, along with a £10m advertising budget in the run up to auto-enrolment. NEST also has an evolving phrasebook "*Clear communication about pensions*". Thus, "accumulation" becomes "adding to your retirement pot", "annuity" becomes "retirement income" and "decumulation" becomes "opening your retirement pot". Some providers have embarked upon a similar exercise, and these initiatives are welcomed……provided that they do not lead to conflicting definitions. Coordination is required.

> **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.

In parallel, some established terms could be reframed to provide deeper meaning; for example, tax relief could become "matching". And exhorting people to "save more" could become an encouragement to "spend less".

(*iii)* *Some stark honesty required?*

Australian employers are compelled to contribute 12% to employees' Super G accounts; when they do so, they make it clear that their contributions are, at least in part, wage substitution, rather than pretend any different. They are also increasingly imparting the message that *you* have to assume some risk, recognising that people have to get to grips with the concept of risk and return (as discussed in Chapter 3).

The industry and the state, in collaboration, have to disabuse people of financial alchemy and any notions of getting something for nothing. The industry has a less prosaic rationale: the availability of risk capital is likely to diminish once Solvency II and CRD III have been implemented[363]. Consequently, the cost of transferring risk to third parties is likely to rise. Savers will *have* to take *more* risk by themselves.

> **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".

This would only work if the industry acts responsibly, emphasising "modest" risks; the initiative should not be interpreted as an opportunity to peddle risky products and illiquid asset classes that are wholly inappropriate to people's needs.

(*iv)* *Come clean about certainty*

People crave certainty of income in retirement, but it comes at the expense of complexity and cost. Products that offer certainty sometimes come to grief as providers over-promise; for example, guaranteed annuity rates (GAR) were the downfall of Equitably Life. With interest rates likely to remain low for years to come, coupled with potentially poor investment returns and rising longevity, perhaps the fairest stance that the industry could adopt is to regularly remind people that they cannot have certainty in an uncertain world.

[363] The implementation deadline for Capital Requirements Directive (CRD) III was 31 December 2011. Solvency II has been delayed until 1 January 2014.

(*c*) *The regulators should relax*

One of the challenges is to keep communication simple, whilst disclosing enough information to satisfy regulators. Regulators should take account of how people behave in practice, rather than how they should behave; rightly or wrongly, few people read (let alone understand) the swathe of literature that accompanies pensions products. Thus it serves the industry and regulators more than the consumer; a lot of regulatory-inspired literature has become an exercise in back covering.

Some current requirements defy common sense, particularly the illustrations based upon unrealistic assumptions for future asset performance. Oft-repeated mantras (such as *"past performance is no guide to future performance*") lose their meaning over time, as people become desensitised to them. The frequent reference to "*investment is for the long-term*" serves little purpose as a health warning, because the long-term never arrives; it just shuffles forward. This means, of course, that when it comes to investment performance, the industry is never held to account.

Health warnings need freshening up and reducing in number, but some would prefer to resuscitate *caveat emptor*, in keeping with the prevailing political ethos of "personal responsibility". In the meantime, everyone who is already accumulating a pension pot should be regularly told, on their payslips:

- the total contributions paid in; and
- what their pensions would be, expressed in today's money terms, based upon the prevailing assets, assuming a *modest* growth rate.

(*d*) *Others communication suggestions*

(i) Simplify the user interface

Simple products are not automatically unsophisticated (or low risk); the challenge facing the industry is to make the user interface simple. The complexity of whatever is "under the bonnet" should be the primary concern of regulators and product manufacturers, rather than that of consumers; indeed it could be hidden from view (provided that this does not mask risk). The ipod is technically advanced, but very easy to use.

(*ii*) *Harness the power of stories*

The pharmaceutical industry has researched how best to market drugs, establishing that people are more susceptible to anecdotes than statistical evidence.[364] In one survey, people were presented with the drugs' statistical effectiveness (ranging from 30% to 90%), accompanied by positive, ambiguous, or negative anecdotes from the prescribing doctors. They were then asked to select their treatment preference. Table 16 summarises the results.

[364] Angela Freymuth and George Ronan; *Journal of Clinical Psychology in Medical Settings, Volume 11; Modelling patient decision-making: the role of base-rate and anecdotal information,* September 2004.

Table 16: Anecdotes versus statistical evidence: drug selection

	Negative anecdote	Positive anecdote
Drug A (90% effective)	39%	88%
Drug B (30% effective)	7%	78%

Drug B, albeit only one third as effective as drug A, was preferred by twice as many people when accompanied by a positive anecdote, drug A being accompanied by a negative anecdote (78% versus 39%). Thus, anecdotes overwhelmed the statistical evidence, confirming that consumers need to be very aware of manufacturer biases. Most lay people are not, of course, which raises a question as to whether they make the optimal decisions on matters they know little about……which includes retirement saving.

It is within the industry's power to direct people to the decisions that are the most appropriate for them, ideally by combining the right product with a good story.

(*iii*) *Encourage people to set goals*

Most people never think about establishing any specific savings objectives, let alone planning how to achieve them. If they were to do so, they may discover a new meaning for the word "risk"; the failure of their investments to achieve objectives, such as a specific capital sum, a rate of capital growth or even capital repayment (perhaps through an endowment mortgage).

For most people, a sensible, simple and realistic goal would be to be a debt-free home owner at retirement. Thereafter, they could 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.

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).

(*iv*) *Use charts rather than tables….and provide context*

People assimilate information in different ways, and when it comes to data, the visual impact of graphical representation is much preferred to tables of numbers. But however financial data is presented, it is devoid of meaning to the average consumer unless accompanied by relevant comparisons. Thus, fund management costs should be presented alongside the charges for NEST and a generic passive (i.e. index-tracking) fund (perhaps 0.5% per annum). Equity fund performance data should be compared with the long-term equity risk premium for the relevant benchmark indices.

(*e*) *Communication: conclusion*

The industry cannot, on its own, convince people that saving is important; this is a role for all stakeholders, particularly the Government (and employers too, but not as a "duty"). New approaches are needed to engage people with saving, including delivering messages more in the style of journalism than as administrative chores. Social media may have the potential to galvanise Generations Y and Z in particular, so that saving becomes a social norm. But the industry's leaders are themselves mostly baby boomers; almost inevitably, some of them cannot imagine social media's potential.

15. Implementation: collaboration required

15.1 A tragedy of the commons?

From the industry's perspective, today's situation is akin to a tragedy of the commons. By pursuing individual advantage, and common greed, almost all of the industry's participants are not taking the concerted action required to rejuvenate their reputations. Given the strategic importance of savings (to fund investment), the industry is risking assertive state intervention in the savings arena, which is unlikely to be to its advantage.

State intervention could initially include addressing some of NEST's structural disadvantages; removing the contributions cap and ending the transfer ban are likely to happen. But there could be other initiatives beyond NEST (concerning annuities, for example?), where the state may enjoy a competitive advantage. And were compulsory saving to materialise, it may be accompanied by tough price controls.

15.2 The prisoner's dilemma[365]

The industry knows that it has to dramatically change, and confront the existing practices that are enshrined in the principal-agent problem. It has to cease harnessing information asymmetries to its own advantage, and address opacity, particularly in respect of the total cost of investing. But individual businesses are struggling to accept that there could be any "first mover" advantage. A leap of faith is required, notably that subsequent business growth would outweigh lower margins.

But how could individuals encourage their industry colleagues (and competitors) to embark upon the necessary transformation and overcome the "prisoner's dilemma" that they find themselves in?

15.3 Be Nice, Retaliatory, Forgiving and Clear[366]

Achieving behavioural transformation across the industry is an exercise to be played out over an extended period; it cannot be shoehorned into a one-off, "big bang" initiative. Witness the attempts to turn UN conferences on climate change into "'two weeks to save the world". Every year the UN tries to corral the whole international community into one room to get them to make simultaneous, binding commitments on emission reductions. Seventeen successive years of negotiations has delivered almost nothing; time and again the talks have turned into a classic prisoner's dilemma, with a subsequent collapse in cooperation.[367]

An alternative strategy, as described by the political scientist Robert Axelrod, is for one or a small group of companies to take the lead by being "Nice, Retaliatory, Forgiving and Clear". In the retirement savings context, the approach could be as follows.

[365] The prisoner's dilemma is derived from game theory; it illustrates why two individuals might not cooperate, even if it were in their best interests to do so.

[366] After Robert Axelrod; *The Evolution of Cooperation,* 1984. This approach was developed by Michael Liebreich (CEO of Bloomberg New Energy Finance), in the context of climate change; *How to Save the Planet: Be Nice, Retaliatory, Forgiving & Clear*, September 2007.

[367] The most recent instalment of the UN Framework Convention on Climate Change (the 17th COP, Conference of the Parties) took place in December 2011, in Durban.

(i) Individual industry participants start by setting an example, by changing the way they themselves do business. This could include establishing a set of guiding principles, ideally endorsed by consumer groups (but not by industry representative bodies, politicians or regulators). The leaders subsequently encourage other industry participants to make similar unilateral commitments.

(ii) The leaders should be publicly scathing of those who refuse to take action ("free riders").

(iii) If others subsequently change course, the leaders should publicly acknowledge that they have done so and build bridges with them (by, for example, inviting them to adopt standardised documentation or sharing technology).

(iv) The leaders should be absolutely clear, up-front, about their direction of travel and how they are going to behave (there is no advantage to be gained through obfuscation).

Industry participants should be concerned that the longer they continue to participate in UN-type behaviour, the less time, credibility and energy they will have to devote to alternative approaches, such as Axelrod's. Furthermore, the longer they ignore consumers' clamour for genuine transparency, for example, the more they will look quixotic, self-indulgent or cynical.....and risk the wrath of those politicians who want to establish a savings culture.

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.

15.4 The trade bodies: leadership or UN-type behaviour?

In November 2011 the NAPF convened an industry summit on costs and charges. A working group was set up to create recommendations for an industry code of practice, to restore public trust in the industry. Establishing the code is relatively simply compared to achieving widespread adoption, and it opens the door for participants to confuse eagerness-to-please with leadership, and subsequently blame someone else for a lack of progress.

This feels like UN-type behaviour. It invites a compromise which will be just enough to keep the show on the road, but not enough to address the main issues at hand: the principal-agent problem, information asymmetry and the lack of transparency. The cultural adjustment required of the industry demands leadership, assertive action and repetitive, clear and concise communication.

15.5 Where to start?

The industry should start to improve its efficiency by collaborating in activities where the majority of individual companies have little competitive advantage. It should, for example, establish a consolidation platform for DC pension pots (to facilitate the payment of contributions and transfer values), which would bring the added benefit of starting the process of endearing the industry to the pensions minister.

Establishing a transparent market for annuities would commence the long process of reputational rejuvenation in the eyes of the public, as well as improving pricing. And this paper's proposals in respect of complete transparency would be simple to implement, as would reducing product choice and narrowing the range of funds on offer. Both initiatives would help cut operational and marketing costs (as well as benefiting confused consumers). Finally, the arrival of a new Chief Executive of the IMA (probably in early 2013) will provide an opportunity for a change in direction. Unfortunately, he (or she) could probably only move at the pace of the least progressive of the IMA's larger members.

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. But public opprobrium is such that it is clear that many people believe that there is no prospect of the industry challenging its own, deeply entrenched, vested interests. Indeed, the industry's pursuit of its own self-interest, at the expense of its customers, ultimately may prove to be its nemesis.

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.

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APPENDIX I:

Life insurers: for some, a future without a purpose?

In the 1980s the UK's life companies were vertically integrated. They collected profit margins at every link in the whole (opaque) value chain, including advice and distribution (thorough their own (i.e. tied) sales forces), the manufacture of complex products, investment management, administration, tax wrappers, and the provision of guarantees, including annuities.

(*a*) *Margins under relentless pressure*

Since then, the business model has come apart, something that has been long forecast.[368] Life insurers have now lost their competitive advantage at almost every stage of the business of providing customers with pensions products. Profit margins have suffered accordingly.

(i) **Distribution**. After selling off their direct sales forces (to cut costs), life companies lost their distribution-derived income. They have subsequently purchased third party distribution (thereby losing control over their customer relationships), through IFAs, brokers and platforms, but this is at great cost. Between 2007 and 2009, AXA, Standard Life and Old Mutual alone injected a combined £225 million to support loss-making platform offerings.[369]

Once the RDR is implemented (end-2012), the banning of commission puts an end to a major competitive advantage for life companies; the ability to use their capital to finance commission payments to purchase distribution. The RDR effectively forces the independence of life companies' sales channels, further disenfranchising them.

(ii) **Fund management.** There has been little to prevent the (non-tied) distributors from allocating client assets to fund managers unconnected to life companies.

(iii) **Product manufacture.** The reputation of life insurers' home-manufactured products has disintegrated, notably with-profits funds, investment bonds (which harbour some of the worst excesses of commission income, bordering on criminal) and some guarantee products. Consequently, life insurers' product-derived income streams are withering.

(iv) **Administration**. The growth of third party administrators (TPAs) such as Capita has made administration a highly competitive business, leaving life insurers with

[368] See, for example, Ned Cazalet's seminal *Polly put the kettle on; pensions profitability*, January 2006.

[369] Based upon reports from AKG, actuaries.

little scope for profit. Furthermore, some life companies (notably Aviva) are burdened with serious (i.e. expensive) legacy IT systems issues.

(v) **Tax wrapper**. Now a commoditised component, and less valuable with the decline in tax benefits for pensions and allied products (notably the 2011 cut in the tax relief limit from £255,000 to £50,000).

(*b*) *A declining back book*

Some life companies are living off the cashflow derived from their back books, which is fast disappearing. This includes their share of terminal bonuses from mortgage endowments, a product with a typical life of 25 years, but a business that peaked in 1985 (i.e. 26 years ago). Single premium investment bonds have a typical ten year maturity, but that market peaked in 2001. Demand for unit-linked pensions products and life cover is also on the wane, the latter partly due to people living longer, and with-profits redemptions continue apace.

(*c*) *The threat from NEST*

From 2012, NEST will be offering a (basic) pensions product at a cost of 1.8% upfront with a 0.3% AMC. This, plus the distribution advantage of auto-enrolment, will put further pressure on life companies.

APPENDIX II:

The All Party Parliamentary Group for Financial Education for Young People report: recommendations

(i) Financial education should be compulsory in every school's curriculum, and assessed.

(ii) Every school should have a dedicated “champion” to coordinate financial education drawn from the senior leadership team.

(iii) Banks and businesses can play an important role, particularly the British Bankers Association.

(iv) Primary schools should continue to teach financial education using a cross-curriculum approach, but teachers must be able to teach basic maths and money skills.

(v) Secondary schools should use a cross-curriculum approach grounded in maths and personal social health and economic (PSHE) education.

(vi) All teaching materials should be quality marked by a trusted body.

APPENDIX III:

The Myners Principles to improve trustees' investment decision-making and governance

The Myners Principles were originally set out in 2001 by the Myners Review and the Government's Codes of Investment Principles. They were updated and simplified in 2008, the ten original principles being consolidated into six, less prescriptive, principles. An independent Investment Governance Group, co-sponsored by the Treasury and the DWP, and under the chairmanship of TPR, monitors compliance with the regime and suggests further improvements.

Principle 1: Effective Decision-Making

Trustees should ensure that decisions are taken by persons or organizations with the skills, knowledge, advice and resources necessary to take them effectively and monitor their implementation. Trustees should have sufficient expertise to be able to evaluate and challenge the advice they receive, and manage conflicts of interest.

Principle 2: Clear Objectives

Trustees should set out an overall investment objective(s) for the fund that takes account of the scheme's liabilities, the strength of the sponsor covenant and the attitude to risk of both the trustees and the sponsor, and clearly communicate these to advisers and investment managers.

Principle 3: Risk and Liabilities

In setting and reviewing their investment strategy, trustees should take account of the form and structure of liabilities. These include the strength of the sponsor covenant, the risk of sponsor default and longevity risk.

Principle 4: Performance Assessment

Trustees should arrange for the formal measurement of the performance of the investments, investment managers and advisors. Trustees should also periodically make a formal policy assessment of their own effectiveness as a decision-making body and report on this to scheme members.

Principle 5: Responsible Ownership

Trustees should adopt, or ensure their investment managers adopt, the Institutional Shareholders' Committee (ISC) Statement of Principles on the responsibilities of shareholders and agents. A statement of the scheme's policy on responsible ownership should be included in the Statement of Investment Principles. Trustees should report periodically to members on the discharge of such responsibilities.

Principle 6: Transparency and Reporting

Trustees should act in a transparent manner, communicating with stakeholders on issues relating to their management of investment, its governance and risks, including performance against stated objectives. Trustees should provide regular communication to members in the form they consider most appropriate.

APPENDIX IV:

Thornton report into pensions institutions; main points[370]

The three most significant areas where changes are needed are:

- **to underpin the close co-operation and co-ordination which already exists between the Pension Protection Fund (PPF) and the Pensions Regulator (TPR).** Thornton concluded that, notwithstanding some potential benefits from combining the two bodies, this would not be helpful at such an early stage in their development. There are no significant difficulties arising from their operating separately, so far; instead recommendations were made designed to underpin closer working;

- **to further develop the joint working between the Financial Services Authority and the Pensions Regulator in the area of work-based defined contribution pensions.** Thornton concluded that there is a need for greater clarity on the respective roles of the two bodies, with a more holistic approach to regulation of DC schemes; and

- **to transfer the office of the Pensions Ombudsman (PO) into a new Pensions Jurisdiction in the Financial Ombudsman Service (FOS).** Thornton concluded that the current arrangements could be streamlined and made more robust by integrating the functions of these two bodies.

Specific recommendations:

- to institutionalise the effective co-operation and close working between PPF and TPR;
- to develop further the current joint working arrangements between TPR and FSA, particularly in relation to DC regulation; and
- to bring the functions of the Pensions Ombudsman, and with them the functions of the PPF Ombudsman, within the FOS.

Consultation issues:

- Is there a good case for bringing TPR and PPF closer together?
- Is there a good case for bringing the FSA and TPR closer together?
- Is there a good case for bringing the PO and the FOS closer together?

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[370] *A Review of Pensions Institutions; an independent report to the DWP*, Paul Thornton, June 2007.

APPENDIX V:

The RDR's original objectives (2006)

The FSA set six objectives against which the effectiveness of its Retail Distribution Review (RDR) proposals should be measured, over the long term.

1. An industry that engages with consumers in a way that delivers more clarity for them on products and services.

2. A market that allows more consumers to have their needs and wants addressed.

3. Standards of professionalism that inspire consumer confidence and trust.

4. Remuneration arrangements that allow competitive forces to work in favour of consumers.

5. An industry where firms are sufficiently viable to deliver on their longer term commitments and where they treat their customer fairly.

6. A regulatory framework that can support delivery of all of these aspirations and which does not inhibit innovation where this benefits consumers

APPENDIX VI:

EFAMA: Overview of eight recommendations to European governments to address the savings challenge implied by demographics[371]

Long-term savings recommendations:

A1. Increase total European retirement savings by encouraging governments to introduce compulsory long-term saving schemes (with opt-out clauses), that are organised with employer and/or industry scheme support.

A2. Increase the consumer-friendliness of long-term investments by introducing a personal retirement plan (referred to as "Officially Certified European Retirement Plan" (OCERP)) that has consistent certification standards across Europe.

A3. Give all product providers equal access to suitable and efficient OCERPs in order to foster competition for the best investor solutions.

Retail investment product distribution recommendations:

B1. Harmonise distribution standards for packaged retail investment products (PRIPs) across product categories.

B2. Improve quality and transparency of activities at the point of sale.

B3. Promote further confidence in UCITS as a trustworthy investment vehicle.

Recommended industry actions to underpin improvements:

C1. Promote financial literacy and competence of individual investors and financial advisors.

C2. Set industry aspirations for better business conduct and performance.

[371] European Fund and Asset Management Association (EFAMA); *Revisiting the landscape of European long-term savings – A call for action from the asset management industry*, March 2010.

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