The big challenges for the UK pension system

Introduction

I am grateful to Graeme for today’s invitation. It provides a welcome opportunity to set out my understanding of the challenges and to discuss them further in the roundtable.

I will touch on each of the three “pillars” of the pension system: the state pension, occupational pensions and private (also known as retail) pensions in the context of the two essential challenges to the pension system. First, to deliver a reasonable retirement income for citizens. Second, to generate that income in a way that is compatible with a well-functioning wider economy, in other words to be derived from an efficient and responsible capitalism.

Let me take each in turn.

The problem: background to delivering a reasonable retirement income

The demographic context in which the UK pension system operates is one of rising longevity and increasing dependency ratios.

The political culture is not generally favourable to tax rises to fund welfare including pensions (and in any event both the short and medium term are likely to be dominated by other calls on revenue).

The savings culture is not strong and the pensions sector has been damaged by the unintended consequences of state action, miss-selling scandals, and opacity as to the real costs and returns from private providers.

Private employers are dramatically reducing the scale of their contributions towards the pensions of their general workforce. Historically, the average contribution of employers towards a defined benefit scheme was of the order of 16.5% of an employee’s salary. Typically, contributions into a trust-based DC scheme are of the order of 6.5% and they will only be required to pay 3% under auto-enrolment (although there will of course be scope to contribute more). Note that at the required contribution level under auto-enrolment, the split between employer/employee and tax relief, at a combined 8% of salary will be at a level which Scottish Widows say is below that necessary for the median earner to achieve a 50% salary replacement (including the state pension) after a 40 year career on the average salary. [They say 12% needed.]

The latest ONS statistics indicate that 60% of the private sector workforce (which comprises just under 80% of the working population) is not saving towards a pension at all.

Qualitative surveys by a range of organisations find both that individuals do not trust the state or private providers in this field and that they find the issue too complex to engage with.
The objective is to ensure that citizens have a reasonable income in retirement. (Note that the OECD defines a reasonable income as 70% of wages). The structure within which this objective is sought is as follows:

The UK Pension System

The UK pension system is unusual amongst those found in OECD countries because the wage replacement rate provided by the Pay As You Go state pension is low – at approximately 40% of the average wage.

The PAYG system is under the same pressures as those found throughout most of the Western world: rising longevity, increasing dependency ratios and hostility to increases in taxes.

The solution in the UK is similar to that adopted in many countries: increases in the state pension age to keep the system in balance. Clearly, the state pension is not going to be the mechanism by which anything near a 70% replacement rate is achieved.

The UK state system is also characterised by a complex interrelation between basic pension, second pension, means-tested relief and contracting-out. The government has consulted on reforming this – although things have gone rather quiet on this front.

Historically, the major form of private pension was the defined benefit scheme provided by an employer. For a number of reasons, including regulatory rigidity, these are now in decline. According to the Workplace Retirement Income Commission, these now cover only 2.4 million workers. In the future, coverage will fall much further since according to the ONS’s 2011 report into private pensions, a much smaller number are still open to new members - covering roughly 1 million private sector workers.

Most workers contributing to a pension are therefore covered by individual defined contribution schemes – either trust based (1 million) or individual but via the company (approx 4 million) or purely private (approx 4 million).

Raising income: more participants and more contributions

In order to increase retirement income, more people would have to join occupational or private schemes and they would have to contribute more to them. To persuade them to do so is going to require much more confidence in the system.

Governance is likely to be relevant to gaining confidence. The defined benefit and trust-based defined contribution schemes are managed on behalf of contributors by trustees. Under the other schemes, the relationship between the individual and the provider is purely contractual. There is a legal difference in the obligation owed to the individual under the two arrangements. In a fiduciary relationship, the interests of the beneficiary are paramount. In the contractual arrangement, the paramount interest of the provider is
legally obliged to be the shareholder - subject only to meeting the terms of the contract and any regulatory obligations. In the contractual scenario, any tension between shareholder and customers interests is likely to be resolved in favour of the shareholder since, as discussed previously, according to surveys, people do not understand pensions. An example of how conflicts of interest are resolved in DC pensions can be seen in how annuity markets operate. Providers remain far too content to sell customers products which are simply not in the customers’ interests: a situation which Joanne Seegars of the National Association of Pension Funds described last week as “toxic”.

In relation to all UK private schemes, trust-based or individual, there tends to be a high degree of opacity, particularly around costs and charges. Plentiful information may be provided, but it is difficult to understand. It is clear from the surveys of trustees conducted by The Pension Regulator that the majority of trustees (let alone retail customers) do not have a very good understanding of costs and charges. The lack of standardisation around disclosure makes it even more difficult to compare between funds. In any event, the information provided is almost always incomplete. It is not usually possible to see all the costs deducted from your pension’s savings. Some providers have told me that it would be misleading to disclose all the costs because that would not tell you about the returns. I think it is right that higher returns could justify higher costs on a genuinely actively managed fund. However, this is a justification for making a proper disclosure on returns as well as costs, not for making costs obscure.

It is not clear that regulatory supervision in this sector is in practice correctly calibrated. UK pensions regulation seems to be focussed on ensuring contributions are made to defined benefit schemes. It does not appear to be focussed on dealing with market failures relating to transparency or costs. I note that the industry is discussing a code of conduct with regards to costs and charges. I welcome this but dealing with transparency alone may not be sufficient, if excess costs derive from misaligned incentives. I note with interest that in June 2010 that the incoming Chair of the Investment Management Association said that the industry needed to deal with excess intermediation and conflicts of interest. I also note that subsequent to this speech industry practice remained the same but the comments of the Chair changed.

Auto-enrolment which is getting into gear this year will lead to a large increase in the number of people saving for a pension. Regulation around the quality of provision is de minimis. If poor quality products simply absorb peoples’ savings, we may end up with very high levels of opt-out and a public policy failure. I think it is critical that the government reminds itself that the last Labour administration endowed it with reserve powers to set quality criteria. It needs to monitor provision very closely indeed and act where poor quality products are going to let the consumer down and tarnish the industry as a whole.

Pension funds, long-term investment and the general economy
The second, fundamental challenge is how the pensions industry generates wealth. In principle, investing for pensions should tend to be compatible with responsible long-term investment. In turn, it should drive companies in whom pension funds invest to adopt long-term strategies. However, the evidence tends to suggest that overall the pensions industry does not engage actively with invested companies on governance and sustainability issues.

Many funds also churn equity holdings at a furious pace, generating substantial transaction costs. While the latter may be of benefit to financial intermediaries, it is unlikely to be of benefit to future pensioners, since the costs are deducted from their holdings.

It seems likely, as a CEO of Aviva Investors has observed that these two issues are linked. Paul Abberley said: “If you are investing in a company with a long-term horizon, it very much matters to know about sustainability issues, but if you are taking a time horizon of an average holding of six weeks, you might take the view that there may be a time bomb ticking but it is unlikely to go off in my holding period.”

Final Comment

So far today I have portrayed a gloomy picture. However, I do not think that “we are Ali doomed”. In particular, I think that the duty on employers to auto-enrol can potentially be key in stemming the decline in pension saving. I look forward to discussing how the big challenges might be met. In today’s short sessions, we can of course only touch on some of the issues. However, if you feel a point has not been fully developed or has not been covered, do get in touch.