

# Pensions policy

How Government can get  
us saving again

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# How Government can get us saving again

Truly radical pension reform requires a broadly-based consensus since it is impossible for politicians to please all the people all the time. Consensus between the political parties is particularly essential in the world of pension planning where the timeframes transcend the normal electoral cycle. Here we seek to achieve such a consensus in many key areas. Where immediate consensus is not possible, we see a continuing role for the Pensions Commission as adviser to Government. We seek consensus here on:

- the role of Government as a significant pension provider
- the role of employers in the provision of work to older workers and of pension opportunities to workers of all ages
- an acknowledgement that financial service companies should be allowed to innovate and operate profitably within a proportionate regulatory environment
- a rigorous approach to taxpayer-financed savings initiatives.

## The role of government

Government has a role as a universal provider of taxpayer-financed pensions to the old who may or may not be retired. In some countries the problem may be over-generous state promises which need to be reined-in to reflect current and future demographic reality. In the UK the state system is a major problem not because of its generosity but because of its parsimony. Because the state pension has never provided a pension which Parliament has regarded

as adequate, private sector arrangements assume the role of privatised welfare and are therefore susceptible to unhelpful political micro-management. In order that the private sector can work efficiently, the UK basic state pension needs to be increased dramatically over time. By 2008, the basic and state second pensions should be amalgamated and the facility to contract-out should be terminated. By 2025, the universal state pension should deliver a benefit of around 40% of national average earnings. By the same date, the earliest age at which such a pension could be drawn should be increased to 68. It should be the role of the Pensions Commission to provide the Government with regular analyses of the options governing the pace at which it might be possible to move from where we will be in 2008 to where we ought to be in 2025. The Pensions Commission should have a continuing role of informing the political debate on the impact which demography and wider economic indicators have on state pension parameters. Once the starting level of the basic state pension has reached its consensus point, future increases may be linked to the growth in GDP.

As private savings in general, and private pensions in particular, lose the status of privatised welfare, Government should retreat to the touchline. It should not be for Government to define employee benefit programmes or to influence the shape of commercial products. The market can do both of these more effectively than the Government provided that the basic state pension ensures that absolute poverty is no longer synonymous with old age.



## **Pivotal role of the employer**

Changes in savings patterns alone are not a sustainable response to increased longevity and diminished fertility. Significant changes in attitudes to work and working patterns are required. No longer can we pension-off workers in their prime. Every adult, irrespective of age, should have access to suitable employment and training opportunities. Allowing older people to remain economically active for as long as they wish can create a virtuous circle which will have wider economic and social advantages, quite apart from the impact on making our pension challenge more manageable.

A number of welcome initiatives are already in train. More are required. Above all, we need a change of mindset among both employers and employees.

Three key roles can be identified for employers in our pension consensus. First, employers must ensure that older workers get the training and employment opportunities which they need. Secondly, it should be made as easy as possible for employers to make a tangible financial contribution to the pension accumulation of their employees. Thirdly, employers should be encouraged to use the workplace as a marketplace for increased financial awareness. The recent Government initiative on 'informed choice' is welcome and the plans outlined need to proceed apace.

Employers should be free to offer the sort of pension arrangement that suits them, their shareholders and their employees. Government should not

seek to micro-manage scheme design whether the pension plan is based on pure defined benefit, defined contribution or some form of risk-sharing. It should not be for Government to determine where, on the spectrum between 'best endeavour' and 'guarantee' the financial backing for a defined benefit promise should be located. Converting 'best endeavour' into 'guarantee' costs money. The parties to a scheme should determine whether that price is worth paying. It is essential, however, that where a promise is based on 'best endeavour' the workforce is left in no doubt as to the strength of their particular pension covenant.

The promised review of the Financial Promotions Order as part of the wider review of the operation of the Financial Services and Markets Act is essential. Everything possible should also be done to make sure that those employers who make an attempt at improving financial awareness are not more vulnerable than those employers who choose to do nothing at all. The fear of being sued with the benefit of hindsight is a real one in our litigious society.

## **Role of commercial provider**

There is nothing wrong with making a profit out of selling good quality financial products or from providing advice on the individual suitability of those products. Indeed, an absence of profitable opportunities will stanch product design and lead to mass exclusion of moderately well-off people from the financial services

marketplace. Neither Government nor regulator should be expected to design or approve products but the use of CAT standards may provide a useful guide to the unwary consumer.

The anticipated simplification of the tax regime and hoped for simplification of the social policy environment, within which private pensions are offered, should make it easier for a wide range of financial service companies to ply their trade. Technical back-offices should no longer be a pre-requisite of an ability to manage the accumulation phase of the pension lifecycle. Players old and new should be encouraged to develop innovative products that will help individuals manage risk throughout their career and share that risk with employer or commercial provider. While certain investment techniques might be regarded as commodity-like activity, products that meet real customers' needs are manufactured and not mined.

Notwithstanding the continued role for external regulation, self-regulatory initiatives aimed at raising standards should be encouraged.

Commercial operations of all forms should consider the extent to which they can help improve financial literacy. Activity in this area should be generally welcomed and not seen as a purely self-seeking commercial project.

As with employers, commercial providers should be subject to much less regulation once the products they offer are properly seen as employee benefits or marketplace products, rather than surrogate welfare. They should, however, be left in no doubt

that bad practice which leads to avoidable consumer detriment will be heavily punished.

## **Role of the informed consumer**

It is not sensible to turn every citizen into a 'do it yourself' financial adviser. However, increased financial literacy is essential if consumers are to plan their finances with the same alacrity that they can plan their holidays. The Government is proposing to increase financial street wisdom in the schoolroom. While some basic messages can be delivered at that stage, care must be taken to ensure that financial awareness training is part of the mathematics and literacy modules and does not unintentionally further marginalise these basic skills. Without them, folk will find their future economic survival increasingly difficult.

The Government can play its part in creating an environment in which improved financial literacy is achieved. However, this should not be achieved by Government telling people what they should save, when they should save and how they can save. Even if we succeed in making the pension system more rational, we should not try to impose a universal definition of rational behaviour on a diverse population. What is rational for one group will not be rational for another.

In recent years, governments have tried to extend the equity culture by a number of means. While people should be aware of the merits of equity investment, this one asset class must not be portrayed as the only rational

asset class for the serious saver. For those who are entirely risk-averse, being on the sticky end of equity volatility may turn them off saving all together.

Consumers of financial products, even given increased literacy, need more protection than consumers of other products which are bought more regularly. However, excessive protection can lead to the certainty of not buying replacing the risk of mis-buying.

## **Role of the regulators**

Neither the Pension Regulator nor the Financial Services Authority should be expected to deliver absolute consumer security. Not only is it extremely expensive to aim so high, it is an undeliverable objective. Both regulators should be encouraged to develop an approach to regulation which is risk-based and principle-based. They should not be expected to design or authorise particular products or distribution channels.

Consumers should be able to rely on good faith whether they are taking advantage of benefits or products offered by their employer or commercial provider. Both are in business to make a profit and should treat stakeholders fairly. However, extreme care must be exercised when imposing any unnecessary burden on an employer who chooses to remunerate the workforce partly in pension form or through the provision of subsidised financial advice. Like it or not, compensation schemes are here and once they are here, they are probably here to stay. Reference has

already been made to the common interest of all financial service market participants in the maintenance of consumer confidence in that marketplace. Thus, self-regulation and a compensation scheme financed by the industry are a compelling partnership. Care does, however, need to be exercised when extending the compensation principle to those employers who choose to provide a pension for their workers. Such employers may have nothing in common and if they are not to be alienated, the scope of any benefits covered by a compensation scheme and the premium rating system are critical parameters.

## **Role of incentives**

Governments have regularly used taxpayers' money to finance savings incentives. Notwithstanding these incentives, Britain has a savings habit in decline. Incentives may simply serve to distort the savings market rather than increase the amount being saved. While these distortions may have short-term beneficial effects, these are often short-lived and can become counterproductive.

The drive for simplification should remove many disincentives to the participation of employers, employees and commercial providers in the savings process. Beyond the removal of these disincentives, careful thought needs to be given to the value for money that will flow from further positive incentives, particularly when we are calling for an increased use of taxpayers' money to boost the basic state pension. Bigger state pensions

may, in fact, be a very cost-effective and non-distorting way of increasing the nation's savings.

A case can be made for rewarding those who choose to save long-term through a pension arrangement which, after 2010, they will not normally be able to access before age 55. Much of the headline figure for tax incentives is actually accounted for by tax deferral rather than tax avoidance. However, the anticipated Inland Revenue simplification will increase the amount of tax free cash that most pension holders will be able to draw. This is a genuine incentive.

If further incentives to pension saving are to be offered, it might be sensible to target those at employers rather than employees. Those employees who pay little or no tax may be better incentivised to save if their employer is sharing in the accumulation process. Employers may be more willing to share in this way if remuneration via a pension scheme is fiscally advantaged vis a vis remuneration through immediate cash. Care does, however, need to be taken to avoid unintended distortions of remuneration strategies.

It is highly debatable whether other short-term savings should be fiscally advantaged. If it is public policy to reward or incentivise saving, perhaps it should be the act of saving which is rewarded rather than the choice of a particular short or medium-term product. People might be given a savings allowance to allocate as they see fit rather than in accordance with a short-term menu determined by an incumbent government.

## The next steps

It is our aim to secure maximum buy-in from a wide range of stakeholders to the agenda set out here. If such a buy-in is forthcoming, the emerging consensus should act as a supportive buttress to our politicians as they seek to help society respond to the retirement implications of the good news that, on average, we are all living longer.



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