

Adam Smith Institute

BRIEFING

The Passbook Pension

Meeting *all* the objectives for pension reform

The Passbook Pension is the Adam Smith Institute's proposal for a stakeholder pension, addressing the challenges and requirements described by Harriet Harman in her statement of 17 July 1997. While retaining the guarantee of state provision, it offers people a voluntary, funded, simple alternative to SERPS and the basic pension.

Easily accessible and understood, the Passbook Pension assures everyone of security and dignity — not dependency — in retirement.

This paper describes the main features of the Passbook Pension, its costs and benefits, and its relationship to today's personal and occupational pensions. There are also reflections on the tax regime and the speed and costs of moving from state to private provision.

- The ***Passbook Pension*** is the first and major building block of the Institute's proposed Fortune Account system, which would give people the option of moving to privately provided savings and insurance plans that will offer better value than today's state-provided benefits.
- The ***Passbook Pension*** is the personal property of the holder, giving people a real stake in their own future.
- Moving to a funded system, and investing what is presently paid out as national insurance contributions, gives an enormous boost to economic growth. This in turn means that the transition to proper funding can be achieved within a generation, without anyone losing out.
- The proposals which follow spell out a more sustainable balance between the roles and responsibilities of the public and private sectors and between the individual and the state.
- These proposals are challenging to the financial services industry, but are certainly deliverable commercially. With government support, they

are fully capable of securing a public consensus.

BENCHMARK OBJECTIVES

Responding to demographic change inevitably requires some move towards funded, individually-owned accounts, so that each generation pays for its own retirement. By investing in the industry of the UK and other countries, the current generation can benefit directly from the economic success to which it has contributed.

Such a transition must harness competition to deliver high value, low cost and exemplary service quality. To assure people that their pensions are secure, and to give them confidence in the new system, all *Passbook Pension* plans will be benchmarked to a basic and easily intelligible set of criteria providing:

- **a voluntary alternative** to state pensions — but with state pensions remaining for those not wishing to make the change;
- plans which deliver **high value**, even for those on low incomes, with 100% of contributions invested;
- **low and clear charges**, so that people can easily compare different plans, helped by a passbook to show how their savings have grown;
- **regulation of providers and products** instead of sales, thus reducing cost and complexity while maintaining the security of people's funds;
- plans which **respond to social**

and labour market changes and narrow the pensions gap between men and women; and

- **guarantees** such as penalty-free transfers, the right to return to the state system, and state top-ups for anyone who reaches retirement with insufficient funds.

THE KEY FEATURES

The *Passbook Pension* is structured to ensure that it is appropriate for all savers. The following notes describe its key features.

Competitive provision. This ensures that providers strive to out-perform each other on costs, fund performance and customer service. That permanent and explicit pressure will deliver ongoing value to the consumer.

A voluntary alternative. The state pension remains available, as today, for those who do not want to transfer to a *Passbook Pension*, and for any who do transfer but then wish to return to the state system. Thus the *guarantee* of state provision remains secure for everyone.

Approved products. Today's pension regulation is costly, complex, and ineffective because it focuses on the sales process.

Passbook Pension regulation must focus instead on the solidity of the providers and the quality of their products. Simpler regulation means greater security and lower charges.

A safe foundation. The *Passbook Pension* is designed to provide only a safe financial foundation for

retirement. Personal and occupational pension schemes will continue for those who want to save significantly more.

Re-directing NICs. The national insurance contributions of those who opt for *Passbook Pensions* are re-directed from the state scheme into their own account. Because the money is now properly invested, it grows to give them a pension much larger than today's basic pension and income support level.

An age-related NIC rebate would allow people to build up, at no extra cost to themselves, a pension sufficient to allow them to retire in dignity, not dependency.

Adding to an account. However, many people will want to do more than this minimum, and the *Passbook Pension* makes it easy for them to build on their basic provision. Holders can top up their savings, or friends and family can do it for them. Thus parents or grandparents may start off a child's *Passbook Pension* account with a gift or inheritance, while working people can add to the account of a non-working partner.

An insured plan. As a standard feature of the *Passbook Pension*, there would be provision for:

- **partner's benefits:** whereby people could nominate a spouse or partner as beneficiary for the whole fund (if the holder dies before retirement) or a part of it (where the death is within five years of retirement);
- **life assurance:** providing a

cash lump sum (perhaps £25,000) or a regular income (perhaps two-thirds of earnings) to a dependent partner;

- **a pension contribution guarantee:** assuring account holders that their monthly contributions would continue to be credited to their account when their earnings are interrupted for any reason.

In the longer term, the Fortune Account proposals envisage extending the insurance package to replace large parts of the benefits now covered under national insurance — including sickness, incapacity, long term care, and unemployment. Again, the premiums for this would be met by re-directing people's national insurance contributions into their Fortune Account plan.

BENEFITS AND CONTRIBUTIONS

Annuities. To make the *Passbook Pension* simple, and to ensure it remains sufficient even for an extended period of retirement, benefits are drawn by way of an annuity. Annuities would be indexed to prices. In the event of an early death, there would be a guaranteed payout of the first five years' pension.

Retirement age. *Passbook Pension* holders may choose to retire at any time, provided they have built up a fund sufficient to buy a retirement annuity of minimum size. For those who have not, the state tops up their fund when they reach the official retirement age.

Investments. The provider would ensure automatic "life-stage" switching, matching risk to age and protecting the growth achieved in the fund. Thus the investments of younger account holders might go largely into shares, those of older ones largely into bonds.

Returns. Investment returns — and thus the growth of people's funds — cannot be guaranteed. To build in guarantees would add cost and would deny people the higher returns they could achieve from more volatile investments. The ups and downs of such investments will in any case balance out over the long period of a pension plan.

A single account and penalty-free transfers. For simplicity, people can hold only one *Passbook Pension* account at a time. If they choose to move to another pension provider, the whole of their fund goes with them. There would be no charges for transferring to another provider, or back to the state.

Contribution limits. People should be encouraged to pay more than the minimum towards their savings. If the *Passbook Pension* is bolstered by tax reliefs, however, some annual limit on contributions (say, of £3,000-£6,000) may be necessary to prevent abuse.

INCLUSIVENESS

Closing the pensions gap. The government wants to help those

with patchy contributions records who today face a "pensions gap". Most affected by this are women (who are more like to face career breaks because of family caring responsibilities) and workers on low or intermittent earnings.

The *Passbook Pension* meets all these objectives. It guarantees a minimum retirement fund for the low-paid, and ensures that contributions continue to be made for those taking career breaks.

Insured contributions.

Passbook Pension holders will not lose out on future pension entitlement when pregnancy, caring responsibilities, sickness, incapacity or unemployment means they cannot continue to work and make contributions. For a short initial period, the responsibility for maintaining contributions would remain theirs, but thereafter the *Passbook Pension* provider would make up the contributions for an extended period, with the state as the contributor of last resort.

The low paid. Where, at the point of retirement, an individual's fund is insufficient to generate an adequate pension by means of an annuity, the state would meet the shortfall, simply by topping up their fund to the required level.

Thus everyone is guaranteed to receive a decent pension of a minimum amount, no matter what their lifetime circumstances have been. But the main responsibility falls on the individual, with the state stepping in where it is needed.

COSTS AND CHARGES

Full value. To ensure that people's pension resources are used to maximum effect, contributors must receive regular and clear information about the value of their fund and any charges that are made. Savers must be assured that 100% of their contributions are invested.

A single charge. The charging structure must be clear, simple, easily understood by contributors, and readily comparable between providers. The *Passbook Pension* envisages a single charge, and a standard expression of fund growth performance.

Such a charging structure — as clear and as easily comparable as APR figures are on building-society accounts today — would promote open competition and sweep away the jargon and complexity which today forms an impenetrable barrier against members of the public who try to compare rival pension plans.

Level of charge. Charges may vary according to the size of the *Passbook Pension* holder's fund, but a typical provider might be expected to charge 1% or less, with some early moves to rates well below that, possibly at 0.6%.

Member statements. The simplicity of a single charge and a standard expression of fund growth facilitates clear reporting to members on the accumulated value of their retirement provision. It makes possible a passbook system, similar to a savings-account passbook, in which people can at any time update and record

the growth of their savings. However, many providers might offer an electronic smart-card, or a 24-hour telephone information service as alternatives.

Changing providers. Armed with such clear information, *Passbook Pension* holders can make informed comparisons between providers on the basis of charges, returns, and customer service. Moving one's fund to another provider will be as straightforward as moving an account between different banks or building societies today.

That freedom will further increase the pressure on *Passbook Pension* providers to maximise the quality of service they deliver, so as to keep customers over the long term and minimise the costs of churning.

TAX REGIME

Today's personal and occupational pensions are aided by favourable tax treatment of contributions and fund growth. In public expenditure terms, the introduction of a *Passbook Pension* would be made easier if contributions were made out of taxed income (like national insurance), with tax-free growth and benefits (like PEPs).

Introducing the *Passbook Pension* does not require any change in the tax treatment of today's company and personal pension plans. They can continue to exist alongside the *Passbook Pension*, with their own tax and regulatory structures.

The choice of the tax treatment is

ultimately a political decision, and the *Passbook Pension* can work under either regime. But it works best if benefits, not contributions, are tax free. This is because:

- NICs would be easier to re-direct if all contributions were similarly taxed;
- tax-free contributions are not very attractive to low-income families (whom the government particularly wants to encourage into saving) because they pay little or no tax anyway; and
- tax-free benefits are easier to police because the amounts are smaller and less complicated.

PROVIDERS

Providers would be required to meet a set of criteria in order to secure "approved" status, including good progress on the pensions mis-selling review, technical competency, financial strength and administrative and technical infrastructure capabilities.

Market assessments suggest that there would be around 50 potential qualified *Passbook Pension* providers, of whom perhaps half would take the view that they had to be present in this new market.

Value-added "gateways". Against a background of a market of perhaps 25 approved pensions providers, purchasers are likely to form or join groups to obtain greater bargaining power. Such groups would be expected to form

a gateway through which the public can reach providers at low cost, adding value for customers by:

- operating as an informed "super-customer";
- negotiating bulk deals with *Passbook Pension* providers;
- operating their own sales force to improve penetration;
- providing members with access to independent financial advice;
- facilitating low-cost scheme administration, *e.g.* by using existing communication channels to collect premiums and deliver statements; and
- providing an independent ombudsman to resolve disputes.

Natural gateway groupings might include large employers, trade unions, trade associations and professional bodies, geographically-defined bodies (such as local authorities), affinity groups, and service providers who have a close relationship with a large customer base (such as retailers or banks).

A role for mutuals. Many of these gateway providers would opt to work through a mutual or trust arrangement to serve their members. This would be distinct and separate from the gateway group itself, and would work under fiduciary duties requiring it always to act in the members' interests.

Creating choice. Prospective

purchasers of a *Passbook Pension* will be able to choose their provider direct (by selecting one of the "approved" providers) or to go through a mutual or commercial gateway which has already selected the best *Passbook Pension* provider for its entire membership.

ADMINISTRATIVE SYSTEMS

Cash collection. Individuals could make payments into their *Passbook Pension* by any of three routes, whichever was most convenient.

- **Payroll deduction.** Pension providers already offer computer software that links with the employer's payroll system to capture employee contribution data in electronic form. Employers would pass this same information to the Contributions Agency for reconciliation with existing NI records. This may be an attractive method for large employers and offers the benefit of fast funds transfer.
- **NI / Inland Revenue.** The second route parallels the collection system that operates for Personal Pensions today. It is a simple, efficient and accurate method, particularly attractive to small employers and to the self employed, and capable of processing additional voluntary contributions.

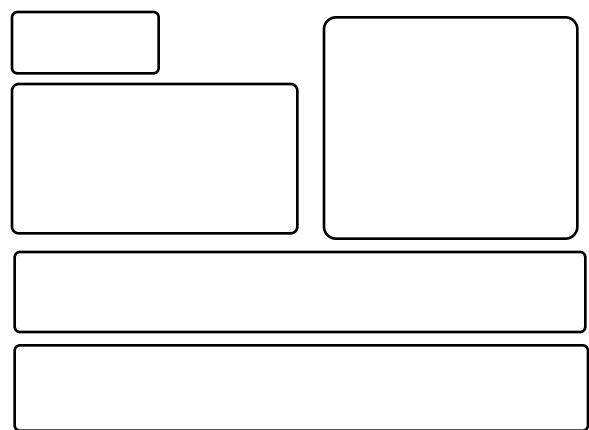
However, some revamp of current systems would be essential to speed up the transfer of people's contributions to their *Passbook Pension* providers.

- **Third party clearing house.** We should also expect specialist facilities operators to provide contribution collection services, acting as a clearing house which collects contributions from individuals or gateway groups, consolidates the payments, and directs them electronically to *Passbook Pension* providers. This could provide a low-cost method of collecting small payments from disparate individuals, such as the self-employed.

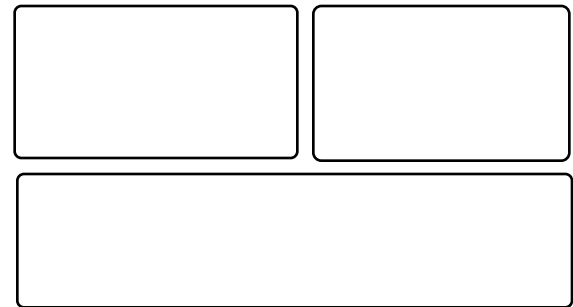
OTHER PENSION PLANS

The *Passbook Pension* will co-exist with and underpin occupational and personal pensions schemes. Those schemes, as today, would provide a top-up to basic pension provision and would continue to be governed by their own regulatory and tax regimes, wholly separate from that of the *Passbook Pension*.

Today's pension scene



The *Passbook Pension* scene



Over time, it might be that the close regulation of occupational and personal pensions could be eased.

With basic retirement provision assured through the *Passbook Pension*, we could reasonably leave people to make more adventurous

decisions about their upper-tier provision.

GETTING THERE FROM HERE

One worry about any move to fully funded pensions is the belief that "one generation must pay twice" — once to pay what is due to today's elderly, and once more to build up funds for its own retirement.

This fear is unfounded. The economic gain from funding is so large that we could make the transition within a generation and still leave everyone better off.

As we showed in our report *The Great Escape*, people see NICs as a tax on jobs. This has seriously depressive effects on the labour market. Because *Passbook Pensions* are seen as saving, not a tax, they reduce this problem. Second, state pensions can grow no faster than future tax receipts — whereas real investments can grow much more quickly than this. And moving to full funding would also provide a massive capital boost to UK industry, improving productivity and increasing economic growth.

So large are these effects that US researchers have calculated that moving to funded pensions in that country could produce a welfare gain of 4%-5% for all future generations, without loss to the present one. Our own calculations for the UK suggest equally large gains, amounting to a doubling of economic growth.

A NEW PARTNERSHIP

Dividing the tasks. It will require a new partnership between the public and private sectors if we are to achieve these gains and make any new pension system work with security and confidence,

To achieve the full benefits of the *Passbook Pension*, both the government and the financial services industry will have to enter into a number of clear commitments.

The government's role. For its part, the government must:

- regulate products and providers, not sales;
- simplify contribution and eligibility rules;
- ensure viable contributions by re-directing the pensions element of NICs;
- meet any shortfall in pension payments on retirement;
- require only one *Passbook Pension* account per individual;
- actively promote the scheme and further public education, possibly funding customer advice at the point of first purchase.

The provider role. On their part, the providers of *Passbook Pensions* must agree to:

- provide access to all, regardless of income or employment patterns;
- deliver good value for money, particularly for low income groups, and close the pensions

- gap between men and women;
- meet each person's pension contributions for an extended period during breaks in earnings, for whatever reason;
- offer easily understood, readily comparable ***Passbook Pension*** accounts with high levels of customer service;
- offer their customers quality access to stockmarket growth, with automatic life-stage switching to limit their financial risks near retirement;
- offer genuine portability and penalty-free transfers.

easily accessible, funded, and individual form of retirement saving which allows ***everyone*** to retire in dignity, not dependency.

These proposals are challenging to the financial services industry, but certainly deliverable commercially. They should achieve wide support among the public. It is now up to policymakers to grasp the public's demand for change and to develop that new consensus through the ***Passbook Pension***.

CONCLUSION

The ***Passbook Pension*** is a simple,

FURTHER READING

More detailed argument on many of the points made in this paper can be found in the Institute's publications, which include:

The Fortune Account (29pp, 1995)

Beyond Pensions Plus: Developing the Fortune Account (51pp, 1997)

The Great Escape: Financing the Transition to Funded Pensions (32pp, 1997)

Available from: The Adam Smith Institute,
23 Great Smith Street, London SW1P 3BL

In constructing the proposals in this paper, the Adam Smith Institute has had the benefit of advice from the financial services industry, academics and other leading think tanks. In particular, the study group that has been working on these proposals over the last year has had the direct support of Legal & General, Natwest Life, Pearl Assurance, Scottish Amicable and ICL.