SIMPLY NO MISTAKE
How the Stakeholder Pension must work

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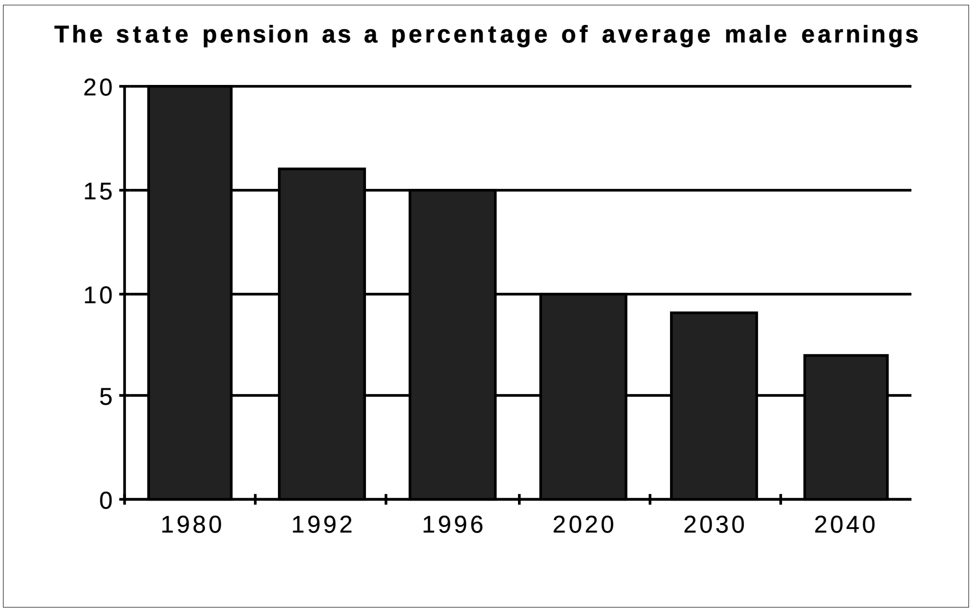
1. Difficult choices

The state pension never promised anyone a luxurious old age, and recent changes to the eligibility and indexation rules have ***deepened the cliff edge between people's incomes in work and in retirement***. But no government is now likely to restore the value of the pension from public budgets: the cost is huge, the number of pensioners is growing, the cash would not be focused on the needy, and there are many other pressing priorities for government spending.



So unless people build up some financial cushion of their own, more and more of us will come to grief at the retirement cliff-edge. Nobody wants to see that, and yet ***many people who could save for themselves nevertheless reach retirement with no financial cushion***. The policy challenge is to change that situation.

No easy solution

It may seem remarkable that people who *could* save in fact do *not* save, given the looming prospect of poverty in retirement. But we must recognize that there are many reasons for this — not all of them bad. Even the briefest survey of the situation and what to do about it immediately reveals some of the difficult choices that face us in reforming pensions.

- ***Short-sightedness*** is one. Spending today is always nicer than saving for tomorrow, and people underestimate how poor their retirement might be, or overestimate how far the state will support them.

  Compulsory saving might cure such wishful thinking; but it also ***coerces*** people for whom the decision not to save is entirely rational — those who would lose state benefits as a result of having savings, for example, or youngsters for whom saving will be much more affordable in later years as their careers develop.

- Another obstacle is that ***pension savings are locked up for years***. In an uncertain world, that is too big a risk for some people — especially those who can least afford to cope with an unexpected disaster in the meantime.

  Some ***loan-back*** or ***emergency-relief*** provision might overcome these fears, but only at the cost of ***complexity***. A more promising way of making people save for the long term is to provide some ***valuable incentive*** — but one that is far ***more obvious***, and ***available to more people***, than today's complicated tax reliefs.

- ***Complexity, opacity, and unintelligibility*** are three more reasons why people choose not to save into a pension. They have neither time nor energy to become expert enough to make a rational decision on something so complicated. And they know how easily an expert can defraud them.

  Yet people are willing enough to save into things that they do understand. ***Radical simplification*** of the pension regime (charges, the lump sum, tax reliefs, earnings limits, carry-back, carry-forward, contracting-out rules and all the rest) would make pensions equally accessible to millions more people. But how can we simplify the existing pensions regime without ripping up peoples' long-term savings contracts and potentially leaving some savers worse off?

The Stakeholder Pension ideal

The aim of the Stakeholder Pension (ShP) approach is to make good-value pensions ***easily accessible and attractive*** to more people — particularly those whom the present system excludes, alienates, or gives poor value and little (or no) incentive. It calls for the development of a new kind of pension that is characterized by:

- ***simplicity*** (easy for savers to understand and for providers to run);
- ***security*** (savers are confident of receiving a fair pension);
- ***flexibility*** (so that those on low earnings, taking career breaks, or changing jobs will not be disadvantaged); and
- ***value for money*** (with low running costs and quality benefits).

The practical dangers

This ideal is easy to describe. But introducing it, and getting it widely accepted by the target public, could be anything but simple.

For example, long-term saving vehicles that are very close to the ShP ideal are in fact already available, and can be bought off the pages of almost any daily newspaper. Unfortunately the take-up is not high.

Or again, some descriptions of the ShP look very similar to the notion of a group personal pension. So why all the fuss? Adjusting the rules to make these existing group schemes fully portable and more widely accessible should be relatively easy.

While providers do what they can to make these off-the-page and group products as straightforward and as low-cost as possible, it is hard to cut costs, or simplify pensions, as long as they remain subject to today's ***cumbersome regulatory system*** and ***highly complex tax rules***. Radical simplification on these tax and regulatory fronts might well do more to make pensions intelligible, and more to promote pension saving, than introducing any number of *new* pension concepts.

Indeed, there is even the danger that bringing in yet another type of pension, under yet another set of regulations and tax rules, will actually ***add complexity*** to an already complex system — the chart below gives some indication of just how many different pension arrangements are possible for an individual — making it harder still for people to come to a decision about how best to save for retirement.

Current complexity: some pension options for the individual — in the jargon of the pensions sector

BSP only ***or*** BSP + SERPS ***or*** BSP + COSR ***or*** BSP + COMP (rebate only) ***or*** BSP + COMP (non-rebate only) ***or*** BSP + CISR + SERPS ***or*** BSP + CIMP + SERPS ***or*** BSP + APP (rebate only) ***or*** BSP + APP (non-rebate only) ***or*** BSP + GAPP ***or*** BSP + PPP + SERPS ***or*** BSP + GPP + SERPS ***or*** BSP + CISR + APP (rebate only) ***or*** BSP + CIMP + APP (rebate only) ***or*** BSP + CISR + FSAVC ***or*** BSP + CIMP + FSAVC ***or*** BSP + COSR + AVC ***or*** BSP + COMP (rebate only) + AVC ***or*** BSP + COMP (non-rebate only) + AVC ***or*** BSP + CISR + AVC + SERPS ***or*** BSP + CIMP + AVC + SERPS ***or*** BSP + COSR + FSAVC ***or*** BSP + COMP (rebate only) + FSAVC ***or*** BSP + COMP (non-rebate only) + FSAVC ***or*** BSP + CISR + FSAVC + SERPS ***or*** BSP + CIMP + FSAVC + SERPS...

Moreover, if existing pension savers merely ***switched their contributions*** out of their company or personal pension schemes and into this new ShP system because they understood it better, there would be little impact on the prevalence of poverty in retirement. Some people might even make themselves ***worse off*** by switching.

On the other hand, there are limits to how far one can widen access to and understanding of pensions by reforming the present system. When people have entered long-term investment commitments, it is unjust to change the rules against them halfway through, while leaving them no chance of escape. Though exactly that has happened several times already in the last few years, the public's endurance may by now be wearing a little thin.

The route forward

The way forward must be to decide the ***general principles*** which would characterize a truly ***simple and accessible pensions regime***, and see if we can gravitate towards that vision over the years. Anything new that we do must be consistent with that vision and consonant with those principles; while any changes we wish to make to the existing regime must be packaged and timetabled in ways that secure the consent of existing pension contributors.

Having set out the broad vision, we must then define ***the general features that would make the ShP ideal a practical success***. How simple and accessible can it be made within the limits of today's tax and regulatory rules? And if it cannot be made simple within those rules, how far we can go in reforming them?

Practical reforms. Certainly we can open up today's pension system to ***those who are presently excluded*** — new incentives to encourage non-earners to build up pension savings alongside people in paid work, for example, or new inducements for the self-employed to commit to long-term saving. And there may be many other ways to make today's pensions system more intelligible and more widely accessible, without doing injury to current contributors. ***Such measures, by themselves, could go a long way to achieving the ShP goals of accessibility, simplicity, and better value***.

Removing the ban against people contributing to occupational and personal pensions at the same time, for example, would remove much confusion. The Inland Revenue will fret about the potential abuse of the tax concessions, but the real things to worry about are that the present system is over-complicated and that in consequence, too many people are under-provided.

The earnings limits on pension contributions should go, too. Again the motive behind them is revenue protection, but the rules themselves have become impenetrable to the would-be saver. If people want to save in a building society, they simply walk in and deposit the money: but the amount they can save in a pension depends on their age, their (allowable) earnings, what they have contributed in past years, and much more — all of which has to be ascertained and certified by their pension providers. It is surprising that anyone bothers: and certainly, few people could navigate the rules in the absence of professional advice — which somehow has to be paid for.

Since only 1% of the population contribute up to the maximum anyway, these very complex rules ***do not prevent any wide abuse***. Yet they do prevent the other 99% of the population from understanding what pensions are all about. They also prevent all those people without independent earnings — those at home with family caring responsibilities, for example, or people who have a windfall to invest but have no qualifying income — from getting near a pension at all.

A better approach is to view pension saving as just ***something we want people to do if they can***, whether or not they have qualifying income right now. By removing the earnings cap and cutting out some of the less productive regulatory overheads, we could see charges fall by up to 40%. The second-best solution is to fix the cap on tax-free contributions at some use-it-or-lose-it annual cash sum (say £6,000), but even this demands costly administration by providers and employers.

Other simplifications could further cut administrative complexity, make the pensions market more transparent, and reduce the need for costly advice. All of that, again, would make pensions ***more affordable for more people***.

Principles and details. However, we cannot expect pension providers to develop new solutions, nor the public to concede any of its tax privileges, until the direction of reform has been clearly stated: principles such as whether pension saving will be compulsory or voluntary, and the likely future of SERPS.

Once the vision is clear, however, we are confident that pension providers could quite quickly coalesce around straightforward, intelligible, and accessible concepts that fulfil all the objectives of the Stakeholder Pension.

This paper identifies the core features which we believe must be present in order to make the ShP work, and which will set the agenda for pensions reform more widely. We believe that they can be realized in a way that is both politically pragmatic and commercially deliverable.

Our precise specification for this ***deliverable ShP*** is detailed below. It takes account of the many responses that were made to the government's consultation document on Stakeholder Pensions and has been ***calibrated for their commercial and political***

practicality against the views of a series of expert panels drawn from senior figures from the financial-services, management systems, and economic policy worlds.

While individual commentators and companies naturally dissent from different elements within these proposals, we are confident that as an overall package they are deliverable. A significant number of the major pensions providers have already signalled to us their clear readiness to support an ShP concept based on the principles we identify.

THE PROS AND CONS OF REFORMING THE PENSION SYSTEM

Strategy	Advantages	Disadvantages
Set up a new and simpler form of pension (the ShP)	✔ New easy rules ✔ Less overhead and so better value for money ✔ Easier access without the need for advice ✔ Helps poorer people making smaller and less regular contributions ✔ An easily-intelligible first introduction to pension saving for many	✘ Adds another set of rules to an already complicated system ✘ May make advice even more necessary ✘ May not raise saving because people will switch from company schemes ✘ People switching from company schemes may get worse value for money ✘ Could be an expensive policy failure
Reform and simplify today's complicated pension rules	✔ Today's rules are complex and confusing ✔ Rules are costly to administer, giving people poorer value for money ✔ Large public and private bureaucracies are needed today ✔ Employer costs cut ✔ Regulatory complexity could be eased ✔ Simpler incentives could help poorer people more than today's	✘ It is unjust to tear up long-term contract rules ✘ Adds yet another set of rules to today's ✘ New rules mean more burden on employers and providers ✘ Despite faults, today's system has create vast pension savings in the UK

2. Broad structures

In line with the government's ambitions, our ShP proposals envisage large funds which ***pool the savings of many contributors***, making ***economies of scale*** possible in administration and fund management.

We see the ShP as being ***easily accessible*** to all, and ***effectively promoted*** through ***gateways*** that might include workplaces, trade unions, retailers, affinity groups, and associations of the ***self-employed***.

A set of ***benchmark standards*** and other steps to ensure that ***members' interests*** are ***represented*** and ***protected*** in ShP schemes.

Access and economies of scale

Like any other pooled savings arrangement, the ShP must have mechanisms in place for the purposes of:

- ***administration*** (collecting and processing contributions, keeping membership records, ensuring that benefits are paid, etc.); and

- ***investment management*** (choosing the right asset mix to give members an acceptable balance of risk and fund growth).

Each of these functions entails a cost, of course; and the higher the cost, the poorer is the return that contributors get on their money. So we should aim to ***structure*** the ShP to keep these costs as low as possible.

Group access. Some commentators argue that costs could be cut if people were able to access their ShP as members of a group, perhaps through schemes set up by employers' associations, trade unions, local authorities, retailers, utilities and other large bodies. Such ***gateways*** could increase the value-for-money of the system by:

- ***negotiating good deals*** as ***an informed super-customer***;
- ***promoting take-up*** of the ShP among their members;
- helping members with ***financial advice*** and ***resolving disputes***; and
- ***cutting communication and administration costs***.

Others go further, and argue that the ShP should be built around specifically ***mutual*** groups. The idea is that the mutual approach will allow costs to be cut even further and members' interests to be better protected.

Limits to group access. Valuable economies of scale are possible if an ShP scheme can achieve a total membership of 100,000 or more, and obviously it helps to achieve that target if people can be introduced to the scheme in large groups. Even if members are then free to leave or transfer individually to another ShP provider, much of the cost advantage still remains, as long as the total membership holds up.

The 100,000-strong ShP scheme might of course derive its membership from many different affinity groups and individuals. It might even give each gateway a different branding and a customized service around fundamentally the same offering, and yet still preserve the economies of scale required.

Nevertheless, there are limits to the group-access concept.

- Our lives and needs change rapidly these days, so it would be ***wrong to lock people in*** to any group arrangement. Frequent job-changers, for example, often get poor value from group schemes arranged by employers. People must be able to ***join or leave an ShP arrangement individually***.

- The ability of people to choose their ShP individually is beneficial because it ***stimulates robust competition, customer focus, efficiency, and value for money***. It also ***reduces the scope for corruption*** between group leaders and pension service providers.

Limits of mutuals. There are problems too in imposing a mutual interface.

- The supposed cost-busting 'mutual interest' of many large 'affinity' groups is ***usually rather weak***: the financial and other services they offer being merely their own branding on someone else's product. Even ***industry-wide pension schemes rarely work well*** unless there is some powerful lead sponsor.

- The existence of some mutual interface ***does not make administration costless***. Services such as premium collection still have to be paid for — ultimately, by customers. Interposing some mutual organization between individuals and the ultimate ShP managers or administrators may ***add to cost*** rather than reduce it.

- The public is not convinced that mutual groupings will be best at handling their pension savings. A recent Audience Selection poll found that 50% of the working population in the target group would be happy to arrange a pension through an insurance company, but only 12% would happily entrust their savings to a trade union, and even less to a club.

Who would you be happy to arrange a pension with?
Audience Selection survey of UK residents 15-64, excluding class A/B

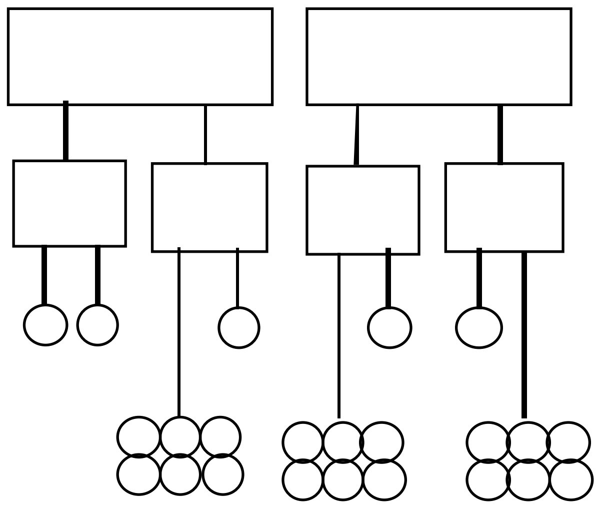
Employer	57%
Insurance company	50%
Local authority	12%
Trade union	12%
Supermarket	5%
Sport/leisure club	3%

In summary, gateway groups may prove cost-effective as ***introducers*** of large-scale new ShP business, but not necessarily in other ways. If they emerge naturally and prove useful, that is welcome; but ***policy makers would be wrong to formalize them*** within the institutional structure of the ShP.

Similarly, there is no clear case that some mutual arrangement is necessarily better than any other. If mutual arrangements involve trust law, it can place a heavy financial and burden on employers and scheme managers, which may actually eat members' value.

With these points in mind, it is worth asking more widely what structural models might in practice serve as the basis for the ShP.

The occupational pensions model



One possible model for the ShP already exists in the occupational pension system. It has ***group access*** — through employers, who can collect contributions cheaply by payroll deduction — and ***mutuality***, the schemes being set up under trust law.

Hence the ***groups*** in this model may (for example) be groups of workers in a particular company. There may be many ***tens of thousands*** of schemes, as there are for occupational pensions today. Each scheme will be operated by a board of ***trustees***, working under existing trust law in order to represent members' interests. The trustees would be responsible for making sure that contributions were collected properly through the employer, and would appoint and supervise ***professional fund managers*** in running the investment strategy of the fund.

Indeed, one could simply ***extend occupational pensions*** to achieve the bulk of the ShP objectives — by allowing defined-contribution company schemes to take all-comers. (Though is not clear that many schemes would *want* to take on non-employees, except perhaps past employees, and this individual access route could well add to their costs.)

More generally, however, the occupational pensions model seems quite unsuited to the ShP approach:

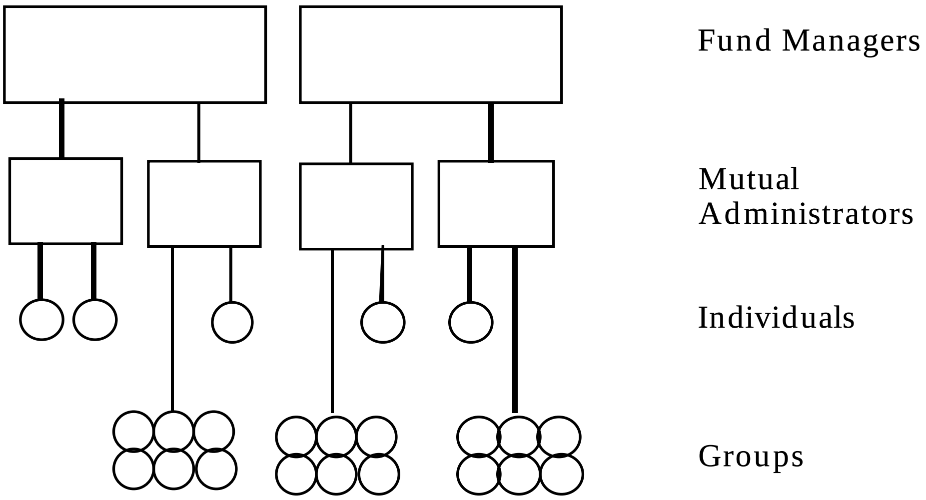
- while employers, with their payroll-deduction facilities, provide easy access to pensions, there are tens of thousands of employer-based pension schemes, and having a similar large number of ShP schemes ***would not promote simplicity*** or understanding;

- the existence of large numbers of ShP schemes might ***not promote portability***, and lack of portability might produce poor value for contributors who were no longer part of the mutual-interest group (*eg* those who had changed jobs);

- ***trust law is not cheap to operate*** (and many occupational schemes already contract out their management to professional trustees). This approach to mutuality would not add anything useful to the ShP concept and would ***not*** cut costs;

- the expensive protection of trust law did not save the Maxwell pensioners and ***does not prevent poor value*** being delivered by some company pensions today.

The mutual administrators model



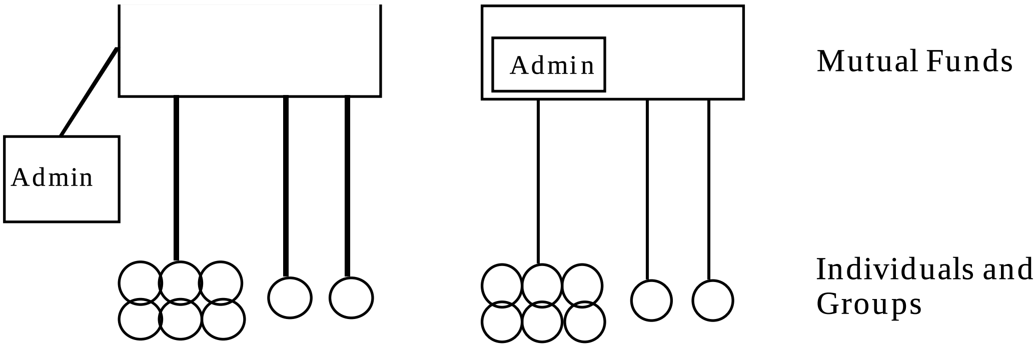
One widely-discussed option is to set up much larger, mutual, ShP administrators — perhaps a few hundred in number — who can sign up contributing members in groups based on their employment or affinity.

The idea is that large ***trade unions***, or ***groups of employers***, might provide the focus for this arrangement. They would be free to contract with ***commercial fund managers*** to invest their members' money — and to switch fund managers from time to time if they thought this would maximize members' interests.

This model encapsulates scale and mutuality, but is ***not obviously cheaper*** than a robustly competitive commercial arrangement:

- building the mutual round a particular industry, or trade union, or geographical area might preserve some mutual interest, but it ***does not serve the needs of today's mobile population***;
- if schemes are open only to people who are members of the mutual group, then those who move on (*eg* people who move from one industry to another) may see their share of the fund 'frozen' and receive poor value for money;
- in very large collections of employees and affinity groups, the ***'mutual interest' is necessarily spread too thin to be of much value***;
- in fact the pressure to set up mutual administrators will probably come from ***fund managers seeking business***, rather than from any genuinely mutual interest;
- the mutual layer could simply ***add to costs*** by imposing an additional tier between individuals and their pension providers.

The mutual funds model

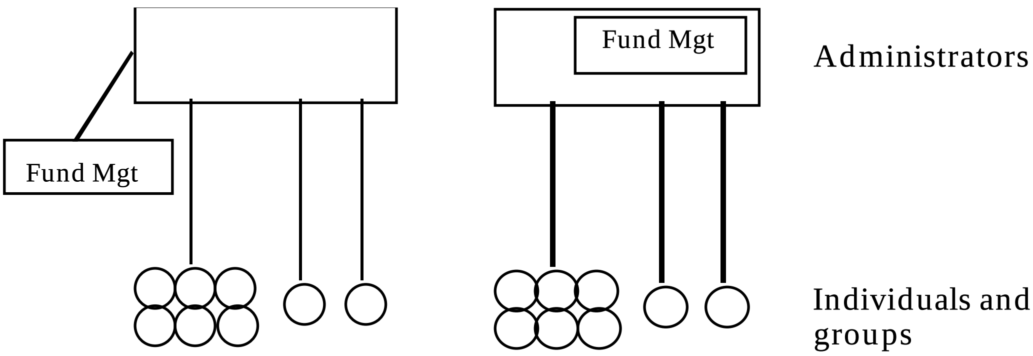


Another option that preserves scale and mutuality is to make ***investment funds*** the mutual focus of the ShP — owned and controlled by their contributing members. The fund custodians could contract with commercial administrators who could sign up member groups, handle premium collection and so on; or they could internalize these functions. Since there are only a small number of dominant fund managers in the UK, we may be talking here about only ten or twelve main ShP providers, though they might offer different service levels and 'badging' to different member groups, and offer a range of different investment strategies to scheme members.

This model has the advantage that it ***works well in the United States***, where it has contributed to a large growth in private pensions. It also ***allows mobile individuals to stick with the same fund manager*** if they choose — when people who started in an employer-sponsored scheme leave their job, they can simply transfer their funds into an individual scheme — and so has much to commend it.

However, given proper safeguards over members' funds in the design of the ShP itself, it is not clear that restricting the field to mutual funds is necessarily better than opening things up to commercial providers too.

The commercial administrators model



The commercial model allows today's banks, insurance companies and other financial firms to provide ShP schemes alongside their other pension offerings, providing the administration and pulling in the fund managers they deem best for the investment task (or doing it themselves). Many countries are in fact moving in this direction, or have already done so.

In this model it is unnecessary to limit providers to friendly societies and mutual insurers, since the main guarantee of ***consumer protection*** comes not from mutuality, but from ***transparency*** — with regulated companies providing benchmarked ShP offerings that are easy for the public to access, exit, and compare. In this model we could envisage a final market of perhaps 25-30 ultimate ShP providers, each offering their own version of a fairly standardized benchmarked pension arrangement.

Gateway groups would also serve their members' interests, by negotiating good value for their members and monitoring the performance of the administrator they chose to go with. Regulation could then focus on the gateways, rather than on each individual pension sale and contract, which would reduce much bureaucracy.

Competition is absolutely essential to consumer protection in this model. It would occur at the gateway level, as providers tried to offer attractive ShP packages to prospective memberships. But it would also require that ***individual members*** should be able to ***change their ShP provider whenever they deemed fit, and without penalty***. This too would serve the needs of a mobile population, so that people did not have to be locked in to any particular group, scheme, administrator or fund manager.

The rules under which companies are authorized to conduct pensions business today are a natural foundation on which to base the authorization of ShP providers. Indeed, ***the fact that this model is how group pensions are largely provided today is a strong argument in its favour***. While many companies claim to be willing to step forward as ShP providers, we would expect that the market would soon coalesce around perhaps two dozen providers — enough for strong competition without being so many as to confuse the public.

Conclusion. Of these four options, the mutual-funds and commercial-provider models seem to have most to commend them — especially the fact that they already work in the UK, the US, or other countries. But any model chosen for the ShP has its strengths and its weaknesses, so it seems ***unwise to preclude some viable options*** by legislating for a single model only — which may then not work.

Viable structures should be allowed to arise naturally on the basis of the defining principles of the ShP — specifically, from the need to establish pension provision which is accessible, inexpensive, simple and intelligible. We should not second-guess the arrangements that will work and with which members will feel comfortable by specifically legislating for a particular arrangement, such as a mutual focus. The key strategy is to design a set of rules which will promote a good-value and intelligible set of offerings, and then let the appropriate administrative and distribution systems arise naturally themselves.

Compulsion and incentives

People are already compelled to save for retirement, through the taxes and national insurance contributions that finance their basic state pension and other benefits, or privately using SERPS rebates. But given the widening gap between the state pension and average earnings — and the large number of people who have made inadequate private provision and are now dependent on state benefits — the issue is whether people should be compelled to save *more*, and whether the ShP may provide a suitable vehicle to help them.

The case for compulsion. There is a strong 'free rider' case for compelling anyone who can afford it to save enough to ***prevent them placing a burden on other taxpayers*** in retirement.

This includes the self-employed: since today they are much more likely to be contract workers than building up a business to fund their retirement, there are fewer grounds than there were for the traditional SERPS exemption. But equally, since many are on modest incomes, any change would have to be phased in to avoid undue hardship.

Problems with compulsion. On the other hand, there are ***serious problems*** with increasing the level of compulsion. For example:

- it would be seen as a ***new tax***, and politically unacceptable;
- the experience of other countries is that it ***may not raise total saving***;
- many people ***could not afford to save*** and would have to be exempted anyway;
- people may have ***good reasons*** for deciding not to save for a pension;
- the ***black economy*** would grow as people concealed income to avoid paying;
- if set too high, people might be ***better off in retirement than in work***.

Compulsion would be ***particularly harmful to older workers on low incomes***, who would be forced to pay more now, but whose additional pension would simply come off their state benefits in retirement.

The rate or level of compulsory saving would be a continuing source of contention and dissatisfaction — in particular, the argument whether people should be forced to save at a specific rate or up to a specific cash amount:

- while it seems fair to make people save enough to prevent them becoming a burden on others, it is hard to justify *compelling* them to do more than that minimum. But if that means compelling people to ***build up a fund of some target size***, and excusing them from further contributions, things immediately become very complicated to explain, operate, and monitor: particularly for people on irregular earnings. And if some part of the contribution came from employers, firms might be tempted to ***discriminate in favour of older and wealthier workers*** who had already reached their target and could therefore work for lower rates.

- a much simpler alternative is to compel everyone to ***pay a set percentage of their income*** into an ShP or some other pension plan. This may be harder to justify on liberal principles, but on the grounds of simplicity it has advantages. Yet it could leave some people over-provided in retirement, while those on very low earnings would still be underprovided.

Incentives. With simplicity in mind, we tend to favour retirement savings being made compulsory up to a set percentage of income, and payable by the individual rather than by employers, which helps preserve the idea that individual benefits are linked to individual contributions. Within that overall percentage, we would not presume to prescribe to people whether they should contribute into the state pension, an ShP, an employer scheme, or a personal or group pension arrangement.

Yet raising the level of compulsion would eat into people's incomes, and would be branded as a new tax, making it ***politically difficult to introduce***. We might move towards compulsion in gradual steps, but if the ShP were brought in at the same time, the initiative would surely be tainted by the same public resentment.

Given these sensitivities, it seems unlikely that compulsion would begin until after the ShP has been introduced. If the ShP is to be made attractive from the outset, there will have to be some form of ***incentive*** instead. The ***incentive will have to be strong***, since we are asking people to tie up their savings for very long periods in a vehicle which (in order to keep costs down) offers only limited choices. And if we are meet the aim of widening access, the incentive would have to be available to taxpayers and non-taxpayers, earners and non-earners alike. We outline such an incentive strategy later in this paper.

COMPULSION: PROS AND CONS

Strategy	Advantages	Disadvantages
If ShP saving is voluntary	✔ Personal freedom: people can choose if and how to save themselves ✔ Does not coerce those for those for whom saving would be irrational ✔ No implied government guarantee	✘ If unattractive, ShP will be a policy failure ✘ simplicity may attract people but ShP may give people worse value ✘ Adds complexity ✘ Advice needed ✘ Many can't afford it, so are still excluded ✘ Hard to devise top-ups without moral hazard ✘ May still not end can-but-don't save problem ✘ Needs incentives and/or rebates, which may be complex and costly
If saving into an ShP is compulsory	✔ Helps protect taxpayers from claims by non-savers ✔ Reduces some poverty in retirement ✔ No moral-hazard problem in state top-ups for underprovided people ✔ No advice needed ✔ Incentives possible but not essential	✘ No rate is right for all ✘ Many people cannot afford to save anyway it, so are still excluded ✘ Some forced to save will simply lose social benefits ✘ Negative work incentive ✘ Implies compulsory saving rate is 'enough' ✘ People may be better off in other pension schemes ✘ Lack of trust in private sector providers ✘ Can't force people into a system they distrust ✘ May divert savings from superior pension vehicles ✘ Potential headache and cost for employers

If saving into some pension plan is compulsory	✔ Helps protect taxpayers from claims by non-savers ✔ Reduces some poverty in retirement ✔ No moral-hazard problem in state top-ups for underprovided people ✔ Incentives possible but not essential	✘ No rate is right for all ✘ Many people cannot afford to save anyway it, so are still excluded ✘ Some forced to save will simply lose social benefits ✘ Negative work incentive ✘ Implies compulsory saving rate is 'enough' ✘ Can't force people into a system they distrust ✘ May only divert savings from other saving vehicles Big collect-and direct headache for employers

3. Benchmark standards

We should be clear about the purpose of the ShP. It is not designed for high-flying investors who want to exploit every nook and cranny of tax relief, but for ordinary people who just want to save a little for their retirement.

Today's 'best advice' sales-process regulation is far too costly for this second purpose, eating deeply into small budgets. Indeed, it may add more to public confusion than public confidence. There is a case for simplifying it now, so that the ShP does not add further to that confusion.

New approach. It is no answer to say that mutual or group sponsors will be able to give members all the advice they need. Advice still costs money, and the more complex the system is, the greater the cost. For the ShP, a new approach is needed.

By ***regulating the ShP product*** through benchmarking, rather than through the sales process, we can give ordinary people better protection at lower cost, *provided* the product is simple enough for them to understand and compare.

Simplicity and ***direct comparability*** through a ***tightly defined ShP specification*** must in fact be benchmark standards themselves, since complex, non-standard offerings would be difficult to compare.

Who regulates? Some state agency is required as the ultimate regulator. The FSA may seem the natural choice, given that many of the potential providers already have to report to it. However, the FSA has a very wide remit, and the today's existing regulatory complexities (such as in sales regulation) must not be allowed to contaminate the ShP — making OPRA the better choice of regulator. Another fear about having too large a regulatory agency is the possibility of regulatory rules becoming ossified and out-of-date, yet hard to change.

Structure and competence. To meet the aim of ***security***, OPRA will want to be satisfied on several points:

- members' investment assets must be ***entirely separate from the corporate finances of providers or gateway groups***, so that business mistakes by those bodies would not cause the loss of members' funds;

- ***everyone involved*** in providing an ShP scheme should be able to deliver high standards — investment managers, administrators, the marketing team, and insurers must all be competent;

- every ShP member should have access to a ***quick and efficient complaints mechanism***. Gateway groups may well set up their own ombudsman systems to help with this.

A simple vehicle

The ShP should set the standard of simplicity that is a key principle for pension reform more generally. It must be:

- easy for potential purchasers to ***understand***,
- likely to minimize ***mis-selling*** opportunities, and
- cheap for providers to ***administer***.

The benchmarking criteria must therefore ***rule out ShP designs with complexities that make it hard for people to make comparisons***. Unavoidably, this in turn means that we must ***cut out some customer choices*** in the ShP, and develop a more standardized (or 'commoditized') approach. Specifically:

- the ShP must have a ***simple money-purchase structure***, which avoids the actuarial burdens of defined-benefit schemes and some of the costly procedures needed to regulate them;

- there should be ***no difficult choices*** for members. and therefore no need to take professional advice (though some may wish to);

- ***charges should be simple and comparable*** between different ShP plans, and contribution limits should be easily understood;

- the ShP should be a ***benchmarked*** product, such that fair value for money is assured and that different schemes can be ***easily compared*** by savers.

A single account. Though ShP investments are ***collective***, and so achieve ***economies of scale*** in their management, members should each have an ***individual account*** showing their share of the collective investment fund.

This ***'individuation'*** is crucial because it gives people a ***sense of ownership*** and therefore a stake in their own future. It makes it easy for members to ***see how their savings are growing***, and to ***understand the link*** between what they save today and their future retirement income, so encouraging them to save more.

Some providers worry that the cost of keeping individual records and servicing individual customers (answering enquiries, providing information, etc) is large and admits few economies of scale. However, we believe that the cost *can* be kept to reasonable proportions. While the annual administrative cost of an individual pension today is around £20, and that of a group personal pension is around £15, the Americans achieve a charge as low as £8 per annum on their mutual fund arrangements. The more difficult tax and regulatory environment in the UK makes the American figure hard to achieve, but we calculate that an ShP scheme of 100,000 members might still be able to keep the annual administrative charge down to approximately £10 per year — though this would be a challenging target. If it could be achieved, however, it would mean that even small savers could be confident that most of their money is going straight into investment.

Open to all. The ShP should be open to ***anyone over 16*** who has not yet retired. (If retired persons were able to open an ShP, it might be used to tax-shelter the family's inheritance, not as the means of saving for retirement for which it was intended.)

One account. For simplicity and as a guarantee against fraud, people should be able to hold ***only one ShP account at a time***.

Straightforward benefits

If the ShP is to set the standard of simplicity for the pension system, its benefits too must be easy to understand and cheap to administer. Thus we recommend that ShP

pension benefits should be paid in a standard way within a ***standard window of retirement ages***, with the whole of an ShP saver's account being used to provide a regular pension income. This rule will promote simplicity and keep costs down.

No tax-free lump sum. Today's pension savers are allowed to take a ***tax-free lump sum*** at retirement. This can be attractive, particularly for those on low or irregular earnings who comprise much of the ShP target group.

However, the ShP is a foundation-level plan. It aims to help people build up an ***adequate retirement income***, not a tax-free cash sum — which would add to its complexity and require safeguards against 'double dipping' (people squandering the lump sum and then falling back on state support). So we propose that people should be able to draw on their ShP savings as a regular income only.

There is a case for wanting to extend this same principle into the existing pension rules, where again it would promote simplicity and intelligibility, and reduce costs. But then many contributors are relying on that lump sum when they retire. It would require delicate design, perhaps balancing this loss by removing the contribution limits and other regulations, to make this a publicly acceptable strategy.

If the ShP is to be a ***voluntary*** saving arrangement, and does not have the tax-free lump sum attraction, then ***its attractiveness must be boosted in other ways***. Simplicity, transparency, intelligibility and easy access are a good start.

Pension income. It is possible to allow people to ***draw regular amounts*** from their fund — at least, up to some limit which prevents them exhausting it too rapidly. This may be an attractive option for those with other sorts of assets or income, or for those who fear they may die earlier than average and want to pass on their savings to friends and family. However, there is always the risk that people will die much later than average, and could exhaust their fund well before that.

The ***annuity*** alternative shares this risk with insurers. As with private pensions today, ShP savers could use their money to ***buy an annuity*** that will pay them a regular income for the rest of their lives. For individuals, the risk remains that annuity rates may be poor at the exact moment of retirement, leaving them with a pension of small size — which is why a large degree of flexibility over conversion dates has been built into the private pensions schemes of today. Allowing comparable flexibility over retirement date may help ShP members — except those who had little choice about when they would need their retirement income.

Other possibilities also exist. For example, savers' annual contributions could be used to buy a deferred annuity for their retirement; but this concept may be hard to explain to many ordinary people.

Another prospect is a form of ***phased conversion***, where only a part of the member's fund would be converted should annuity rates be poor, with some of the rest being available to be drawn in cash now, the residue being converted when annuity rates improve. Or people could draw on their fund, but only in amounts that always left them with enough to purchase an annuity of minimum amount.

Such hybrid or phased conversion systems would also allow people to leave the balance of their fund to relatives in the case of early death, which total conversion to an annuity would not. But they do add complexity.

To counter this, one further proposal has therefore arisen — that, as with final-salary occupational pensions, ***ShP providers could simply commit to paying members a regular pension*** from the totality of members' funds. The pension might even be specified as a cash sum or as a percentage of lifetime earnings. While this sounds attractive because it gives savers some definite pension target, it still cannot eliminate the same risks, which still have to be paid for. In this case, the scheme itself would have to insure the retiring group each year, just in case they tended to live longer than expected; so those retiring in a certain year would still share the cost. Or the insurance cost could be spread to the entire membership, which seems unfair on them.

Choice. The scheme-based approach sounds simple: members at work pay money over to the provider, and the provider pays money over to them when they retire. But the cost of such pension guarantees is expensive, and almost certainly represents poor value to those who can least afford it.

Equally, providers who offer good returns to their savers might not necessarily offer a good service to their pensioners. So allowing people to drift unthinkingly from saver to pensioner with the same provider may not serve their best interests.

If people can switch providers at any time, retirement might be a good opportunity for savers to move to one they feel will serve them better as pensioners. The annuity route, however, can actually be used to push people into making an active choice — by allowing them to ***shop around between annuity providers***.

Future value. With people now living much longer beyond retirement age, a pension income is easily eroded by inflation over the years. We suggest that the ShP pension should feature ***limited price indexation*** up to 5% pa: an unlimited guarantee would be costly and would represent poor value for money.

In other types of pension, there has been some move towards ***equity-backed annuities***, which give pensioners the chance to capture some of the stockmarket growth that could occur over what may be quite a long retirement. This approach may seem too risky for the ShP target group, whose savings may be quite small.

Unisex pensions. Because women live longer, annuities give them a lower regular income than men. To help ***close the pensions gap*** between the sexes, some have suggested that the ShP should pay pensions at ***unisex*** rates. While this is possible, it does lead to some significant practical problems. For example:

- it may ***make the ShP unattractive to men***, who could do better in other pensions products;
- if men could do better in one of today's non-unisex pension products, then ***advice would be required*** in order to avoid ***ShP mis-selling***, adding to the regulatory burden and complexity of the ShP;
- there might need to be safeguards against women ***transferring large sums into their ShP just before retirement***, solely in order to capture an above-market annuity rate.

Retirement age. A standard pension age would promote cheapness and simplicity, but if the 100% annuity approach is adopted, there must remain some flexibility so that people are not forced to convert when annuity markets are unfavourable.

Being able to draw benefits within a specific decade, say 60-70, would mean that people had a reasonable period of around 40 working years in which to build up their savings, and equally would help promote flexible working in the few years before they reach the state retirement age. This seems quite appropriate for the ShP.

Investment patterns

Growth and security. Meeting customer expectations over the long term requires the correct investment mix. For most of the time, ***an ShP investment must be held in 'real' assets*** (such as equities) in order to deliver the potential for real growth relative to inflation.

However, to provide the necessary ***security*** to members, ShP fund managers will be expected to protect those close to retirement from the volatility of the stock market, and from a downturn in the annuity market, by switching into appropriate assets (such as gilts). In practice this is done, not by buying and selling individual equity or bond holdings for each individual member — which would be cumbersome and costly — but by grouping members according to their age and risk-aversion, and then adjusting the balance of the underlying pooled investments in which they share.

Types of fund. The money which people subscribe into their ShP buys them units of a ***collective investment fund***. By way of example, the underlying assets could include: ***equity-based*** investments, both index-trackers and non-trackers; a ***managed fund***; a ***fixed interest*** fund; or an insurance company ***with-profits*** fund.

Investment should not be limited to ***tracker funds***, for a variety of reasons:

- because of exchange-rate fluctuations, it is hard to track indexes across currency areas, meaning that tracker-fund investors would be denied both the ***returns*** and the ***diversification security*** of ***investing overseas***;
- trackers are neither precise nor necessarily cheap — annual tracking errors of up to 0.3% are common, as are charges of up to 1% of funds under management, both of which make a big difference to an investor's savings fund over a lifetime;
- there are also ***volatility*** dangers when much of the market is tracking itself;
- there would be a large ***political risk*** in locking people into tracker funds were the UK market to fall for a protracted period.

Limited choice. If people are to purchase an ShP without needing a financial adviser, they must ***not be faced by confusing choices*** about how or where their money should be invested. At most, they might express a preference over ***what degree of risk*** they could be prepared to contemplate; and some providers might offer an ***ethical investment option***. But further choices would complicate the ShP concept and could be an unsettling barrier to the target group.

Where people join an ShP scheme through a ***gateway*** group, such as a trade union or employer, the group itself will have selected the investment strategies that seem most appropriate for its membership, so that individual members do not have to.

Portfolio regulation. Otherwise, the objectives of simplicity and transparency dictate that any investment choices open to ShP savers must be ***comparable*** between the various ShP providers: for example, there must be broad uniformity on descriptions such as 'low-risk'.

There is no need to be excessively ***prescriptive*** on the investment portfolios of ShP providers to guard savers against risk. UK fund managers have long experience in managing risk and growth.

Making the ShP attractive

Contracting out. The ability to take a ***SERPS rebate*** could provide a valuable contribution to the ShP savings of many people. But if people might be made worse off by contracting-out, they will need advice, which is expensive.

One option might be to ***re-calculate SERPS rebates*** so that anyone would almost certainly be better in an ShP or other pension instead, so that people do not need costly advice before they contract out. But it is hard to imagine any government spending enough on SERPS rebates to make this a certainty.

Many people argue that SERPS will be costly to maintain into the future, and that its earnings-related nature is anomalous in a welfare state that otherwise focuses its benefits on the poorest. Since it also complicates people's decision on how best to save for themselves, the best policy is probably to phase it out. If complete abolition is impossible for political reasons, SERPS might otherwise be focused specifically to help only those whom the private sector cannot provide for very cost-effectively (say, up to an income of £9,000 at present, but perhaps less than that if the present system were made simpler and cheaper to operate).

Need for strong incentives. Private pension vehicles today allow earlier retirement, tax-free lump sums, a wider choice of investments and annuities, and many other features that are more attractive than those we have proposed for the ShP. If the ShP is to be a voluntary option, therefore, it must have other attractions that restore the balance. Simplicity itself is one such attraction, but we must go further.

A new sort of incentive. Many millions of people have bought into today's personal and occupational and pensions systems on the basis of marginal-rate tax reliefs and established percentage-of-earnings limits. ***It would be unfair and unjust to interfere with this***.

Yet since the whole purpose of the ShP is to extend the savings habit more towards those on low or irregular earnings, a ***different sort of incentive*** is appropriate for this new vehicle. After all, ***many in the target group pay little or no tax, and so are not attracted by tax reliefs, nor tax credits***.

Instead, we suggest adding a ***government bounty*** to all ShP contributions up to some annual limit. An incentive of this sort is easy for people to understand, and looks more attractive than today's tax reliefs precisely because it is so clear and obvious.

The bounty should be available to taxpayers and non-taxpayers alike, extending to everyone the incentive to save. In particular, it will help the ***non-earning partners*** of working people to establish a pension of their own, which today's tax rules disallow. (Which in turn would reduce their dependence on widow's benefit or the income support system.)

Independently of us developing this idea, we have been pleased to discover that Julian Le Grand and Phil Agulnuk have also advocated the partnership, matching-funds incentive approach. Their analysis shows that, the more generous the bounty can be made, up to a straight £-for-£ matching, the more help it provides to those on smaller incomes making smaller contributions.

With this in mind, we suggest at the bounty should be as near to a £-for-£ matching as revenue considerations will allow: that is, for each pound the individual puts in to an ShP arrangement, the government contributes one pound more. To limit Treasury exposure, less generous bounties are obviously possible — say, the government giving savers 50p for each £1 they invest in an ShP — but they do not benefit smaller contributors to anything like the same extent.

Plainly, such a matching-funds system cannot be open ended. Setting a figure of £2,000 per person per year seems about right as a limit on the bounty. With smaller sums, a larger percentage of contributions is absorbed by cost overheads, so it helps to encourage them to do as much as possible. Equally, though, the ShP is designed as an entry-level pension plan, not a means to allow larger investors to save tax.

We suggest that this annual limit should be fixed first, with the precise rate of matching then being decided afterwards on the basis of predicted uptake and revenue implications.

To curb administrative costs, this has to be a ***use it or lose*** it limit: if not used the £2,000 allowance cannot be carried over into other years. And the bounty would be easy to administer: ShP providers would simply collect it from the government on the basis of the contributions made by members each month.

Some people might want to contribute more than £2,000 in a year, even though they might accept that no further bounty would be payable. However, there would be a significant administrative cost involved in non-bounty and bounty contributions at the same time, and broadly speaking we believe that people who want to invest larger sums should move on to some other pension arrangement.

The ***growth of ShP funds should be tax-free***. Again, this is easier to manage if all the money in an ShP fund qualifies for relief, not just the bounty-qualifying part.

Intelligible charges

A single charge. As an essential step on the road to transparency, the ShP charging structure must be clear, simple, easily understood by contributors, and readily comparable between providers. To this end, providers should levy ***a single annual charge only***, based on the value of the funds managed (or an equivalent for with-profits fund arrangements).

This charging structure would be as clear and comparable as APR figures are on deposit accounts today, and would promote open competition while removing complexity and jargon. It would also encourage good service: since set-up costs could not be charged directly, providers will earn more from a loyal and long-term customer base than one which churns rapidly.

The charge could ***vary according to the size of the member's fund*** — as savings-account rates do today — though comparability would demand a ***standard scale***. However, it is probably better if providers levy the ***same percentage charge on all their customers***. This would be much simpler in terms of comparability; and (happily for the government) it would be mildly redistributive. There is little danger in providers 'cherry picking' the larger accounts, since most ShP accounts are likely to be modest in size anyway.

Level of charge. There need be ***no regulated maximum charge***, since transparency and competition will bid down charges generally, and some ShP schemes may wish to offer superior customer service which costs a little more than the norm.

However, on the basis of the present specification, we believe that a typical provider might charge 1% or less, with some early moves to rates below that, possibly at

0.6%. The American mutual funds seem quite able to deliver high standards of customer service and information on annual charges of between 0.5% and 0.75%

The actual level of the charges that can be achieved here in the UK will depend on just how simple the terms and structure of the ShP can be made. With much simpler tax rules, a more open incentive structure, benchmarking, standard investment and benefit options, and the use of more automation in reporting to regulators and customers, it should certainly be possible to match the low US charge levels.

Standard growth figure. There must also be a ***standardized expression of fund growth***. With only two standardized figures for customers to compare — returns and charges — the ShP market should be completely open and transparent.

Moving your money

ShP savings should be ***fully portable*** within the ShP environment — not merely because people today are highly mobile, but because the threat of customers moving their accounts is a strong stimulus to competition.

ShP members must be able to switch from one ultimate ShP provider to any other, at any time — and taking the ***full value of their fund*** with them, without any charges, or loss of bonuses, or deductions for early discontinuance.

This freedom to move between providers will further increase the pressure on ShP administrators and fund managers to maximise the quality of service they deliver, so as to keep customers loyal over the long term and minimise the costs of churning.

In the event that the regulator withdraws approval from an existing scheme, there must be provision to transfer investors' funds without penalty to another provider or another scheme.

Transfers between ShP and other pension vehicles would be problematic, however, because of differences in the tax and regulatory structures. Again, the other attractions of the ShP must be sufficient to make this price seem worth paying.

Wider protection measures

Guarantees are costly. Mechanisms to guarantee a minimum level of fund growth are highly expensive and would give long-term savers poorer value for money. The ShP should ***not give such guarantees***.

This means that there must be a strong level of ***public education*** about investment, and that ShP customers must know that in any year the value of their investments may go down as well as up.

Dependants. ShP savings ***belong to the individual contributor***. A saver should therefore be able to nominate any dependants (*e.g.* a spouse, partner, or children), who would receive the whole value of the saver's fund were he or she to die before retirement.

Were the saver to die soon after retirement, it seems reasonable that the remainder of (say) the ***first five years' pension*** should continue to be payable to the nominated dependants. Most people would regard this as only fair, though it does add to the cost of providing the ShP.

If there are incentives for everyone — and not just those in paid work — to take out an ShP, it is likely that a pensioner's dependants will themselves have an ShP plan to draw on in retirement. So it should be unnecessary to build in more extensive benefits for the surviving spouses or partners of ShP members.

Insurance top-up. In principle it is possible to build some ***insurance protection*** into the ShP, which will continue to credit a saver's regular contributions into their account in the event that their income dries up because of sickness, injury, disability or unemployment. A reasonable way to set the amount credited would be to take an average of the individual's last three years' contributions.

But again, any such guarantee adds to costs. Insurers would find it hard to cover the first 3-6 months' loss of earnings because of the potential 'moral hazard' effect: that people would have less reason to hang on to their job. An open-ended commitment is also expensive: if someone remains out of work for more than two years, it may be more cost-effective for the top-up burden to be borne by the state.

Loss of benefits. There is little point in people on low incomes struggling to save small amounts into any pension plan, if as a result they lose state benefits and end up no better off. Yet this is what happens today.

The ShP will simply not attract the target group if this possibility persists. We suggest therefore that ShP savings and pension income ***should not be taken into account in the eligibility tests for means-tested benefits***.

Irregular contributions. Some people — particularly those who are not in regular work — will need ***flexible collection facilities*** so that they can stop and re-start contributions easily, or make occasional or one-off payments. Our focus groups suggest that potential ShP savers would value, in particular:

- a range of different ways to save;
- easier ways to save small amounts;
- being able to pay more when they can afford to;
- contribution holidays when family finances were tight.

We believe that providers should have to provide this flexibility, and their charging structure must ***not penalise or discourage such variable contributions***.

Information to members

Contributors must receive ***regular and clear information*** about their ShP funds, written to Plain English standards. At the very least, this should include an annual report, showing:

- the ***size*** of the member's fund at the ***start of the year***;
- the ***contributions*** that have been made over the year;
- any ***charges*** that have been deducted;
- the ***size*** of the fund at the ***end of the year***;
- the ***rate of return*** on the investments;
- what ***size of pension*** the fund would buy today.

It should also be possible for members to ***check their fund*** at any time, perhaps through 24-hour telephone helplines.

The public must also have ready access to ***simple and standardized illustrations***, showing the contribution level required to achieve a target pension, or the future impact of changing their contribution levels. Strict comparability would be the rule, so that people could not be misled by illustrations of growth over arbitrary periods chosen by the providers.

Processing

Although gateway groups, including employers, might be well placed to collect contributions from ShP savers, to consolidate them, and send them on to the appropriate provider or providers, these functions still have a cost.

If the ShP places yet another burden on employers, it will put further pressure on wages and work opportunities. If gateway groups do the processing, then that has to be paid for by someone, and ultimately by the members themselves.

A ***clearing house system*** has been suggested to help employers and gateway groups collect and distribute the millions of contributions made each week. Once again, however, there is a danger that ***imposing this extra administrative tier will simply add to costs***. It is certainly possible that large gateway groups may take the lead by setting up some electronic administrative mechanism, to which others might then be able to plug in. But it is better to let the marketplace evolve its own structures than impose them through legislation.

Processing systems will inevitably have to match up with the National Insurance recording system, and be open to electronic monitoring by the regulatory authorities. At the very least, there will need to be some ***simple and standardized electronic format*** by which employers, gateway groups, and ShP administrators can communicate cheaply and efficiently. But public policy should be formulated so that it does not obstruct such the development of such simple solutions.

The NI recording system could itself become the clearing house, at least for those who pay national insurance — collecting their ShP contributions along with their NI contributions, consolidating them, and directing them to the relevant ShP providers. However, providers today would need a lot of convincing that NIRS could actually conduct such operations accurately, cheaply, and promptly.

More widely, research presented to the Adam Smith Institute suggests that the more of the pension management process that can be dealt with in electronic form, the lower the costs are likely to be. This includes items such as deducting, consolidating and transferring contributions to providers, individual account administration, investment management, and reporting to members.

The new partnership

Dividing the tasks. A deliverable ShP 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 ShP, 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:

- keep the ShP ***easy to understand***;
- make the ***eligibility, contribution and benefit rules*** simple;
- ***benchmark*** the ShP to promote ***clarity and comparability***;
- ***protect customers through open competition***, not over-regulation;
- ***reform social benefit entitlements*** so that it always makes sense for people to save into an ShP;
- deliver incentives through a straightforward ***bounty*** system:
- actively promote the scheme and further ***public education***, possibly ***funding customer advice*** at the point of first purchase.

The provider role. On their part, ShP providers 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 limited period during breaks in earnings, for whatever reason;
- offer ***easily understood, readily comparable products*** with high levels of customer service;
- give customers ***quality access to stock market growth***, with automatic procedures to limit their financial risks near retirement;
- offer ***genuine portability*** and ***penalty-free transfers***.