TOMORROW'S INVESTOR:

Building the consensus for a People's Pension in Britain

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RSA Projects

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ABOUT THE RSA

The RSA

The RSA has been a source of ideas, innovation and civic enterprise for over 250 years. In the light of new challenges and opportunities for the human race our purpose is to encourage the development of a principled, prosperous society by identifying and releasing human potential. This is reflected in the organisation's recent commitment to the pursuit of what it calls 21st century enlightenment. Through lectures, events, pamphlets and commissions, the RSA provides a flow of rich ideas and inspiration for what might be realised in a more enlightened world; essential to progress but insufficient without action. RSA Projects aim to bridge this gap between thinking and action. We put our ideas to work for the common good. By researching, designing and testing new ways of living, we hope to foster a more inventive, resourceful and fulfilled society. Through our Fellowship of 27,000 people and through the partnerships we forge, the RSA aims to be a source of capacity, commitment and innovation in communities from the global to the local. Fellows are actively encouraged to engage and to develop local and issue-based initiatives.

To find out more about the RSA, please visit our website at www.theRSA.org

About the author

David Pitt-Watson is Chair of Hermes Focus Asset Management. He was formerly head of all Hermes shareholder activist activities, the largest stewardship programme of any fund manager in the world. He has enjoyed a varied business career, both as a prominent City investor and as a senior strategic advisor. He has advised leading policymakers on issues of industrial and financial policy for more than 20 years. He is a director of Oxford Analytica and a trustee of the Institute for Public Policy Research (IPPR). He has been a member of several policy commissions, and is a trustee of two pension funds.

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In the next phase of our work, we aim to build on the emerging consensus described in this report. We look forward to working with all these groups, and indeed to embracing all those who seek to create a better framework for pension provision in Britain.

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Sir John Banham (Chair)

Robin Ellison

Vicky Price

Olaf Sleijpen

Matthew Taylor

Lindsay Thomas

TOMORROW'S INVESTOR ADVISORY BOARD

Sir John Banham, advisory board chair

Sir John Banham is the chairman of Johnson Matthey Plc (ranked number two in the Management Today league table of Britain's Most Admired Companies 2008) and the senior independent director of Invesco Ltd. Since 1992, he has chaired five major UK plcs and has significant experience of venture capital as chairman of Westcountry Television, ECI Partners and Cyclacel Pharmaceuticals. Banham was the first controller of the Audit Commission (1983-1987), director-general of the Confederation of British Industry (1987-1992), and the first chairman of the Local Government Commission for England (1992-1995)

Robin Ellison

Robin Ellison is head of strategic development for pensions at Pinsent Masons, advising on the development of pensions and related products as well as European pensions, pensions trustee law and pensions in matrimonial matters. In addition to being an accredited mediator, Ellison is a non-executive director for a number of companies and trustee of several pension funds. He is visiting professor in pensions law at the City University Business School (now the Cass Business School) and visiting senior lecturer at Kings College London. He founded the Association of Pensions Lawyers and is chairman of the National Association of Pension Funds. He was the first solicitor to be elected honorary fellow of the Pensions Management Institute.

Vicky Pryce

Vicky Pryce was chief economic adviser and director general, economics at the Department for Business, Innovation and Skills. She is on the council of the Royal Economic Society and has recently been elected a fellow of the Society of Business Economists. Pryce is also visiting professor at the Cass Business School and has been elected to the Council of the University of Kent.

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Olaf Sleijpen has recently been appointed Director of Pension Fund Supervision at the Dutch central bank (DNB). He is Professor of European Economic Policy at the University of Maastricht and was previously Managing Director of Institutional Clients at APG Group. He is also member of the executive board of Cordares, a subsidiary of APG Group.

Olaf Sleijpen joined ABP — and later APG — in 2004. Before he has been Personal Advisor to Wim Duisenberg, President of the European Central Bank (ECB) and Coordinator of the Counsel to the Executive Board of the ECB.

He is also winner of the Young Captain Award in 2008, a prestigious business award for top talent in The Netherlands.

Matthew Taylor

Matthew Taylor became chief executive of the RSA in November 2006. Prior to this appointment, he was chief adviser on political strategy to the prime minister. Taylor was appointed to the Labour Party in 1994 to establish Labour's rebuttal operation. His activities before the Labour Party included being a county councillor, a parliamentary candidate, a university research fellow and the director of a unit monitoring policy in the health service. Until December 1998, Taylor was assistant general secretary for the Labour Party. During the 1997 general election he was Labour's director of policy and a member of the party's central election strategy team. He was the director of the Institute for Public Policy Research, Britain's leading centre-left thinktank, between 1999 and 2003.

Lindsay Thomas

Lindsay Thomas was a director of the Financial Services Authority until 2006. His senior FSA roles included directorships of Retail Firms Supervision, Knowledge Management and Authorisation. As a senior supervisor he has been at the centre of almost every major issue in financial services markets stretching from the 1986 crash and Barings, to LTCM and Equitable. Thomas is now working with FD Public Affairs' specialist financial services practice, providing advice to clients. In addition, he is also CEO of Sustainable Risks Ltd, a risk, communications and regulatory advisory practice.

EXECUTIVE SUMMARY

The system of occupational and private pensions in the UK is not fit for purpose. It is not the low cost, trustworthy system which savers justly demand.

It needs reform. In the UK, the state pension is the lowest relative to income of any OECD country. We therefore depend on private provision. Yet only 50% of employees currently contribute to a private pension.

For those who do save, the current system is poor. Indeed, if a typical British and a typical Dutch person save exactly the same amount for their retirement, the Dutch person will end up with a 50% larger pension.

British savers are often unaware of how costly pensions can be. Our research shows that people who are sold pensions at a charge of 1.5% per annum, do not realise that over the lifetime of a pension, this will result in 38% of their possible income being lost to fees.

Reform is needed. In this report, we outline how the UK has ended up in such a poor position, and the key questions which pension policy makers now need to address.

We also describe what an effective pensions architecture would look like. Building on the positive but partial reforms which are currently in place, Britain should aim for a low cost system of occupational pensions, based on auto-enrolment, and a limited number of suppliers whose scale allows them to offer low costs. Pension savings should be aggregated in a way which will give adequate returns; that suggests collective provision and trustee governance. And those charged with investing our money should do so responsibly; as trustworthy agents of those whose money they invest.

Few dispute these conclusions. Indeed most of the characteristics we suggest can be found in the pension systems of other countries, notably Denmark and Holland. Both are recognised as having one of the most effective pension provisions, and the lowest levels of pensioner poverty in the world. Few experts dispute the overall framework which the RSA advocates.

For this reason, we conclude that the answer to Britain's inadequate pensions is not just a technical one. It is also a political one. No single agent can create effective occupational pensions. It requires all stakeholders to work together; politicians of all political persuasions; regulators and policy makers; representatives both of employees and employers; advisors, actuaries, academics and think tanks; industry groups and pension providers.

In this report, we lay out in a series of memoranda, the sort of actions which these stakeholders need to take. During our work we have had the opportunity to talk to all of them. Those conversations make us optimistic. If momentum for reform builds, there is every prospect that, at reasonable cost, the new generation of British workers can enjoy adequate income in retirement.

INTRODUCTION

Over the past two years the Royal Society for the encouragement of Arts, Manufactures and Commerce (RSA), has been investigating how to improve the way savings and investments are provided in this country. In particular it has focussed on the provision of occupational and private pensions in the UK. Its conclusions are stark.

The system of pension provision in this country is not fit for purpose. State pension provision is very modest. Indeed the UK has the lowest rate of state pension provision relative to income of any country in the OECD.

Private and occupational pensions do not fill the gap. They are not provided comprehensively. They cost more and more, and hence give lower returns. A citizen wishing to save for retirement today through a private pension might typically find they need to set aside more than twice the amount of money which would have been required of their parents' generation.

All this is despite the fact that we devote massive resources to our pension provision. Figures in 2007 showed that £145 billion, more than 10% of GDP, is set aside each year for this purpose[1]. Over the years, a pot of nearly £2 trillion pounds has been accumulated to create adequate private pensions[2], yet the nation still cannot offer adequate retirement incomes to all.

To break out of this unsatisfactory and costly structure will require more than simply a new government policy. Of course the government has an important role to play. However, in the past, successive tinkering by government has contributed to the problems we face today. To be successful pensions policy needs to be sustained for generations. Further, it is not just government policy which is required. If there is to be successful private pension provision it will require individuals, employers and pension providers to support the new regime.

The political imperative to resolve pensions issues is often low because the problem of inadequate pension provision will make itself felt many years from now. However, if these problems are not resolved, Britain will look forward, in future generations, to a level of pensioner poverty we have not experienced for over 70 years.

There is also good news. During the period of this study, the RSA has undertaken extensive consultation with pension savers, with employer and worker representatives, with academic experts, policy makers and other pension stakeholders. They are all agreed that there is a problem. Crucially, on issues concerned with occupational and private pensions, they are also agreed on the nature of the solution.

Further, recent government policy, in particular the introduction of auto-enrolment, creates a foundation on which we can construct an effective architecture for pension provision.

That architecture can be found by looking at pension provision in other countries such as Holland, Denmark and Australia, where pension provision is recognised to be the best in the world. It is an architecture which is recognised by leading thinkers in the field.[3]

1 £60 billion of the National Insurance fund were used to finance pensions (NIF Annual Report, 2008). Total contributions to private pensions were £85.2 billion (ONS, 2008)

2 Pensions Policy Institute, Pension Facts, 2008

3 For example, the International Centre for Pensions Management at the University of Toronto, whose advice and insight have been invaluable for the RSA's work

During the period of our work we have been in contact with pension providers from those countries. We have discovered that, if the right incentives were in place in the UK, Dutch and Danish pension funds would be willing to create in the UK the same type of pension provision as is available in their country, and would join with British suppliers to create a system which, over time, could become one of the best in the world.

There is thus a huge and difficult problem to solve. But there is also a clear opportunity to solve it and to create a pension system in the UK which is truly “fit for purpose”.

The aim of this paper is to provide an overview of how that system would operate; a blueprint for the new pensions consensus.

It aims to address a number of questions:

- How and why did the RSA go about this work?
- What are the main features of the UK pensions system?
- What are the key policy choices we face?
- Why has the UK ended up with inadequate occupational and private pension provision?
- What are the key issues which need to be addressed to create a successful system of occupational and private pensions?
- Therefore, what architecture should we seek to create for our pension system?
- Will it be possible to achieve a consensus to create such a system?
- If so, what actions need to be taken, and by whom?
- What will the RSA do now?

...at the conclusion of our research, we discovered that their priority was not to be able to intervene in companies where their pension fund had a shareholding, valuable though this might be. It was to know that there was a system of savings and investment which was trustworthy.

SECTION 1. *Background*

The RSA "Tomorrow's Investor" project began two years ago. We observed that the pension and savings industry of Britain was very large. Indeed, most of the money which funds our capital markets comes from the amalgamation of relatively small amounts of savings by many millions of people. So, for example, the shares in most of our major public companies are owned by pension funds and other institutional investors which represent the savings of many individuals, not just from Britain, but from all around the world. However, it was far from clear to us that the system of savings and investment gave proper "voice" to citizen investors. The aim was therefore to try to help think through how it might be possible to construct financial institutions which met the needs and desires of those millions of savers.

Our work therefore began by consulting those long term savers. They were brought together in the manner of a "Citizen Jury", to discuss the issues associated with the provision of pensions and other long term savings, and the way in which those savings are invested. Our original hypotheses had been that citizen investors would be interested in finding structures through which they could exercise their influence over the operations of the companies which they communally owned.

However, at the conclusion of our research, we discovered that their priority was not to be able to intervene in companies where their pension fund had a shareholding, valuable though this might be. It was to know that there was a system of savings and investment which was trustworthy. The system should be one which would take their savings and ensure that they were responsibly invested at low cost, without the need for constant oversight. As we discuss below, they were aghast at the cost of private pension provision.

Therefore the first output of our work was been to suggest a structure for pension provision which could meet the citizen investors' requirements. This outline was published last year.

Since then we have had extensive discussion with those most closely involved in the pensions debate. These include:

- Stakeholder groups, including the CBI, representing the employers who sponsor pensions, the TUC, representing the workers who receive pensions, and the National Association of Pension Funds, which is the leading UK body providing representation for those involved in designing, operating, advising and investing in all aspects of pensions
- Experts, from the fund management, law, actuarial and other relevant industries, and from universities
- Providers of pensions from other countries, including in particular from Holland and Denmark
- Universities and research institutes from around the world
- The UK government

The aim of these discussions was to understand the extent to which the directions we suggested in our earlier paper reflected current thinking and best practice, and to try to devise a new consensus for pension provision which would meet the goals of savers and society.

SECTION 2. *The Current UK Pensions System*

Those writing about pension provision often describe it as having three "pillars". The first pillar is provision made by the state. The second is provision made through an employer. The third, provision made privately. There is, of course, some overlap between these pillars. For example, the government provides pensions as an employer to public sector workers. Employers may negotiate for a single provider to offer private pensions to its workforce.

However, the three pillars are a helpful way of thinking about the scale and nature of pension provision.

As regards state provision, about £60 billion from national insurance contributions, or 5% of our GNP was set aside in 2007 to pay pensions.[4] This means that the state pension only provides 38% of previous earnings. Britain therefore provides the lowest "income replacement rate" of any OECD country. As a result many pensioners who have no other income are entitled to welfare benefits in order to avoid poverty. Attempts to enhance the state pension, through a second state pension have proved complex, and of limited success.

The second pillar of pension provision is occupational pensions. Save for some public sector employees, whose pensions are paid from taxation, occupational pensions are funded by making payments into a fund during an employees working life, usually with contributions made both by employer and employee. Historically these pensions were ones where the level of pension was targeted at the level of the employee's salary, with a proportion of salary awarded for every year of service. Over time, these targets became promises, hence the pensions being known as Defined Benefit (DB) pensions.

However, over the past twenty years employers have become concerned that with the uncertainty of life expectancy, and of investment returns, they can no longer keep the DB pension promise. As a result, DB pensions have been replaced with Defined Contribution (DC) pensions where the level of pensions is simply dependant on the contributions made and the returns made on those contributions.

One unintended effect of the switch from DB to DC is that some employers have used the opportunity to reduce their contribution to the pension of their employees. So, an average DB pension receives annual payments of 20% of the employee's salary, with about 15% funded by the employer and 5% by the employee. In contrast a DC pension receives 9%, 6% from the employer and 3% from the employee[5]. And, as we shall see, the cost and return from DC schemes is markedly lower than that from DB schemes, reducing still further the benefit the employee will receive in retirement.

As employers have switched from DB to DC, they have also switched from collective to individual provision, and from trust to contract based governance. So, in a DB pension, the money set aside is held and invested collectively against the promise which has been made to the pensioner. An individual DC pension could also be managed collectively, but typically it is not. Indeed the money set aside for an individual DC pension is usually an individual claim on a pot of money; a saving account rather than a pension.

Collective pensions were managed through trustees, with strong legal protection to ensure that what was done is in the beneficiaries' best interest. The individual savings account is simpler and, hence, often contracted without trustees. Indeed many employer DC pensions are simply individual arrangements between the employee and a pension provider. Apart from initially choosing the supplier, the employer has no ongoing responsibility for the way in which pension money is managed.

Some £80 billion a year is spent on private and occupational pensions. Of this about £40 billion is placed in traditional DB pension funds. A further £20 billion goes to pay unfunded government pensions, and £20 billion is spent on private and occupational DC pensions. It is this last area which is growing.

We would note that many employer DC pensions look much like private pensions, which are the third pillar of pension provision. These are essentially individual savings accounts, but with the tax and other advantages which accrue to pensions.

Occupational and private pensions in the UK are extensive, but far from comprehensive. In 2008 just over 50% of employees were covered by some sort of an employer sponsored pension, down from 55% a decade earlier. Around 34% were covered by a DB pension, down from 45% a decade earlier[6]. More than three quarters of people on income below £5000 do not contribute to a private pension, 60% of those with income between £5000-15,000 have no such provision[7].

4 NIF Annual Report, 2008

5 Pensions Policy Institute, op cit

6 ONS, Annual Survey of Hours and Earnings

7 Family Resources Survey, 2004/5

SECTION 3. *Key Pension Policy Choices*

The work of the RSA does not pretend to have answered all the issues associated with pension provision. It has particularly focussed on occupational pensions; the so-called "second pillar". However, there are other important issues in the provision of pensions in the UK. Amongst these, some are fundamental to the design of the pensions system. On some of these fundamental issues there is considerable debate. On others there is consensus. There are four fundamental themes which it is worth touching upon.

The Dependency Ratio

One critical issue where there is agreement amongst experts is that the pensions "dependency ratio" needs to be managed. That means that, if pensions costs are not to get out of hand, there must be consistency between the number of working years during which pension savings are made, and the number of years in pensionable retirement. So in 1911, when old age pensions were first introduced some 5.2% of the population were over 65. Today the figure is 16% and will increase to 23% by 2034[8]. The government has taken action on this front with a decision to raise the retirement age to 68 over time. If life expectancy continues to rise, it would seem sensible that a principle be established that the dependency ratio should not be allowed to rise to a point where pensions become an unaffordable burden on the working population. (One important caveat to this argument is the need to make appropriate provision for those involved in arduous physical employment, which it is simply not possible for someone in their late 60's to undertake.)

While the state pension has been adjusted in response to greater longevity, the same cannot be said of private pensions. Arguably the failure to create flexibility on this issue has led to the closure of so many DB pensions.

The Efficacy of Collected Benefits

A second, related issue is that pension benefits typically advantage wealthier people. The value of a pension depends on how long you live. In the UK there is a considerable gap between the life expectancy of wealthier and poorer people. So, for example, according to the Office for National Statistics, "males in the professional class had a life expectancy at birth of 80 compared with 72.7 years for those in the manual unskilled class"[9]. Thus, all else equal, the poor subsidise the pensions of the better off. This effect is exaggerated in DB plans which give a pension proportionate to final salary, since typically the better off find that their salary is progressively larger throughout their career, and thus the ratio of their contribution to their pension is lower than those with a more stable salary. And finally, those who would be entitled to welfare benefits to supplement their state pensions, get less marginal benefit from their pension savings than those who are better off.

Yet, despite the apparently regressive nature of pensions, trade unions and other representatives of less wealthy citizens have been strong supporters of comprehensive, collective pension provision. Therefore, while these considerations suggest lessons for pension fund design, the fact that trade unions are so supportive of collective systems gives some indication of how important pension provision is to those who might otherwise be in need in their old age.

Balancing State Pension and Private Saving

More contentious is the question of the balance between state and private provision. As we have seen in the UK, state provision of pensions is limited, and often needs to be supplemented by welfare benefits.

One school of thought suggests that it would be better to simplify and raise the state pension.

Part of this would be paid for by the elimination of many welfare benefits. Part might be paid for by raising the retirement age.

However, there is another potential way in which a higher state pension might be funded. Today, in the UK, there are very significant tax advantages and other subsidies given to private pension savings. One powerful school of thought suggests that it would be better to eliminate these subsidies, but provide more substantial state provision. This is an important debate, and beyond the scope of the RSA study. We would note, however, that if there were to be a fundamental change in the pension regime in the UK, this would have profound effects which go well beyond pensions themselves, and would be likely to change the way in which British industry and commerce is financed.[10]

The Architecture of Non-state Pension Provision

While there is a heated debate about these issues, we have been struck by the fact that there seems to be a broad consensus that all citizens should be able to access occupational and private pensions. Any such pension should, at the lowest possible costs, allow savers to access a portfolio of investments which is designed to defray the liability they are seeking to protect against; in the case of pensions this means income in their old age. Further there is also a consensus that the current architecture of pension provision is deeply flawed and very expensive. Estimates vary, but it is our belief that for no additional cost, pension outcomes could be improved by 50% or more, compared to a typical DC pension which might be offered today. We have discussed this figure and debated it at length with experts, stakeholders and fund managers. While some have queried individual assumptions, no-one has challenged the view that a massive improvement is possible in the pensions which are typical in the UK.

The payoff from such reform would be huge. As we noted above, £20 billion a year is already saved through individual DC or private pensions, and this is growing. Some 6.5% of the GNP is spent in total on non-state pensions. Therefore, a 50% increase in the productivity of pensions would be a huge prize, both for pensioners individually, and for the efficiency of the economy as a whole.

However, such a prize will require changes to be made. The regulatory framework to create that structure is not presently in place. There will need to be a broad consensus about the sort of pensions architecture we are trying to create, and commitment to it from policy makers and stakeholders. Such consensus must not be dependent on party politics — it will need to last for a generation. There need to be providers willing to offer these new pensions.

We believe that all this is possible. The necessary changes to the regulatory structure are comparatively modest. From talking to stakeholders, we believe that, despite the understandable concerns of employees to defend their pensions, and of employers to limit their liability, there is a broad consensus on the need for change, and for the characteristics which any new pension system might have. Finally, we believe that private sector providers would be able and willing to respond to this demand, offer considerably improved pensions, at no additional cost to beneficiary or sponsor.

In the rest of this paper we will look at why we have such high cost and inadequate provision of occupational and private pensions in Britain, and lay out the actions which need to be taken to resolve the problem.

8 British Social trends since 1900· Ed Halsey, McMillan, 1988

9 See http://www.statistics.gov.uk/pdfdir/le1007.pdf

10 See, for example, Michael Johnson, **Simplification is the Key**, Centre for Policy Studies, 2010

SECTION 4. *Inadequate Pension Provision in the UK*

A generation ago, occupational pensions were the mainstay of non-state pension provision. These were typically designed with the aim of providing a known pension to the recipient, often based on their final salary. An actuary was employed to ensure that the expectations that were being given were matched by the funds available to meet them. Both employer and employee made contributions to fund the pension, and those contributions and the returns on them were allowed free of tax. Tax was only paid on the pension benefit.

As we discussed in the section above, these schemes were not perfect. But they did command support both from the sponsoring employer and the employee beneficiary. However, over the years, these schemes became the subject of regulatory tinkering. In particular, regulators limited the amount that could be paid into the pension funds, to avoid their being used as tax shelters. Then, in the 1990s, as stock markets rose, it appeared that these schemes had set aside more than enough to meet the expectations they had given the beneficiaries. So sponsoring employers asked pension trustees if they could stop making contributions for a time; to take what was known as a "contributions holiday". In response the pension trustees demanded that the employer would have to fully underwrite the promises that had been made, so that, if circumstances changed, there would be no risk that the pension fund would be unable to meet its commitment.

Thus the typical pension changed from one where there was the expectation of a given pension to one where that pension was guaranteed. However, we would note that the guaranteed pension contained two, potentially serious, flaws, one for the beneficiary and one for the sponsor.

For the beneficiary, the guarantee was not a complete one. In particular, it did not protect against high inflation. This in turn means that many pension trustees will be inclined to invest in a way which ensures they can pay the nominal value of a pension, but its purchasing power could be deeply eroded. For those who remember the plight of those who had all their savings in bonds in the 1970s this should be a sobering observation. Particularly so when it is clear that many Defined Benefit schemes are indeed trying to make a specific match of their investments to their contracted liabilities, without consideration of how their beneficiaries might be affected by high inflation. In extreme conditions, this could be a time bomb at the heart of our Defined Benefit system; the pension will be paid as contracted, but it may have little real value.[11]

However, the more immediate problem with Defined Benefit pensions was the promise which had been made by the employer. When it was established, a typical pension plan would have set expectations of a pension, but not made a hard promise; this was because it was not possible to predict the future with any certainty, particularly over the eighty or more years that a pension fund would need to stay open in order to pay the pensions due to all its members. In particular, life expectancy and investment returns were uncertain over this period of time.

In the early years of the millennium, it became apparent that life expectancy was increasing much faster than had been expected. This is of course was very good news for the population. But it created a problem for the pension industry.

As we discussed above, for pensions to be affordable, it is necessary to manage the "dependency ratio"; in this case the number of working years where contributions are made, relative to the number in which pensions payments are withdrawn.

Longer life expectancy had knocked this out of kilter. Further, as the millennium progressed it became clear that the high investment returns which had characterised the 1980s and 1990s were unlikely to be realisable in the future. So the Defined Benefit schemes which had been in surplus now discovered that they had significant deficits. Not only did this mean that existing promises would need to be funded, it also highlighted the danger of making future promises. Employers became reluctant to underwrite pension benefits.

Their nervousness in doing so was exacerbated by changes to the way in which pension deficits were accounted for. In the past, in order to calculate the solvency of the pension fund, actuaries would estimate the payments which would be due each year. They then examined the fund's investments, which had a market value, and estimated whether the income they would generate would be adequate to meet these liabilities. Both these calculations require judgement, so, in an effort to objectify the calculation, the rules were changed. Actuaries were asked to calculate the liabilities in the same way, and then to discount the future payments to a single figure representing the liabilities. This would then be subtracted from the market value of the investments to calculate the surplus or deficit in the scheme. While such a calculation may seem to have a degree of academic rigour, it means that the annual calculation of surplus and deficit can be very volatile, depending on assumptions about the discount rate used on the liabilities, and the short term movements in stock and bond markets.

All these factors taken together had a dramatic effect on employers' willingness to support Defined Benefit pensions. One by one, private sector organisations have closed or modified them. Very few private sector employees taking a new job will now be offered a DB pension.

[In the public sector the future of DB pensions is still to be addressed. As this paper is being written, a Commission, under Lord Hutton, is currently at work reviewing the future of public sector pensions. Its outcome will be made more complicated by the different way in which public sector pensions are funded. Some, like those for local authority workers or university teachers, are financed in the same way as private sector pensions; that is that money is set aside each year to create a pension fund from which payments are made. But most public sector pensions, for teachers, police, the army, the health service and the civil service are paid from current revenues. For this latter group, it will be expensive to move to a Defined Contribution structure, since that would require funding a new reserve as well as paying current pensions — a course of action which is unlikely to be attractive to a government which needs to cut the public spending deficit.]

These developments also affected the nature of the debate about pensions. Employers, quite naturally, wished to avoid making any promises which circumstances might later mean they lived to regret. Equally naturally, the trade unions, and other worker representatives were robust in wishing to preserve the defined benefit promise. Therefore discussion of pensions in the UK has narrowed to one where employers wish to escape from future promises, whereas the trade unions seek to defend the status quo. This has meant that there has been too little discussion about the best alternative system of pensions management.

11 Some leading figures in the pension industry have also pointed out that this "liability driven" investment philosophy may end up having damaging effects on the financing of industry. If pension funds withdraw from equity investing, and invest in bonds instead, they will starve companies of the long term risk finance which they require to grow.

Further, the law in Britain makes the exploration of this topic difficult. Because of scandals, such as those at Equitable Life, lawmakers have been keen to ensure that any promise is well defined. As a result, those designing pensions have been encouraged to believe either that they must promise a defined benefit, or that they must create an individual savings account, on which the saver has full claim, but no other entitlement or expectation.

With this backdrop the UK has, we believe, ended up going down the wrong route in the development of its pensions architecture. On the one hand there are the old Defined Benefit schemes. But, outside the public sector, most are closed to new entrants. Thus DB pensions will remain, for many years, a huge store of investment value, but over the years they will begin to decline. In their place many employers have introduced individual DC schemes, where there is no employer guarantee. DC is becoming the dominant form of pension provision.

But as we have seen, occupational DC pensions are not receiving the same level of contributions as DB pensions. Further, only 50% of employees are covered by an occupational scheme. Others need to buy a private pension, which are often, as we shall see, extremely expensive.

Indeed the cost of pension provision through private and DC plans is extremely high. This is often overlooked by consumers and regulators alike, who perhaps believe that market forces will create the necessary pressure to reduce costs. We believe market forces must play an important part in the provision of pensions. But they must be organised in a way which gives the consumer the best chance of choosing the right product. In addition, the architecture of the pensions industry must be designed to advantage those who can offer the lowest cost/highest return products to their customers.

Therefore, to design a better pension system we must first have regard to what drives costs and returns in pension management. That is the subject of the next section of this report.

We believe market forces must play an important part in the provision of pensions. But they must be organised in a way which gives the consumer the best chance of choosing the right product.

SECTION 5. *The requirements of a successful Pensions System*

Anyone visiting a business bookshop will discover that many volumes have been written about the best way to invest. In the City of London, many thousands of people earn many billions of pounds by investing or advising on investment. This report does not seek to duplicate their debates. Rather, it seeks to answer a different question: *"However you invest, what are the key features of the architecture of pensions which will deliver the best value to savers."*

We would suggest that there are five features which need to be addressed in any effective pension system. We discuss them under five headings; cost, returns, product design, pension governance and responsible investment.

Costs

The cost which we pay for pensions matters a lot. Often this is overlooked because pension costs are expressed as an annual charge on the balance saved. However, the "average time" during which money is held in a pensions saving might be around 25 years. On that basis, a 1.5% charge per annum translates into 37.5% over the lifetime of the pension. We would note that when this was explained to our Citizen Jury they were aghast. They had not understood the mathematics of charges and felt strongly that this should have been explained to them. This, more than anything, made them feel the system was not trustworthy. So it is perhaps worth taking an example of how charges affect returns.

Imagine a wise young person who decides, at the age of 25, that they will save for a pension, so that they can retire at 65 and enjoy a pension for the next 20 years. They set aside £1000 each year, and raise that sum to cover inflation, which is 3%.They receive a 6% return on their money. That means that, by the age of 65 if they have no fees to pay, they will have a pension pot of £248,170.This in turn will create an inflation protected pension of £16,080 for the next 20 years. Now imagine that this person has to pay a fee of 1.5% per annum on their savings. How much will that reduce the pension that will be earned? The answer is that it will be reduced to £9,900. In other words, someone who pays no fees gets a 60% higher pension than someone who pays 1.5%, because £16,080 is about 60% more than £9,900.12 Of course some fees will need to be paid to administer the pension. However, in the past, a large DB pension plan would have charged less than 0.5% for this service.

This is a very large difference in pension payment from what seems a modest charge of 1.5%. As we noted, it happens because costs compound over time. The "average life" of a pension, i.e. the average time over which a pound stays in the pension, pot is about 25 years. So a 1% per year charge will take about 25% off the value of your pension.

Any reader who wishes to delve more fully into this topic might wish to visit the Financial Services Authority (FSA) website[13]. In particular the page which illustrates various private pensions, allowing the user to decide the sort of pension they will buy, and illustrating the fees which they will pay. They might take a really simple example of an individual who invests £10,000 at the age of 25, and cashes it in to buy a pension at the age of 65. So this covers the fees only during the accumulation period of the pension. He will find that the fees range from £41,468 to £98,987. In government sponsored stakeholder plans they vary from £51,200 to £68,144. Many are shocked to discover fees are several times the initial investment.

12 For those interested in the maths, this example is explained in more detail at http://www.thersa.org/__data/assets/pdf_file/0010/220141/Tomorrows_Investor_Pensions-for-the-people.pdf

13 http://www.moneymadeclear.org.uk/tables

The point of this illustration is not to criticise any particular pension provider, because in part, providers are trapped in a system where costs, in particular distribution costs, are high. We simply point out It is simply to point out that, based on the official numbers presented by firms to their own regulatory authority, the fees charged on pensions are very large, and of huge significance in determining the size of the pension.

During this study we have come across claims that some pension providers have charged three per cent and more. In other words, three quarters of the possible pension was swallowed up in cost. So costs matter. And they matter a lot. As such, any future pension system must be designed with this in mind.

Returns

What is true for costs is also true for investment returns. A 1% lower return will give a 25% lower pension. So someone who expected £100 a week as a pension will get £75 if the return is 1% lower. Putting it the other way around, someone who expected a £75 pension will get £100 if returns are 1% higher — a 33% uplift in their pension.

Any future design for pensions must allow that the money is well and appropriately invested.[14] By this, we do not wish to enter into the debate about the advantages or disadvantages of active and passive investment, or opine on appropriate asset allocation. Rather we would observe that the assets and liabilities of a pension fund should be well matched. Funds should be invested in a way which seeks a long term real return over the life of the fund. The promise the pension fund makes should be designed to allow this to happen remembering a pension promise may last for eighty years.

Any future pension fund must be sensible in the promise that it makes and appropriately flexible in the investments with which it defrays that promise.

Product Design

A well designed, low cost pension should be just that; a pension. A pension is an income which will be provided in retirement, or to your dependants should you die leaving them in need. It is different from an individual savings account. It is worth reflecting on the problems which are caused by someone who uses an individual savings account to provide for their retirement. Since they don't know how long they are going to live, even if they know how much you will need each year, they don't know how many years they will need it for. To be on the safe side, they either need to save too much, or else buy an insurance policy which will work like a life insurance in reverse; that is that it will pay out if you live for longer than might be expected. That is essentially the principle of buying an annuity, but annuities are very expensive.

An individual DC pension, behaves exactly like an individual savings account. As a result, it creates precisely the problem illustrated above, either forcing the participant to over-save, or to buy an expensive annuity.

While such pensions may have their place, in particular for those who have special requirements or the need for great flexibility, they are, as we shall see, a very expensive way of providing pensions.

The alternative is to save for your pension collectively. If all save together then, provided we know *on average* how long people will live, in the event one individual lives longer, their pension will be supported from the savings of those who did not.

A well designed, low cost pension should be just that; a pension. A pension is an income which will be provided in retirement, or to your dependants should you die leaving them in need. It is different from an individual savings account.

Further, such a system allows a more flexible investment philosophy, and it costs less to administer. However, it requires that those who subscribe to the pension trust those who are managing it to do so competently and selflessly.

If we take all these features (costs, returns and product design), they make a huge difference to the likely value of the pension paid. One study, by Beth Almeida and William Fornia, illustrates just how large the difference can be. They reckoned that for the same expected pension, an individual DC pension cost 83% more than one which was collectively provided! A summary of their study is included in the boxed example. These differences in product design are often not apparent to consumers. There is therefore a significant need for good and clear communication in the selling, and reporting of the performance of pensions. The latter can be greatly assisted by the use of internet communications.

Governance

The need for trust lies at the heart of an effective pension system, because outcomes are uncertain and it may be many years before someone who subscribes to a pension enjoys the final benefit. Savers need to trust that, even when there are unforeseen circumstances, the pension fund will still be run in their interests. This is particularly true in the case of collective pensions, where the beneficiary may not be able to specify their precise claim on the fund.

The British legal system has a solution for these sorts of circumstances. Rather than writing a contract, where it is difficult to specify all the permutations of events, the money is invested "in trust", and a trustee is charged with only looking after the interests of the beneficiary, and cannot themselves benefit from their role.

In talking to legal experts, some have suggested that it may be possible to write a pension contract that would have a similar outcome to a trustee based pension. However, an equal number have told us that, given an uncertain future, pensions are better governed through trustees.

So, an effective, low cost/high return pension system is likely to be one which is governed by trustee law, rather than by contract law.

Responsible Investment

The final element which is required of a successful pensions system is that it is responsibly invested. That is, that the way in which the future pensioner's money is invested is appropriate for the liability they are trying to defray, and that the investments are chosen and managed in a way which does not damage the beneficiary's broader interests. So, for example, an investment portfolio should be properly diversified. It should be invested in assets which offer long term value, i.e. they should not be rendered valueless in the event that high inflation was to return.

There are two reasons why pension funds may not be managed in this way, both of which are dangerous. The first would be an over adherence to a specific promise. (For example, to meet a nominal payment without considering the effects of inflation.) The second reason is that it can sometimes be to the advantage of one investor, or one company, to behave irresponsibly and allow others to pick up the cost. (For example, an investor may encourage a company to behave in a short term way; or may not exercise their duty of ownership when they purchase a share.) They may turn a blind eye when a company behaves badly. While such actions may be to their individual advantage, if everyone behaves in that way, the integrity of our capital markets will be undermined, and everyone will lose.

14 Paper by Sir John Banham, Producing decent returns for pensioners in turbulent times. Available for download here http://www.thersa.org/projects/tomorrows-investors/paper-producing-decent-returns-for-pensioners-in-turbulent-times

SECTION 6. *The Architecture of a Successful Pensions System*

In the previous section of this report we noted that an effective pension system would require the following features:

- It would be low cost
- It would offer pensions, rather than individual accounts and hence, ideally, collectively provided
- It would be governed through trustee law
- It would invest responsibly

In this section we will tease out the characteristics of a pension system that would meet these requirements.

Costs

We begin by looking at how cost can be minimised. There is agreement on the structural factors which drive costs. These are as follows:

a) A very large part of private pension costs relate to selling costs, and to ensuring that pensioners do not keep switching their provider. So selling costs must be kept to a minimum, and persistency maximised.[15]
b) Costs reduce for larger providers of pensions. So pension organisations need to be of adequate size to enjoy benefits of scale.[16]
c) That pensions that are provided collectively rather than individually have lower administration costs[17].

The costs of selling and switching are being addressed. In 2012, there will be a national system of auto-enrolment. For those not otherwise provided for, the government will provide an individual DC pension at modest cost, known as a personal account. While the nature and scope of personal accounts remains controversial, all the stakeholders we have met support auto-enrolment, and indeed the RSA itself believes that this will be a necessary condition for creating an effective pension system.

Regulators have gone further. In the past, financial advisors were paid for every pension they sold. That encouraged them to sell, and then to resell private pensions. With the introduction of the Retail Distribution Review at the end of 2012, such incentives will be banned.[18]

As second element which is needed to keep costs down, is that pension providers must enjoy economies of scale. Ideally there should be a limited number of large providers, all of whom offer low cost, responsibly invested pensions. The mechanism for achieving this is open to debate, however, we would note that there are other industries, where regulators have created systems which enjoy both the benefits of economies of scale, and effective levels of competition. At a minimum, the government should establish a default pension along the lines of the "My Super" proposals which have been advocated in Australia, and accepted by the Australian government. This ensures that any employee enrolled into the pension system is offered an effective low cost "default" option for their pension, which has the broad characteristics discussed in our proposal.

A third element in keeping down costs is collective provision. There is consensus that collectively provided pensions, where there is no need to administer and report individual performance, will have lower cost than individual ones.

So a low cost pension system will be characterised by large, auto-enrolled and ideally collectively provided pensions.

Returns

Collective provision also helps to ensure the highest returns. As we noted, the study by Almeida and Fornia suggested that these could be as high as 83%. A similar study by the Government Actuary, concluded that they would yield, on average, 39% more than individual accounts, but with less risk. Either way, the advantage of collective provision is enormous.

As we discussed in Section (d), UK law currently makes the provision of Collective Defined Contribution (CDC) quite difficult. In part this is understandable. A collective DC arrangement means that, unlike a DB plan, the pensioner has no certain entitlement. And unlike an individual DC plan, the pensioner has little discretion about how the collective funds will be used. There is, therefore, a natural reluctance, in an industry subject to mis-selling, to set up a system which may set expectations which it is unable to meet.

However, the benefits of collective DC are huge; on the governments own figures they give a 39% higher pension. The aim must therefore be to ensure that all Collective DC pensions are properly sold, rather than to live with a highly sub-optimal architecture.

It must be understood that if returns change, then any DC pension will produce a different result. In fact, collective DC will have less variability, but it will mean that trustees need to be careful about the expectations they are setting, and that they do not end up allowing high "intergenerational transfers", where older pensioners benefit at the expense of younger ones, or vice versa. We have discussed this with actuarial experts. Some felt that it might be a significant hurdle, others that it would be more straightforward.[19]

At their most extreme, some financial economists, such as Dr David McCarthy of Imperial College, have suggested that it is impossible for collective DC schemes to provide more than individual ones, because the risk must have transferred somewhere. There assumption is that it will have moved to the next generation. We disagree with this analysis. The reason CDC is so effective is that some risk does indeed lie with the collective, and that they don't need to pay an agent entirely to mitigate that risk, as happens with the purchase of annuities.

Pensions, not individual savings

As we noted above, one of the reasons that individual DCs are expensive is because they are not pensions, they are individual savings accounts. Therefore, when a person dies, any residual is left in their estate. It is not available to pay others' pensions. Research suggests that this adds around 10-15% to the cost of a pension.[20]

[In passing, we note that other researchers who are working in the field have rightly recommended a simplification of the pension system. However, one proposal they have suggested is that pensions should be treated in a similar way to Individual Savings Accounts. For the reasons given above, we would not support such a proposal.[21]]

15 See Turner Report, A New Pensions Settlement for the 21st Century, 2005, p7

16 See Bikker and de Dreu, Operating costs of Pension Schemes, from Steenbeek and van der Lecq, Costs and Benefits of Collective Pension Systems, Springer 2007

17 See Almeida and Fornia, Better Bang for the Buck, 2005

18 A summary of the Retail Distribution Review and its effects can be found at http://www.eacg.co.uk/documents/Concise-Guide-to-the-Retail-Distribution-Review.pdf

19 We would note that the nature of the promise it is possible to make on a pension, depends on the investments which are held. So, for example, ATP of Denmark offer a hard promise in a collective scheme, but have defrayed that promise through the investments which they have made.

20 See Almeida and Fornia, Op Cit

21 See Johnson, Op Cit

Trustee Governance

As discussed above, pensions need a legal form which is trustworthy for its beneficiaries and focussed on maximising benefit for them. This suggests pension plans would ideally be trustee based (with some flexibility, to allow for marketing activities, such as those offered to NEST) or with similar protection to savers.

Responsible Investment

There is a general view that pension plans should promote responsible investment practice, though less agreement on what might constitute responsible investment, and how it could be enforced. However, we would note the growth in the "Responsible Investment" movement over the past 15 years. Around $25 trillion worth of investments now subscribe to the UN Principles for Responsible Investment (UNPRI).

Additionally, many services have been developed to assist investors in undertaking their duties as owners of securities. In the UK, Hermes EOS (of which the author of this report is a founder), and F&C both offer such services to institutions who feel that working together as owners is likely to be more effective than working separately. In our last report, we asked Hermes to quote on the fee for providing such a service. It was less than 1% of 1%. That means that, over the lifetime of the pension fund, this option would cost less than 0.25% of the total pension paid. The effect it would have on company returns would, we suggest, more than repay the cost. However it is not the only way to achieve responsible investment, nor is it mutually exclusive of other activities which a pension fund and its members might wish to contemplate.

Conclusion

Despite the many controversies in pensions policy there is considerable agreement on the fundamental architecture we need for private pension provision. We note that the structure which stakeholders desire is similar, though not identical to the system of provision in Holland and Denmark, two countries which are credited with having the most effective non-state pension provision in the world.

THE VALUE OF COLLECTIVE PROVISION: AN EXAMPLE

One study, undertaken in the USA, sought to compare the costs of individual and collective pension provision. It was written by Beth Almeida, who runs America's National Institute for Retirement Security, and William Fornia, who is a consulting actuary. The study started out by asking a very basic question: "How much of an employee's income will they need to set aside in order to have an adequate income in their retirement?"

It imagined the situation as it would be for school teachers. It reckoned that, at today's prices, a retired teacher might need a retirement income of around $2,000 per month, with appropriate benefits for their dependants, should they die young. They factored in the number of years of employment, likely salary and salary progression, and the number of years of retirement.

Then they came to the big choice. What sort of retirement plan should the teacher choose? Never mind whether or not the employer agrees to underwrite it. The employee themselves can have the choice between a large collective pension, where everyone contributes to a big savings pot, and receives a "fair share" of that pot when they retire. Alternatively, they can invest in an individual savings account, where the pension they take out will be determined precisely by the money that they have put in and the return it has made.

That's where things become interesting, for three reasons. Firstly because the costs of each approach are different. Typically a large collective scheme has lower costs. Second because the investment philosophy of the funds will also be different. As they reach retirement, the person who saves individually will need to be very conservative in their investment, ideally buying a very safe, but very costly annuity which will guarantee their income. The person who saves collectively can take a higher risk because they take it with thousands of others. So the collective pool can be safely invested in a way which gives a higher return while still being able to guarantee a pension. Third because the nature of a collective pension is different to that of an individual one. A collective pension is just that; you will get a payment for as long as you or your dependents are alive. In a sense those who die young "subsidise" those who live longer. In an individual pension you have to save more because there is no such subsidy; you have an individual savings account, and if you die young, it could go to your beneficiaries; if you live too long, you may end up in poverty. More likely you will buy an annuity, which will provide you a guaranteed income, but will be expensive; hence you will have a lesser pension. The insurance company who sold you the annuity will make the profit by taking the premium for insuring your life expectancy.

How much are all three factors worth? Of course it's difficult to pin this down precisely because each element interacts with the other. For example, annuities cost a lot and give low returns in part because they are safe investments. If you are an individual saver you could get higher returns, but you would have to save more because of the risk.

Almeida and Fornia put all these sort of features together. Please note that there are many different ways to deal with pensions, so the researchers would have used slightly different figures had they looked at the circumstances of any particular individual. But the overall picture they present won't change very much.

The bottom line of their research was as follows:

It cost 12.5% of the teacher's salary every year to provide the collective pension; it cost 22.9% if they took the individual pension. In other words it cost 83% more to provide a decent retirement income using an individual DC scheme, than it did using a collective scheme.

As such, over the lifetime of the scheme, retirement incomes for those using individual DC schemes could be increased by 83% at no additional cost to those funding them.

SECTION 7. *Achieving Consensus to Build the System*

The above discussion has laid out how we can create an effective occupational pension system in Britain. The framework for doing so is not controversial, in the sense that we have met with few stakeholders or pensions experts who disagree with our conclusions. Nor is its implementation contingent on any other major pension policy decisions, i.e. whatever choices are made in response to the key policy areas outlined in **Section 3**, it always makes sense to promote low cost/high return occupational and private pensions.

We are not claiming that the detail of every policy is agreed. However, there are few fundamental objections to the policy framework we have outlined. And the prize is huge; a system which, for the same cost can provide a 50% improvement in the pensions which current practices are likely to achieve.

So why is it so difficult to reform the system?

The reason is that it is not possible to create an effective pension system just by passing a law. It requires not only a strong policy framework, it also requires that pension stakeholders feel confident to purchase, and pension providers are willing to provide the service. It is therefore worth reflecting on how a consensus might be built which can align policy with the various stakeholders who need to be brought on board. We begin with policy and policy makers.

Establishing the Policy Framework

Right now, the structure of British pensions is restrictive. Either a beneficiary has a defined benefit pension, where the sponsor is responsible for the promise made, or they have a defined contribution pension, where it is all the beneficiary's risk. It is difficult to establish a pension in which a group of people save collectively.

This is because the legislation (Pension Schemes Act 1993 s1) treats anything which is not pure DC as DB – and then applies the full rigour of DB rules and regulation, which can frighten off employers. Indeed, a well known law case (*KPMG*) treated what was considered by the employer to be a DC scheme as a DB scheme, leaving the employer with a big bill.

However, it would be perfectly possible to change the law. If we did, we could create, in the UK, a pensions framework which might look like that in Holland; a country generally acknowledged to have the best occupational pensions in the world.[22]

The RSA is currently discussing this issue with the Department of Work and Pensions, and is hopeful that the latter will clarify the law to enable collective DC pensions to become available. We can see little objection to this proposal, provided that adequate protections are put in place, and are delighted that the National Association of Pension Funds not only agrees that the law should be reviewed, but in its "Super Trust" proposals has suggested a framework very close to the one proposed in this paper.

So, in policy terms there is no insuperable problem to be overcome.

But the government needs to do more than pass enabling legislation. It also needs to lead the debate, and help create a new consensus for a pension system which we can trust. This consensus must be built on firm foundations, since pensions policy must last for generations.

22 Indeed, one leading pensions expert, Robin Ellison of Pinsent Masons, reckons you don't even need a change in the law. He has concluded that

It is now clear that provided the scheme is carefully drafted (and in particular does not offer any annuity arrangements within the scheme) collective DC might be offered within the UK. Alternatively, and unfortunately preferably, it would be possible to offer a non-UK-based scheme (perhaps domiciled in Ireland, Gibraltar, Austria or Belgium) with the full advantage of UK tax reliefs under the European Pensions Directive, and cross-border recognition, but avoiding the excessive UK regulation and accounting rules which have made such schemes hard to offer.

Britain currently has a coalition government, which talks about a new consensual politics. Pensions policy would be a good place to start. The first step would be to reach cross party agreement on the way forward. We have talked to both the largest political parties about this, and we can see little philosophical difference between them on this matter. So the time is ripe for such a discussion to take place.

The Stakeholders

Stakeholders also need to be involved in these discussions. After all it is the employers who pay for, and the workers who will benefit from, the new system we are suggesting. Further, representatives of the pension funds themselves are arguably the most knowledgeable constituency involved in this debate.

We are therefore delighted by the similarity between the RSA position and the "Super Trust" proposals of the National Association of Pension Funds.

We have also been very impressed by the discussions we have had with officers and committees of both the CBI and the TUC. We mentioned in **Section (d)** that there are real policy tensions between workers and employer representatives over pension provision in any individual workplace. However, there is no reason why such natural tensions should stand in the way of a wider dialogue about the architecture of future pensions, particularly if the government is willing to lead. It cannot be in the best interests of the workforce if their representatives are left with inadequate fall-back arrangements should their members' defined benefit plan be abandoned. And it cannot be in an employer's best interest to sponsor a benefit for the workforce, whilst knowing that a lower cost/ higher return alternative is available.

Overall, we would be optimistic that, if the debate is properly framed, consensus can be reached with stakeholders.

Potential Providers

One possible objection to the proposals is that no one would be willing to provide the low cost pensions of the type described. Indeed it is because of the failure of the current structure to provide such pensions that it was necessary to establish NEST.

Therefore, the RSA has spent some time talking to providers who have experience with pensions of this type; particularly those in Holland and Denmark. We are pleased to be able to report that both would be interested in providing the sort of service which we have described. Indeed the giant Dutch fund, APG, have been sponsors of the last phase of this work and we expect in the future to be working with them, and the leading Danish fund ATP.

We entirely understand that UK companies are likely to be hesitant about a change in pensions architecture. After all, their current operations have been designed to offer a different service. However, we believe that most UK providers would be perfectly capable of delivering the sort of services we have in mind, since they already undertake all of the activities necessary to make such a system work. We have been asked whether they might object to the introduction of a new and more efficient architecture on the grounds that it might undermine their current business. But to argue in this way would be similar to a car manufacturer refusing to implement improvements in their car on the grounds that they profit from the inefficiency. In competitive terms, it simply invites in competition. So we believe that, given the right architecture, UK pension providers will rise to the challenge.

Consumers

Ultimately, consumers need to be persuaded that the pension they are offered is trustworthy and of good value. Our research has shown that, at present, they are not. However, if consensus can be reached between the government and the political parties, the stakeholders and the providers, if they can be shown that a proper and trustworthy design has been put in place, we have little doubt that consumers will respond positively. Indeed, if consensus is not achieved, consumer distrust is likely to increase still further, which will be damaging for all.

The Future of Auto-enrolment and NEST

The proposals we are putting forward aim to build on the initiatives which are already taking place to secure trustworthy private pensions in the UK. There are two of particular significance. The first is auto-enrolment. From the end of 2012, most employees will automatically be enrolled in a pension, which will be subsidised by the employer and the government. This policy is fundamental to the creation of a successful pension system and it is a necessary condition for the proposals we have put forward.

The second is the establishment of NEST, the National Employment Savings Trust. NEST will be a national supplier of pensions when auto-enrolment is established. In principle, we are very supportive of NEST. It will offer low cost pensions and, although the current plan is for these to be individual pensions, our understanding is that NEST could offer collective pensions if it were asked to do so. NEST promises to offer low fees; these are targeted to be 2% of the initial investment, and then an annual charge of 0.5%. Indeed, without NEST, auto-enrolment could backfire, if workers discovered themselves enrolled into poor pensions. So NEST, or something like it, it is an important component of an effective pensions architecture.

However, there is a difficulty with the way NEST has been constructed, in that for the first years of its operations, it is restricted in the size of the payment it can accept from any individual. Such payments are limited to £3,600 in any year. We discussed this at length in our previous report. The effect of this is that NEST will be handicapped in carrying out its business. Here is how we described the situation:

The effect [of this limit] can best be understood by using an analogy. Consider a town which does not have adequate grocery shops. This is a problem for everyone, but particularly for poorer people. So the council decides it will open a new shop, which sells high quality low-cost produce. But it also restricts the amount anyone can spend in the shop. So if you have a big demand for groceries, you need to go shopping twice: once to the new store, once to another. Further, as the grocery manager doubtless points out to council officials, it is those who spend the most who help cover the costs of the grocery store. By restricting the amount people can spend, the costs and effectiveness of the new store will be undermined; its revenue will be lower, and hence its profitability reduced. We believe that is precisely the effect the £3,600 limit will have on personal accounts.[23]

The reason for restricting NEST was to ensure that a subsidised government body, offering modest pensions, did not undermine better pension provision provided through the market. We would suggest that a better solution would be to allow NEST to compete with others who were willing to offer good pension provision, subject to rigorous standards.

We entirely understand that UK companies are likely to be hesitant about a change in pensions architecture. After all, their current operations have been designed to offer a different service

(In our previous publication we laid out the standards which would be expected of a provider who wished to offer pensions which met the national standard). Indeed, this position is very close to the one taken by the National Association of Pension Funds, and is therefore one on which it should be possible for the government to achieve consensus. There may be some individual critics from the industry but, given how poorly pensions are currently provided, we think that their arguments will not be difficult to counter.

If NEST is to be offered a subsidy, this should be because it provides a public service; that is, it is willing to provide comprehensive coverage, at modest cost, even to the smallest businesses. However, it can make little sense, in public policy terms, for it to require a taxpayer subsidy because its operations have been intentionally handicapped.

Conclusion

In this section, we have outlined how a consensus can be reached to create an effective pension architecture. We have not sought to make ever more detailed proposals. There will be many important policies to be discussed and resolved; how a system can be created which will result in a small number of large pension funds; what the nature of the promise given to savers is, and how they should be informed of it; how funds should be invested. All of these can be resolved once a consensus has been reached. What is needed now is not ever more detailed proposals, but consensus on the framework for low cost, high return, collective, trustee based pension structure whose funds are responsibly invested. We believe that, with leadership and coordinated action, there are no insurmountable obstacles to achieving that consensus.

The next question is, what actions need to be taken and by whom, if we are to achieve this agreement?

23 Tomorrow's Investor, **Pensions for the People**, RSA 2009, p36

SECTION 8. *Making it happen*

The introduction of a new pension system will require discussion and action by many people and organisations. Rather than create a long list, we have structured this section of our report in the form of "open letters" to some of the principal players.

To: Steve Webb, Pensions Minister

As Pensions Minister you are responsible not only for the state pension but also for private pensions. We recognise that, in your first months in the job, and with the Comprehensive Spending Review underway, your focus has been on the state pension.

However, we would urge you also to turn your attention to the occupational and private pension system. As our report shows, it is huge, costing £85 billion per annum (versus a state pension budget of £60 billion), and is enormously inefficient. Its reform will require actions from many parties. In particular, it will require your leadership.

We suggest a number of actions which build on the reforms to the system which are all already in train. We applaud the introduction of auto-enrolment, which is a necessary condition for a low cost pension. We also welcome your continuing support for NEST.

However we would recommend that NEST be released from these unnecessary constraints placed upon it. NEST cannot accept payments above a certain limit. This will add to its costs, (and hence to the government subsidy) and fail to deliver an adequate service for pension savers (as we discuss on pages 26 and 27). We therefore strongly recommend

- The government review its self denying rule which stops NEST providing a service to those with larger sums to save.

The reason cited against such a change is that this will allow a subsidised government body to compete with the private sector, thus distorting competition. For that reason we would suggest that

- A limited number of private sector bidders also be allowed to bid to offer the same service as NEST (viz to be approved default providers of auto-enrolled pensions).

Thus the government can ensure competition while at the same time ensuring all pensions on offer are "good" pensions.

However, even with NEST-type pensions, the Dutch pension system will still provide 30-50% higher pensions for the same cost. This is discussed in pages 18 to 23. We therefore need to be able to introduce a Dutch style architecture into the UK. To do so will require legislative change to encourage the introduction of appropriate large Collective Defined Contribution (CDC) pensions. In December your department decided not to continue the development of such a policy. We believe this was a mistake as do many other stakeholders in the pensions debate. We have been in constructive discussions with your department on this topic and hope that you will now

- Review pensions law with a view to allowing the introduction of CDC pensions in the UK, as they are allowed in Holland.

But simply passing enabling legislation will not be enough. The new CDC pensions should ideally be of adequate scale to minimise costs, and a political consensus and public education campaign needs to accompany their introduction. Pensions policy needs to last for generations, it requires a bond of trust to be established between pensioner and provider. Providers are ideally non-governmental bodies. In short it requires "Big Society" thinking.

The starting point must be a discussion amongst pension stakeholders. In our own work we have found there to be an encouraging consensus on the best future architecture for pensions. We would therefore suggest that

- You might like to attend an informal event with key pension stakeholders to follow up on these earlier discussions.

We believe these will show a broad consensus for pursuing the policies advocated in our report. They would also allow discussion of some of the "open questions" about how the pensions architecture which we advocate can best be optimised.

We would also suggest that

- A similar meeting be organised with the opposition party, to achieve broad political alignment on this policy.

These actions are likely to take a little while. If, as we believe, they result in the development of a broad consensus on the future architecture for pensions, we are sure that providers will be available to deliver this service. In the meantime we would like to

- Invite you to meet policy makers and pension providers from Holland and Denmark, who will explain how their system is able to provide such a superior and comprehensive pension system, and discuss whether and how such systems could work in the UK to trigger the emergence of providers who enjoy economies of scale which can be passed on to savers.

To: Brendan Barber, General Secretary of the Trade Union Congress, (TUC)

For generations the trade union movement has championed better pensions for working people. Twenty years ago, this would have been trumpeted as a triumph. As you will be all too aware, this is no longer the case. The old Defined Benefit (DB) pension system is slowly being closed down. The outlook is currently bleak. It need not be.

In the enclosed report we describe how the system can be reformed to provide the decent pensions afforded to workers in Denmark and Holland. We show how, without any additional cost a typical British worker can achieve a pension 50% higher than the one they might currently expect.

To do so will require discussion, lobbying and campaigning from the trade union movement. We note that Unions 21, which is supported by Nautilaus, the Anglo-Dutch maritime workers union, has already begun to do so, since they recognise the poor pensions which their British members receive. But this work needs to be adopted by a representative of all workers; particularly private sector ones.

We therefore recommend two courses of action. Neither will be easy for the TUC, but failing to follow them may deny proper pensions to millions of your members, as well as to workers who are not unionised.

- The TUC needs to weigh in to the debate about how we provide low cost/high return pensions, recognising that many private sector employers will not re-establish defined benefit provision.

At present there is an understandable desire by union representatives to put all their energies into defending Defined Benefit pensions. That is, of course, a proper role for unions in defending the benefits enjoyed by their members. But the danger is that, in doing so, they have allowed inadequate pensions to replace the old DB ones. Not only do employers pay less money into the new DC pensions. (As we show in our report, a DC pension is much more expensive than one provided collectively.) Union members will also pay that price when in due course they receive low pensions. Thus the need for discussion and campaigning now.

Any such discussion must involve employers. The old pensions system was one of the best examples of how employers and employees can work together for the common good. It is therefore important that

- The TUC should begin an active dialogue with the CBI and other employer organisations on how better pensions can be promoted by employer and worker groups alike.

To: John Cridland, Director General of the Confederation of British Industry (CBI)

We have pleasure in enclosing our report on the future of pensions in Britain. Its conclusions for many of your members are stark. As they have (understandably) switched to providing their workforce with Defined Contribution rather than Defined Benefit pensions, they have inadvertently ended up offering pensions which cost around 50% more for the same expected benefit. As a result, the pensions to which they and their employees contribute will be inadequate.

Our report offers a way to address that problem through the introduction of low cost/high return, collective pensions which are governed by trustees, and invest responsibly. It is based on the Dutch and Danish models of pension provision, and allows full flexibility to sponsoring companies to ensure they do not have to make promises which later prove insupportable.

The introduction of such pensions will require action by members of many organisations, including your own. In particular we would urge that

- The CBI recognises the inadequacy of the current system, and that it campaigns for its improvement.

Any such discussion must involve employees. The old pensions system was one of the best examples of how employers and employees can work together for the common good. An effective new system will require similar cooperation. We recognise that for any individual company, this may be difficult, since they may be in dispute with an individual union over the future of their DB pension. However no such conflict exists between the CBI and the TUC and we would therefore recommend that

- The TUC should begin an active dialogue with the CBI and other employer organisations on how better pensions can be promoted by employer and worker groups alike.

At present there is an understandable desire by union representatives to put all their energies into defending Defined Benefit pensions. That is, of course, a proper role for unions in defending the benefits enjoyed by their members.

To: Joanne Segers, Chief Executive, National Association of Pension Funds (NAPF)

Over the past two years the NAPF and the RSA have worked closely together. As you will see from our latest report, the pension framework which we would suggest accords closely with the Super Trust proposal which the NAPF has put forward.

We applaud the work of the NAPF in this field. It has clearly delivered on its objective of aiming to “secure the future of pensions”.[24] However, today in the UK, the occupational pension system is “not fit for purpose”. We look forward to working and campaigning with you to highlight the inadequacies of the current system and, more importantly, to campaigning for the introduction of a better one.

To: Margaret Craig , Acting Director, Association of British Insurers (ABI)

There is widespread agreement amongst providers of pension products that the current system is inadequate. In its latest report, the RSA describes those inadequacies; they are substantial. However, we believe that, by looking to the example of other countries, including Holland and Denmark, it is possible to design a much more effective pension system.

This will require change. We recognise that, for those who currently provide pensions, such a change may be difficult. However, unless it takes place, the outlook for the pensions industry will not be good. The public already display a considerable lack of trust in the financial services industry. And you will aware of the poor press which the industry currently receives. Unless trust is restored it will undermine the business of existing pension providers.

We believe our proposals, which accord with those of the NAPF, can provide the solution to this problem. They will create an architecture which could raise pension benefits by around 50%. We are not claiming that these proposals are worked through in every detail. However, we would urge you to

- Recognise that the current system of pensions is not adequate, and that the RSA/NAPF proposals should be taken seriously as the basis for a constructive discussion about the future architecture of pensions in Britain.

In these memos we have sketched out the actions which some of the key players need to take. We could, of course, extend the list of people to whom memos are sent. For example:

- Financial journalists and consumer organisations need to continue to expose the inadequacies of the current system, but also to suggest better alternatives
- Pension fund advisors need to explain to trustees of DC schemes the inadequacy of the pensions they are providing, and how a better system might be built.

But the point of writing these memos is not to show how complicated change will be. Rather the reverse. What stands in the way of the creation of a much better pension system is not the complexity of its design, it is the political will, the consensus and the coordination needed to achieve change.

24 www.napf.co.uk/aboutnapf.aspx

SECTION 9. *What next for the project?*

The notion of building a national architecture which can deliver a better pension system may seem radical. But, as we have discussed in this paper, it is one upon which there is widespread agreement amongst experts and stakeholders. It is already in place in other countries. It is a system being promoted on an international basis by academic institutions.

So far, we believe that we have been able to

- Describe a clear and realistic architecture which will hugely improve pension provision in the UK, underpinned by research from around the world
- Begin the process of reaching consensus with stakeholders on the nature of that system
- Demonstrate other countries in which such a system works, and pension providers from those countries who are willing to offer their services in the UK, should the UK industry not wish to do so.

Of course there are some questions which still remain. The key issue now is not what should be done, it is whether they will do it. Will our policy makers and legislators have the will to design and implement the system? Will pension providers at home offer the right services? Will the representatives of employers and the workforce demand that better service?

The RSA was established for "the encouragement of the arts, manufactures and commerce". We are committed to the enlightenment belief that people of goodwill and commitment, who consult and debate the evidence openly and without conflict, can indeed find solutions to many pressing world problems. And we can think of few other areas where the impact of bold initiatives by our government and commercial and voluntary institutions could make such a huge contribution to creating a better society.

We will continue to work to promote a better pension system in the UK amongst stakeholders, policy makers and the public. We will address issues and objections as they arise. We will host seminars and debates. As a charity we welcome everyone to join our discussions. In the traditions of the RSA we will provide whatever help and assistance may be necessary to those who are willing to join with us in building "Tomorrow's Pension".

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