

PO Box 622, Ipswich, IP5 2WN, UK

Phone/Fax: (44) 01473 630100

E-mail: david.harris@torfinancial.com



Submission to the Department of Work Pension's White Paper on Pension Reform

'Breaking New Ground: A new private pension model for the UK – some issues to consider'

**David O. Harris
Managing Director
Tor Financial Consulting Limited**

Note - Major input into this submission was provided by Senator Nick Sherry, Australian Labor Shadow Minister for Superannuation and Intergenerational Finance; Banking and Financial Services

Main Issues and Observations

Based on analysis of Pension Commission Report and DWP May blueprint with focus on Chapter 1 - *Encouraging and Enabling Private Pension Saving*.

Principle Themes Identified

- Ageing population; failure of majority of working population to save extra for retirement – to take personal responsibility. Voluntary versus compulsory system.
- Decline in existing private pension provision
- Greater simplicity
- Affordable and cost effective – structural efficiency both for employers and employees.
- Sustainable and flexible to future ageing trends.

These issues have all been dealt with comprehensively in the Australian retirement model which was introduced 20 years ago. It is acknowledged that with the benefit of hindsight the UK has the opportunity to learn from this experience and modify this model to ensure a simpler a more cost effective outcome. An attachment is provided on the Australian experience.

Whilst total fees and charges are an important part of the equation, the impact of rates of return and contribution levels is of equal importance. In addition communication and education with some level of cost effective, one to one advice is considered highly desirable thus ensuring maximum participation rates are preserved.

The below analysis of the issues is directly cross referenced to the DWP White Paper. Also a number of new issues not dealt with by either PC reports and the White Paper are referred to.

Challenges: Paras 1.1 to 1.31

- General outline of the range of issues facing the pension's system particularly recent trends in private pension provision. Contributions have fallen from 3% of GDP in early 80s to less than 2% in 2002. Private sector coverage fallen from 37% in 1991 to 26% in 2004. DB schemes being shut down/and or converted to dc at much lower contribution levels. It appears to be accelerating. This is a world wide trend, a consequence of funding requirements for DB's, more mobile labour market, business competitiveness both domestically and internationally and government regulation.
- Under saving and adequate replacement rates are also well examined.
- Further government changes since 1997 are outlined.

Other problems: Paras 1.32 to 1.39

- Outline of reasons for under saving for retirement with reference to behavioural economics.

This is an accurate analysis of the fundamental issue facing the UK compulsion or volunteerism.: How to underpin the existing private system with a minimum floor and spread coverage to the now majority who have nothing.

High Costs: Paras 1.40 to 1.45

- Outlines the high up front costs and ongoing costs for low middle income earners.

Personal Accounts/Systems Options: Paras 1.46 to 1.72

Outlines the options preferred and alternative approach for systems administration designs.

Three alternatives are considered:

- (a) Government NPSS with administration tendered to existing private administration providers,
or
 - (b) Supertrusts (NAPF) with employers selecting from multi employer occupational schemes, or
 - (c) Badged Providers. Partnerships pensions (ABI) based on stakeholder with employer selecting.
- Employer Responsibility

In the context of structural options it is important to recognise the limitations of employer selection. In a soft compulsion system it is not just employees but employers who are effectively conscripted into a system they do not actively choose to participate in. At best employers not currently providing a pension will be neutral to participation and many will begrudge paying anything.

Therefore why impose any responsibility on employers to exercise fund selection on behalf of employees? Such an approach would require rigorous regulatory oversight given it is new decision making that employers neither want nor are skilled to make.

Employers who currently provide pensions should of course be permitted to continue to do so subject to minimum contribution, portability and fee/cost requirements. New employers who wish to establish their own fund should also be permitted to do so but on an opt-out basis and subject to minima.

Options Analysis

Mainly for both reasons referred to in Employer responsibility and relating to cost, a preferred model is a modified version of the NAPF Supertrust option (b).

It represents the best combination and balance between the state/government and existing industry providers which will deliver a cost effective outcome.

The modifications suggested would incorporate auto enrolment of employers either on a geographic or industry based structure subject to opt-out outlined earlier. Employees being offered a menu of investment choices, probably 5 to 8 to opt into, otherwise standard investment default option would apply. It will deliver sufficient economy of scale over time to achieve total fee outcomes of about 0.4%.

Perplexingly, this is not further considered and no reasons are given for its exclusion.

Of the remaining two models only the badged providers/person account/fund model somewhat similar to existing Stakeholders and (c) Partnership Pension (ABI) is canvassed as an alternative to the NPSS proposal.

Rightly, the paper draws attention to the likely higher costs. Any individual account/fund model is guaranteed to cost more – Stakeholder proves it. Perhaps it is still on the table out of a misplaced refusal to want to recognise a model that will fundamentally failed to meet one of the government's key objectives – a low cost model, given the current government created it. Stakeholder initially capped at 1% is now at a level of 1.5% to take into account the true costs of individual provision.

It also suffers from the concerns outlined earlier about employer selection.

No matter what regulatory controls are erected around this option – and they would need to be substantial – the bottom line is that it must cost more and substantially so.

The remaining option is the NPSS. Although in a modified form from that initially proposed by the PC in that administration would be subcontracted to existing private providers. This is certainly preferable to direct government administration for both cost and political reasons. Cost, because systems currently exist within private providers that work well so why should the government re-design existing systems? An analogy may be the introduction of Maglev railway alongside, but not using, existing successful railway infrastructure. Political because when operational errors occur, government will be directly blamed.

Nevertheless the NPSS modified option still represents a defacto government "impromata" that will lead members to directly blame government of the day for administrative errors but much more importantly negative investment returns which will inevitably occur in a DC system. A 0.3% cost long term is also unlikely.

Collection 1.55

Low cost payment-collection is vital to minimise cost to members of the system and employers.

Both employer and employee contributions, including authorised higher employee contributions, should either be sent to the NPSS or alternative structure if adopted via a central government clearing house with contributions combined with other tax remittance procedures. This is the simplest most cost effective approach for employers. However a direct payment system by the employer to a single group of sub-contracted, private sector administrators still meets simplicity and efficiency targets for the employer.

Transferring/Portability 1.57

Providing this is important however, there is a lack of appreciation that providing the facility does not necessarily mean individuals will exercise the right to do so. This is a key failure of the Australian system. Many of the individuals in the system will fail to roll together or consolidate therefore a default automatic transfer mechanism is necessary.

Compliance 1.58-1.61

On ground facilitators to explain the new system to employers is very important. The payment mechanism outlined in Collection will also maximise compliance.

One important consideration not mentioned is who pays in the event of employer insolvency, particularly given there will be outstanding employer and employee contributions? A compensation mechanism is required in these circumstances.

There needs to be penalty for non compliance, In Australia contributions by employers are tax deductible if they are paid on a quarterly basis otherwise they become a charge against the employer with a significant penalty.

Administration 1.62-1.72.

Is covered in earlier comments.

Governance 1.73-1.74

It must be independent, arms length, bi-partisan, well resourced and with the ability to act quickly and decisively when and if required.

A critical issue not mentioned at all is the provision for losses in the event of theft and fraud. The compensation needs to be provided in these circumstances.

Investment Fund Management 1.75-1.76

A DC system is the correct approach, however, one in seven years produces a negative return. The system should constantly remind individuals of this emphasising the average long term rate of return not simply highlighting this year's rate through education and simple communication.

A limited menu of investment options is sensible.

The key issue however, is a sensible default option design as most members will not make an active decision.

Pensions 1.77

Compulsory pension/annuitisation is sensible but will require very careful consideration of what is an extremely complex area, particularly built on a dc system with individual account savings.

The access age of 50 to 55 is too low and needs to be phased up to 60 or 65 more closely reflecting increasing life expectancy and the state age pension age.

Consideration should be made towards more flexible annuitisation structures that take into account investment rates of return and in later years, longevity risk.

Charges 1.78-1.82

The case for low charges and the impact of charges over time is well made. Low charges can only be delivered by compulsion delivered into a bulk purchase administration/funds management scheme.

It is questionable, whatever the structure adopted, that 0.3% is achievable even in the long run. Long run costs are likely to range between 0.4% to 0.5%. There still appears to be fundamental failure to appreciate that compulsion delivers a group of employers/employees who due to the nature of employment and income level are a higher cost to service whatever the type of system adopted. For this reason, comparisons with the best existing private pension costs of 0.3% are invalid. In Australia the bulk purchase/public sector corporate funds

are achieving 0.5 to 0.7%.; with a simpler modified Australian approach these charges would be low. This was not investigated by the PC to any sensible degree.

Short term the costs will be much higher due to a combination of establishment and flat administration costs being a high percentage of low fund balances and contributions, therefore government needs to consider an establishment grant for the first few years to overcome high set up costs until account balances built up and an economy of scale is created.

Auto enrolment 1.84-1.98.

Auto enrolment or soft compulsion is the correct conclusion based on the analysis provided. It is the only practical way to both underpin the existing system albeit at a lower level and spread coverage to those not included. It is both practical and fair.

Indeed full compulsion is the logical conclusion, nevertheless soft compulsion, given inertia and the effective pound for pound matching contribution should see effective take up of 70% to 80% of those not currently in a scheme.

What is the alternative – do nothing and watch the current system wither?

The opt-in for self-employed and others recognises both the practical and political difficulties of compulsion for this group beyond current state pension provisions. This is recognised in most pension systems.

Consideration could be given to providing a higher government contribution for this group perhaps 2% rather than 1%.

The mechanism for opt-out should be tight and should only be allowed at a specific point in time annually. Employers should not be permitted to hand out and /or process opt-out forms. These should only be available at a government agency for example the Post office and registered directly, not through the employer.

Contribution levels 1.99 to 1.112

The general level and mix is sound and well based with a few relatively minor suggestions:

- Age 22 is too high. A person is an adult at 18 and this should be the entry age if employed and meeting minimum salary levels. It unnecessarily adds to complexity.
- A higher matching contribution from the government for self employed outlined earlier.
- The status of guest workers is not mentioned they should be included in the system otherwise it will be cheaper to employ foreign labour at the expense of local workers. When they return to their home country, a mechanism for withdrawal should be provided with unclaimed monies remaining the system to possibly assist in administrative expense.
- An issue not mentioned at all is whether the system should provide for a minimum compulsory level of death and disability insurance with the option of purchasing additional coverage. This is a useful additional feature in the Australian system which is popular with members and adds to the overall appeal of the system.

If well promoted the contribution mix will add to retention.

Impact on other schemes 1.113 to 1.118

Exemption for current schemes should be allowed and is referred to earlier.

An issue not considered is an employee moving to an employer from the new structure to an employer with their own pension scheme and vice versa. Full portability and transfer should be allowed in these circumstances and applied automatically as suggested earlier.

Levelling Down

The impact is underestimated. Notwithstanding there is no alternative to soft compulsion, minima will become the "community norm" and add to the existing pressure to levelling down.

The necessary simplicity of whatever structure is adopted will also provide a major incentive for employers to hand over or collapse existing arrangement to the new system.

Whilst levelling down will occur it be noted that in the old Australian system average employer/employee contributions were 15% to 20%, in the new system average employer/employee contributions are 15.5% despite a minimum floor of 9%. The more likely impact is levelling out of DB to DC where the evidence of Australia shows a massive shift from DB to DC.

Impact of Minimum contributions on employers 1.119 to 1.130.

Whilst the impact on employers appears manageable over three years, total contributions of 7% assuming employers reduce increases in real wages over that period to offset their new cost will substantially impact on the real disposable income of the new participants who are generally low/middle income. Presumably the macro economic and political impact of this have been considered.

Perhaps a longer phase in, say five years should be considered. The Australian phase in was 15 years with a start up rate of 3%.

Information and Choice 1.133 to 1.139

Is well addressed and critical to scheme implementation, particularly on minimising opt-out.

One area not canvassed is the provision of on-going advice in the system particularly around extra contributions and investment options. Professional advice is necessary in this area and while understandable that it is necessary to contain mis-selling, bulk purchase fee for service or even free advice, delivered one to one, is a service that should be included.

The Government is already spending taxpayers' money on financial communication and education: why not use the expertise – and investment - of the private sector in this task at a time when many more people need to understand pensions and their investment choices? Why should a potential 80p.c. entry into default funds be acceptable? The NPSS would provide an excellent vehicle for improvement of financial education across the economy.

Conclusion

The issues canvassed in the PC report and DWP report are well researched, widely considered with reasonable, logical and practical conclusions and recommendations in most areas.

The Australian experience is most useful and relevant to the UK because the Australian model 20 years ago was almost identical to that which currently exists in the UK today.

Indeed the then Australian private pension model was totally based on and originated from the UK. This comparison and resulting evolution is therefore the most directly relevant to issues under consideration in the UK today.

This experience is certainly more relevant than Sweden or New Zealand where private pensions are almost non-existent.

It is still considered and argued that a modified Australian retirement model, learning from the mistakes made, is the soundest way forward.

11 September 2006

Attachment

An analysis of issues and outcomes relating to the Australian Retirement Model

By

Senator Nick Sherry

Australian Labor Shadow Minister for Superannuation and Intergenerational Finance;
Banking and Financial Services

1986 – The Australian Model

System based on and "inherited" from UK

Features;

- **Pillar I**

Government age pension – 25 p.c. male total average weekly earnings, assets and income tested, funded from government consolidated revenue.

- **Pillar II**

Superannuation (private pension), mainly defined benefit pension, 40 p.c. of workforce, covered overwhelmingly public sector, middle upper income, full time male employees, some blue collar in traditional heavy industry, eg mining and some manufacturing.

- **Pillar III**

Limited voluntary contributions, tax free contribution the incentive, main application to self employed via individual retail purchase, usually defined contribution.

1986 Structural features

- A \$51 billion fund under management.
- Significant majority in defined benefit, both public and private sector, significantly under funded
- No guaranteed vesting of employer contributions
- Trustee structure usually employer nominated and dominated
- English "common law" trustee principles utilised but not codified.
- 120,000 funds limited data available on segments however majority "corporate" employer followed by public sector and retail funds.
- Corporate/public sector funds mainly defined benefit with majority in-house administration and investment but major presence of contracted in services from insurance "mutual" life companies.
- Retail "personal" products provided by life companies "sold" by insurance agents on commission.
- DB's average notional employer contributions 10 - 20 p.c. employee 3 - 8 p.c.
- DC's average self employed/employee contribution 3 - 5 p.c.
- Fees and charges corporate/public sector 0.4 - 0.6 p.c. often paid by employer, retail 2 - 3 p.c. including commissions.

1987 Onwards – New System based on Compulsion

- Initial 3 p.c. employer "wage trade off" contribution for "uncovered" employees who receive a minimum \$450 wage per month.
- New type of fund for new employees industry "multi" employer eg construction, health, hospitality, retail etc. Approximately 100 established. Administration and funds management sub contracted to existing life insurance providers.
- New employers/employees "bound/covered" by specified industry fund.
- Defined contribution
- Trustee governance equal employer/employee trustees with two-thirds voting rule
- "Prudent person" diversified investment balanced by safety the default investment. Single investment option only.
- Death and disability insurance basic, compulsory, coverage
- Very limited/no advice
- High Fees and charges – 2 p.c. to 5 p.c. Rapidly declined as contributions and account balances increased

Existing system allowed to continue without change subject to new equal trustee requirement.

Further major changes

1993

Prudential Supervision

Superannuation Industry Supervision (SIS) Act

- Codification of English trustee common law, compensation up to 90 p.c. in the event of theft and fraud, phase down of in-house investment, full funding of DB liabilities (except for public sector funds).

1994

Superannuation Guarantee (SG) Act

- 3% employer contributions phased up to 9% by July 1, 2002.
- Slower time frame for small business

1995

Extra contributions foreshadowed 3% employee, 3% government to be phased in by 1 July 2002. Abandoned by new Liberal Coalition Government in 1997.

2007 - Summary

- Currently \$A904 billion of superannuation assets, \$1 trillion, \$2 trillion and \$3 trillion projected by 2007, 2012 and 2016 respectively.
- 90% in defined contribution, 10% in defined benefit, almost all db funds shut to new employees including public sector
- 92% employees covered, 50% of self employed
- Retail "personal" products dominated by life companies and bank subsidiary life companies, agents now financial planners usually on commission.

- Average contributions employer 9 – 11% employee 3 – 5%
- Fees and charges corporate, public sector, industry 0.4 to 0.8% retail 1 – 2% self managed 0.5 to 3%.
- Top 4 major life companies now bank owned, cross selling wealth management, life companies demutualised with substantial consolidation and merger, major foreign presence.
- Funds much more sophisticated, over 90% have 6-8 investment options, some have hundreds (usually retail) however more than 90% of members still default. Now offer salary continuance (unemployment insurance), limited to full advice and housing loans.
- Accountants drive self managed funds – exempt from new Financial Services Reform (FSR) disclosure requirements.
- FSR has seen protection based on disclosure – 50-100 page documents "red tape" overload and major new cost.
- Choice of Fund introduced July 1, 2005-06. Employer must allow employee to choose a fund. Complex with new form filling requirements. Rise of clearing houses. Little change to date, however some evidence of mis-selling based on commission.
- Regulators generally pressuring retail funds on quality and cost of advice, shadow shopping, industry funds to become public offer/retail, trustees to be independent/professional and greater levels of compliance/funds management expertise. Final nail in the coffin for most corporates.
- Lost accounts 5.4 million containing \$8.2 billion, many members fail to roll together/consolidate on changing jobs even though they have a legal right to do so.
- Many other changes such as splitting contributions to a spouse and on divorce, co-contribution \$1.50 for a \$1.00 voluntary contribution for low income earners.

Industry Structure – Summary

	Assets \$b		Fund members (m)		Average balance \$,000	
	1995	2006	1995	2004	1997	2005
Industry	10	150	5	8	5	13
Retail	52	290	6	13.8	10	17
Corporate	49	56	1.4	1	48	74
Public Sector	52	151	3	3	25	47
Self Managed	67	260	.15	.55	16	26

Number and Type of Funds

	Industry	Retail	Corporate	Public Sector	Excluded/ Self managed	Total
1987			16,000*		110,000	126,000
1988			15,000*		108,000	123,000
1989			18,000*		85,000	103,000
1990			20,000*		70,000	90,000
1991			16,000*		58,000	74,000
1992			10,000*		64,000	74,000
1993			11,000*		70,000	81,000
1994			7,000*		78,000	85,000
1995	115	623	5,833	85	95,033	101,689
1996	125	417	5,200	86	121,709	127,537
1997	168	352	4,116	76	149,971	154,683
1998	165	327	3,908	74	173,116	177,590
1999	150	308	3,595	80	193,396	197,529
2000	148	293	3,398	79	210,366	214,284
2001	143	275	3,233	79	225,222	228,952
2002	126	255	2,493	74	233,937	236,885
2003	116	235	1,872	57	260,768	263,048
2004	107	235	1,404	40	289,510	291,296
2005	92	226	963	43	309,676	311,000
2006	85	194	646	42	324,142	325,109

* Individual fund totals have been combined as data limited from these years