

IS THERE A PENSIONS CRISIS IN THE UK?

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Introduction

- UK pension system traditionally seen as example to others:
 - Low social security burden of public sector
 - High coverage of well-financed voluntary private schemes
- But recent developments suggest model has shown weaknesses – main current issue is underfunding of private occupational schemes following bear market, also issue of Equitable Life insurance and annuities
- We seek to investigate whether there is indeed a crisis and what the locus of the true crisis is – longer term weaknesses possibly more crucial

Structure

- Criteria for a sound pension system
- Overview of the UK pension system
- Current pensioner incomes
- Is there a crisis in the UK pension system?
- Evaluation of the UK pension system
- Policy suggestions

Criteria for a sound pension system

- Retirement income security
 - Financing issues - sustainability
 - Effects on labour markets
 - Effects on capital markets
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- We shall return to these in evaluating UK private pensions

Overview of the UK system

- Demography
 - UK showing slower ageing than most OECD countries
 - 10.8 million over 65s now – 18% of population
 - Government projection by 2041 is for 65 and over to be 15.3 million (24%), lower than most OECD countries (e.g. Japan 31%, Germany 29%, Italy 35%)
 - Doubling of very old (over 80) from 2.5 million to 4.9 million over same period
 - High fertility rate for OECD of 1.8 offsetting common rise in longevity, life expectancy set to rise from 75 (men) and 80 (women) in 2000 to 80 and 85.5 in 2050
 - Rise in female labour force participation partly offset by early retirement in aiding financing of pensions

- Pay-as-you-go social security
 - Favourable to private schemes as limited scope and partial opt out feasible
 - Basic state pension (BSP) for all, flat rate, 16% of average earnings
 - State second pension (S2P) for those without a private pension, 19% of average earnings in addition
 - Contracting out of S2P common, as in Japan (less than 50% accruing S2P)
 - Both state pensions indexed to prices not wages
 - Means tested benefits to keep pensioners above poverty line (20% of average earnings, grow with earnings)
 - Pension age of men and women to be 65 in 2020
 - Overall projected burden very low, 5% of GDP with no increase during ageing compared with EU average of over 13% (but tax exemption for private pensions adds another 2.5%)

- Private pensions

- Generous tax relief on contributions to externally funded schemes
- 64% of employees accruing private pension, 42% occupational and 22% personal – but coverage of occupational pensions in private sector declining
- 10.1 million occupational pension members in 2000, mainly by large employers;
 - 90% defined benefit (66% of final salary for 40 year career) with large employer contribution
 - Defined contribution occupational funds (10% in 2000), usually lower contribution by employer
- All personal pensions are defined contribution, often no contribution by employer. 10% are in group schemes and 12% of employees in personal schemes (41% of self employed)

Estimated pension coverage in 2000

	Millions	% of employees in employment	% of self employed	% of employed
Defined benefit pension (private)	4.6	19.2		16.9
Defined benefit pension (public)	4.5	18.8		16.5
Total defined benefit	9.1	38.1		33.5
Defined contribution pension	0.9	3.8		3.3
Hybrid funds	0.1	0.4		0.4
Total occupational pensions	10.1	42.3		37.1
Group personal pensions	2.4	10.0		8.8
Individual personal pensions	2.9	12.0		10.5
Total employees in employment	15.4	64.3		56.5
Self employed (personal pensions)	1.3		41.0	4.6
Total employed	16.6			61.1

- All funds must be annuitised (except for tax free lump sum), defined benefit from within the fund and defined contribution via annuity purchase (staggered purchase permitted up to age 75 for defined contribution plans)
- Assets of UK pension funds very large – over 80% of GDP in 2001 (fell to estimated 65% in 2002), 25% of household assets
- Pension funds often worth more than company itself in case of older industrial firms with mature funds
- Prudent person rule for asset allocation...
- ...allowing long term asset allocation of all types of fund to be skewed to equities, giving high long term returns
- But also exposed companies (defined benefit) or individuals (defined contribution) to excessive risks, as discussed later

Asset allocation of G-7 pension funds, 1998

percent	Liquidity	Loans	Domestic Bonds	Domestic Equities	Property	Foreign Assets
United Kingdom	4	0	14	52	3	18
United States	4	1	21	53E	0	11E
Germany	0	33	43	10	7	7
Japan	5	14	34	23	0	18
Canada	5	3	38	27	3	15
France	0	18	65	10	2	5
Italy	0	1	35	16	48	0

Real returns and risks 1970-95

Mean (Standard deviation)	Pension funds	50-50 Bond Equity	Global Portfolio	Real Average Earnings
Australia	1.8	3.5	6.1	1.0
	(11.4)	(17.5)	(18.2)	(3.4)
Canada	4.8	4.0	7.1	1.3
	(10.0)	(12.1)	(14.7)	(2.4)
Denmark	5.0	6.1	3.7	2.4
	(11.1)	(19.0)	(18.5)	(3.5)
Germany	6.0	6.4	3.9	2.7
	(5.9)	(17.7)	(18.4)	(2.7)
Japan	4.4	6.1	6.9	2.4
	(10.2)	(16.9)	(16.0)	(3.0)
Netherlands	4.6	5.5	4.8	1.4
	(6.0)	(18.3)	(14.7)	(2.6)
Sweden	2.0	8.0	6.3	1.4
	(13.1)	(20.1)	(14.8)	(3.5)
Switzerland	1.7	2.4	3.7	1.5
	(7.5)	(18.1)	(17.0)	(2.1)
United Kingdom	5.9	4.7	5.9	2.8
	(12.8)	(15.4)	(15.0)	(2.3)
United States	4.5	4.4	7.5	-0.2
	(11.8)	(13.3)	(15.2)	(1.9)

Current pensioner incomes

- Overall pensioner income averages 60% of average earnings (44% for single pensioner)
- Currently main source is state (BSP and means tested benefits)
- Nevertheless, over half of pensioners receive income from occupational pensions (22% of income)
- Growing inequality among pensioners – top 20% (receiving sizeable occupational pensions) get 87% of average earnings, bottom 20% only 21%
- Falling proportion of new retirees getting occupational pensions
- Old, female, self employed often still in relative poverty although much less than in 1979

Income sources for single pensioner

	£	Percent
State benefits	112	61
Occupational pension	41	22
Investment income	19	10
Earnings	9	5
Other income	2	1

A crisis in social security?

- No fiscal financing problem now or on the horizon if current system maintained – including income support
- Some increase in proportion qualifying for BSP (home responsibility protection) - but level of BSP already below official poverty line, so those on full pension entitled to income support, raising costs
- Income support has wealth test, discouraging saving by low income worker (40% of investment income deducted, even after reform)
- Future further decline in replacement rate (of BSP and S2P) due to price indexation and lower accrual factor
 - Growing burden of means tested benefits, disincentives
 - How politically sustainable to have such pensioner poverty?

Social security replacement ratios

% of average earnings	2000	2040
Basic state pension	16	9
S2P (current)	19	16
S2P (proposed reform)	19	11

A crisis in defined benefit occupational pensions?

- Current key issue is underfunding
- Current estimates suggest deficits of £160-300 billion (2-3% of GDP), with some firms having funding ratios as low as 65% (average 80%), or deficits of 40% of market capitalisation
- Underlying factors:
 - Bear market – UK shares 50% below peak
 - Large holdings in equities, averaging around 70%
 - Earlier government policies which raised the accrued benefit obligation, notably compulsory indexation up to 5% of current and deferred pensions (link to meagre public pensions)

- Tax policies which encouraged holidays from contributions by employers, notably limits on overfunding in previous bull phase
- Declining bond yields and rising longevity raising liabilities
- Switch from actuarial basis of funding calculation based on sustainable income basis for assets and part-equity discount for liabilities to current market value basis for assets and corporate bond yield discount for liabilities
- Last point reflected initially in the uniform Minimum Funding Requirement requiring shortfalls on accrued benefits to be corrected in 3-10 years, depending on severity (now being replaced)...

- ...and also from 2005 in accounting standard FRS17, which requires deficits be declared on balance sheet at current market prices...
- ...while rating agencies declare that deficits count as debt - concern of companies to lose credit rating due to pension liabilities,
- Also burden of topping up (doubling of 2000 contributions needed by 2005) limiting dividends and fixed investment – and affecting UK growth
- Broader issue of awareness of risks by CEOs from defined benefit obligations
- Other adverse developments for defined benefit funds:
 - Proposed pension benefit insurance burdening schemes
 - Overall burden of regulation increased since mid-1980s

- Consequence has been closure of most defined benefit schemes to new entrants; by 2002 50% of defined benefit funds closed to new members
- Paradox that similar shortfalls seen in 1970s and made up in early 1980s without structural shift
- Closure to entrants will not remove burden of accrued benefits, nor many projected ones
- Debate on whether liabilities better covered with bonds (e.g. Boots) – but costs likely higher...
- ...but shift to bonds underway reflecting maturity, and enhanced shortfall risk under MFR/FRS17

- General loss of public confidence in company pensions, aggravated by:
 - loophole allowing solvent employers to walk away from obligations
 - 10,000 plans wound up since 1997, affecting 300,000 members – often rights not all maintained – MFR funding level insufficient to buy deferred annuities
 - pensioners’ interests absolute priority over workers
- Regulatory response is introduction of benefit insurance to cover benefits in insolvency and not just fraud – likely to generate moral hazard and further flight from defined benefit funds (model, US PBGC, is bankrupt)
- Need for better education of trustees – ignorance led to blind confidence in consultants and high equity exposures

A crisis in occupational defined contribution funds?

- Defined contribution funds could be better for a mobile workforce – where changing jobs 6 times loses 25% of benefits
- Main issue is inadequate contributions (see table)
- When employers close defined benefit funds, contributions may fall
- Risk of crisis of inadequate future retirement income, especially given rising longevity

Average contributions for occupational pensions

Percent	Employer	Employee	Total
Defined benefit	11.1	5	16.1
Defined contribution	5.1	3.4	8.5

- Also heightened investment risk and uncertainty for members
- And issue of incentives by employers to optimise investment, given they do not bear risks (cf. Switzerland and Australia)
- Risk benefits such as life and disability insurance less common than with defined benefit funds

A crisis in personal pensions?

- Outstanding issue of mis-selling of personal pensions in 1980s and early 1990s – after government had incentivised their purchase
- 500,000 left occupational funds, of whom 90% received inappropriate advice (high transfer costs and no employer contribution)
- Response has been massive fines on insurance companies and tightening of regulations on selling
- But deeper issue of inadequate contributions – many only pay in contracted-out rebate (4.6%)
- Again lack of risk benefits such as life and disability insurance usually included in occupational defined benefit funds

- Difficulty of switching between funds, where poor performance is persistent
- And commission charges so high as to use up most of the return, especially for small funds (2.5% of contributions and 1.5% of assets)
- Some government response – launch of stakeholder pensions with commissions limited to 1%
- Resistance by sellers (claim low fees uneconomic) and poor take-up by public, especially low paid for whom designed
- Also concern that means testing implies sale of stakeholder might not be “best advice”

- Meanwhile, where there is a company scheme, employers will generally not contribute to personal pensions of their staff
- (Group personal pensions generally do receive employer contributions)
- So overall issue is again inadequate retirement income in future

A crisis in annuities?

- Compulsion to take annuities justified by tax privileges, need for retirement income security
- Public concern over declining level of annuities from defined contribution funds, when government bond yields fell to 3%
- Low interest rates were themselves partly a consequence of hedging by pension funds against shortfall risk in face of MFR/FRS 17
- Recovery in yields may reduce pressure from this source – which was partly an issue of money illusion (real yields not abnormally low)

- Also losses in annuitisation depend on portfolio prior to retirement
- More justifiable concern over risks to insurance companies from high yield bonds, credit derivatives, underestimation of longevity...
- ...and adverse selection to annuitants owing to voluntary nature of private pensions

- Equitable Life crisis leading to loss of confidence in annuities – and life insurance generally:
 - Option of deferred guaranteed annuities, when option not “in the money”
 - When option gained intrinsic value as lower bond yield and higher longevity, sought to “manage by discretion” rather than reserving, reinsuring, buying out etc.
 - Attempt to pay lower bonus to guarantee holders quashed – attempt to place burden on whole with profits fund (as mutual)
 - Lessons inter alia for reserving (option values) and fund separation

- Information provision to consumers regarding annuities
 - Plethora of choices at retirement
 - Term of annuity
 - Type of annuity (and inherent risks)
 - Timing of payment
 - Choice of company
 - Consumer understanding questionable
 - Open market option in UK rarely exercised
 - Money illusion and failure to value indexation, despite increasing longevity
 - Delayed purchase, cost of “mortality drag”
 - Hence consumer advice literature and stringent regulation of salesmen, disclosure
 - Leading to abandonment of advice as uneconomic by insurers – so consumers uninformed

A crisis in personal saving?

- Rising longevity, low public pensions and declining employer provision puts onus on individuals to save for retirement
- Overall contributions to private pensions only 7.7% of average earnings
- 42% of workers only occasional members of schemes – mainly lower income earners
- Younger workers most likely not to contribute, although returns highest – see coverage data
- One reason is growing burden of student debt
- Also lack of advice – itself seen uneconomic by providers

Coverage of private pensions by age

age group	percent
16-24	21%
25-34	56%
35-44	65%
45-54	68%
55-59	58%
60-64	44%

- Non pension saving low; UK saving ratio low since financial deregulation
- Partly consequence of high level of mortgage borrowing
- Non pension balance sheet of average household has net assets of £13,649, of which £7,786 in securities
- But 25% have negative net financial wealth and 50% have net wealth below £1,500.
- Average non pension wealth is only £5,357 for those without occupational pension; 48% of those without a pension have negative net financial wealth

Personal saving ratio

	Percent of personal disposable income
1963-1972	6.2
1973-1982	9.8
1983-1992	8.5
1993-2002	7.5
2000	4.3
2001	5.7
2002	4.7

- Surveys suggest major underestimation of saving needs for retirement – and focus only 10 years ahead
- Report calculates 13 million will get pension below 2/3 of earnings, 3 million less than half – implying a savings gap of £27 billion a year
- Aggravated by “crises” noted above
- May need to liquefy housing wealth (80% of 45-64s are owner occupiers)
- But also prevent means testing from discouraging private saving
- And prevent frequent change in government policy from generating uncertainty, discouraging saving

A crisis of asset returns?

- Current issue of underfunding will be resolved if bear market ends rapidly
- But experience of 1974 showed that real equity prices can take protracted period to recover, implying protracted deficits and large “topping up” payments needed
- Also evidence of overvaluation in 1999-2000 such as risk premia suggests peaks in share prices may not be readily recovered

Share price behaviour following 1974 crisis

	UK	US	Germany	Japan	Canada	France	Italy
Peak of share prices	Aug-72	Dec-72	Jul-72	Jan-73	Dec-72	Apr-73	Jun-73
Fall to trough in nominal terms (date of trough)	68.5% (Dec-74)	48.4% (Sep-74)	34.4% (Sep-74)	40.2% (Oct 74)	35.5% (Sep-74)	52.7% (Sep-74)	42.9% (Dec-74)
Return to original nominal level	Sep-77	Nov-80	Mar-76	Jan-79	Jan-79	Sep-79	Oct-80
Fall to trough in real terms (date of trough)	77.2% (Dec-74)	56.1% (Sep-74)	43.0% (Sep-74)	56.2% (Oct-74)	46.7% (Dec-74)	68.1% (Apr-77)	82.4% (Dec-77)
Return to original real level	May-87	Aug-93	Jun-85	Feb-85	Oct-96	Aug-86	Aug-86

Estimated equity risk premia

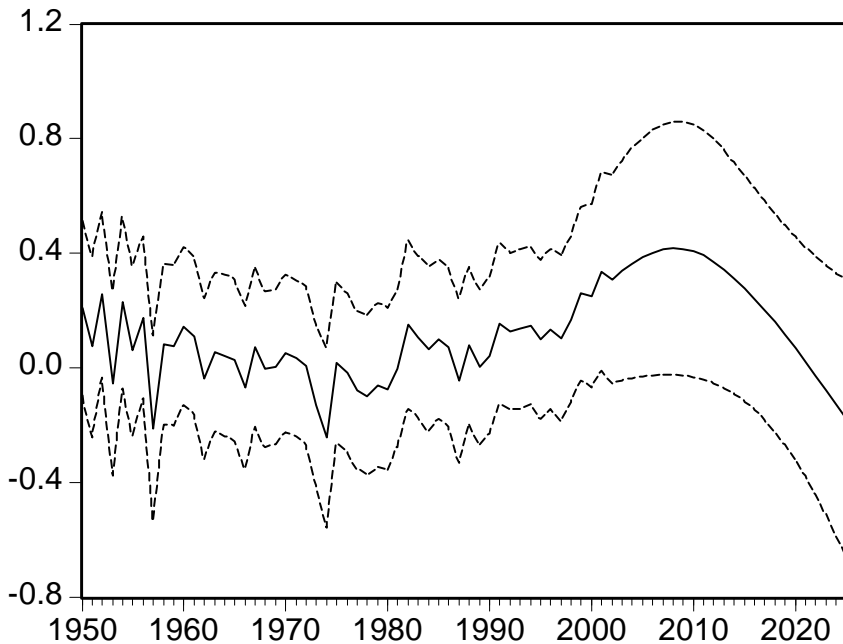
	Germany	US	UK	France	Canada
1960-69	7.6	4.4	4.5	6.6	5.1
1970-79	5.8	7.5	9.4	11.4	7.6
1980-89	2.3	1.8	3.2	4.1	1.1
1990-94	0.8	1.7	1.9	-0.3	-1.2
1995-99	0.4	0.4	1.6	-0.1	-0.6
Memo: 1972	5.9	3.5	4.3	8.9	5.3
Memo: 1999	0.0	-0.4	1.0	-0.4	-0.1

- In longer term, future asset prices could come under downward pressure as OECD population ages (affecting UK via integrated capital markets)
 - Lower real returns on capital as economic growth declines and capital/labour ratio rises
 - Lower saving (“baby bust”) affecting real interest rates or risk premium
 - Switch from equities to bonds
- Chart shows projections for US equity prices and bond yields, varying only the demographics
- Various offsetting factors (issuance, demand from EMEs) that mean scenario unlikely to be precisely reproduced
- But risk underlines need for private saving – and more public provision

Expected US asset prices

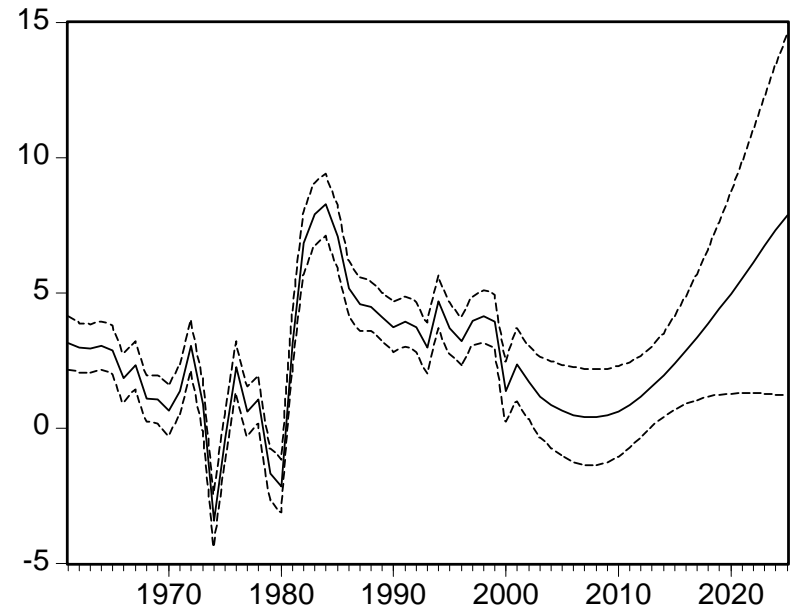
Chart 3: Projected asset prices for equations including AGE65

Equities



— USDLRSPF

Bonds



— USRLRF

Capital market issues

- Possible effects on overall economic efficiency
- Activity in corporate governance limited as no obligation to vote
- Unwillingness to invest in small firms – as illiquid and costly to research. If true may distort UK economy
- Cause capital market volatility as they “herd” in and out of markets, both domestically and internationally, leading to price volatility and/or liquidity failure
- Accused of “short termism” – only aim for profits in the short run and penalise long term investment (e.g. by selling to takeover raiders)

Evaluation of UK pension system

- Retirement income security
 - Poor performance given low levels of private pension saving, underfunding, switch to defined contribution, and low social security
- Financing issues – sustainability
 - Public pensions financially but not politically sustainable – private funds proving unsustainable in current market and regulatory situation
- Effects on labour markets
 - No strong evidence of labour market distortion – and here switch to defined contribution is beneficial
- Effects on capital markets
 - Helping to generate high equity inflows to UK markets but also arguably aggravating volatility, and generating low overall saving

Is there a UK pensions crisis?

- In many areas UK system remains satisfactory, as noted above
- Key issues often link to excessive reliance on voluntary funding:
 - Inadequate pensions for those dependent on social security
 - Burden of indexed defined benefit pensions to firms
 - Inadequate contributions to defined contribution and personal funds, low saving generally
 - Market failures and risks in annuities
 - Exposure of funded schemes to asset price volatility now....
 -worsening in the future as the OECD population ages

Policy suggestions

- Reduction in indexation of private pensions
- Government clearing house for defined contributions as in Sweden
- Better public education and access to advice in retirement planning (possibly subsidised)
- Boost in the level of basic social security to US levels providing sufficient to live on, with no means testing which would boost voluntary pension saving
- (Or) compulsory private pensions to ameliorate adverse selection in annuities and ensure adequate saving - including compulsory and adequate employer contributions to all private pensions

Related issues for Japan

- Appropriate reform of social security
- Deficits in defined benefit plans
- Future moves to defined contribution and the implications
- Difficulties of life insurance companies
- Coping with low asset returns