PENSIONS: THE NEW FRAMEWORK?

INTRODUCTION

THE Government in its Green Paper on Social Security[1] has proposed the phased abolition of the State Earnings Related pensions Scheme (SERPS) both on the grounds of its future cost and because it believes that "social security must . . . reinforce personal independence . . . widen . . . people's opportunity to make their own choices [and] . . . encourage . . . earning and saving."[2] The Green Paper should be read in conjunction with the Government's consultative document on personal pensions,[3] which announces their intention to offer individual members of employers' occupational pension schemes the right to choose whether to remain in their scheme or to provide for their retirement through their own savings. Between them, these two documents represent a shift of responsibility for retirement provision from the state to the private sector, and within the private sector, from collective arrangements to more individual ones. This article examines the arguments for, and consequences of, this shift in emphasis. The first section begins with a brief description of SERPS, and then considers whether it can bc afforded, and whether it is a desirable system when compared with a scheme which increases the basic retirement pension or a system of funded pensions. The second section looks at the Green Paper proposals for SERPS' replacement. It compares the pensions likely to be payable with those offered by SERPS; looks at the likely impact of the proposals on the occupational section; and examines whether the present legal framework provides adequate investor protection for those who will, in future, have to augment their basic retirement pension solely through private schemes. Much of the material which follows is not legal in nature. The specifically legal content focuses on the implications of the Government's proposals for EEC legislation and investor protection measures. The justification for including the other material is that lawyers, if they are to contribute to a debate, should understand the issues involved.

PART ONE

(a) *What is SERPS?*

SERPS was intended to provide a pension equal to one quarter of qualifying earnings in the best 20 years of an individual's

[1] Reform of Social Security, Cmnd. 9517–9.
[2] *Ibid.* para. 6.6
[3] The Government's proposals for individual pension plans are set out in "Personal Pensions: A Consultative Document," D.H.S.S., *passim*, 1984.

working lifetime. Qualifying earnings are earnings in excess of the basic single person's retirement pension payable at the time, and below a ceiling of between six-and-a-half and seven-and-a-half times that amount. Only earnings after 1978 can be qualifying earnings. In times of inflation, the best 20 years will tend simply to be the last 20 years. To counter this, and to prevent the pension being eroded in value as it accrues, an individual's qualifying earnings are indexed to average earnings.[4] Until someone has over 20 years of qualifying earnings there is no question of choosing "best years" and here the pension accrues at the rate of one-and-a quarter of each year's qualifying earnings.

The 20 best years formula is particularly favourable to women who take years off from work to cope with family responsibilities. In theory, a woman could take off 24 years from work and still have a full SERPS pension. SERPS also favours women through its generous treatment of widows. If a woman is over 50 when her husband dies, she inherits his pension, and if over 40 she inherits a fraction of it. This applies even where he dies before retirement age. The widow's combined pension cannot exceed the maximum pension payable to a single person. Widowers can inherit their wife's pensions but only if both are over retirement age when the wife dies.

Although the qualifying earnings, as they accrue, are indexed to earnings, SERPs in payment are increased by reference to the retail price index. Thus whilst SERPS guarantees a real level of income in retirement relative to that enjoyed whilst at work, there is no guarantee that a pensioner's lifestyle will improve as the country becomes richer.[5] People in contracted-out employment are still part of the State Earnings Related Pension *Scheme*, although they don't receive their earnings related pension from the State. Their employers have agreed to provide them with a pension at retirement which is equivalent to SERPS in exchange for a rebate of national insurance contributions.[6] This pension is known as a guaranteed minimum pension (GMP). Unlike SERPS the GMP is not indexed. To prevent the pensions of these contracted-out employees from being eroded with inflation the State pays an addition to their basic pension which represents any decrease in the value of the GMP since retirement.

When SERPS was introduced, the Government Actuary calculated that it would increase the pensioners' share of total personal consumption from 10 per cent. to 13 per cent. over 40 years, and increase average pensioners' income from two-thirds of average earnings to five-sixths.[7]

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[4] Social Security Pensions Act 1975, s.21.
[5] Social Security Act 1975, s.125 as amended by Social Security Act 1980, s.1.
[6] Currently 6·25 per cent. The Social Security (Class 1 Contributions—Contracted-out Percentages) Order 1982. S.I. 1982/493.
[7] Better Pensions, Cmnd. 5713, p.854.

(b) *Can SERPS be Afforded?*

The Green Paper states that it ". . . would be an abdication of responsibility to hand down obligations to our children that we believe they cannot fulfil."[8] We also learn that between 1985 and 2035 the worker/pensioner ratio will fall from 2:3 to 1:6[9]; health service costs for the elderly will rise by over 30 per cent. in real terms,[10] the basic pension will rise from £16·9 billion to either £45 billion if indexed to prices or £65·5 billion if indexed to earnings, and the cost of SERPS will rise to £23·1 billion.[11] These are large sums, can we afford them? Assessing the willingness of workers to pay pensions in 50 years' time is always a matter for speculation. The most that can be done is to find the likely cost in terms of national insurance contributions or taxes and look for evidence that we have met similar burdens before or that others have met or do meet similar burdens without undue strain.

The Government actuary has calculated that SERPS will require that part of the national insurance contribution which pays for pensions to increase from 12·5 per cent. to 19·9 per cent. by the year 2025.[12] Burdens such as this have been absorbed in the past. In the 35 years from 1950 to 1985 the national insurance rate attributable to pensions rose 7·5 percentage points, from 5 to 12·5.[13] On the Government actuary's figures, they must rise a further 7·4 percentage points over 40 years. Assume 1·5 per cent. growth and workers real earnings, over 40 years, increase by 81 per cent. (181·40). To require future workers to pay 19·9 per cent. pension contributions instead of 12·5 per cent. still leaves them with earnings, net of contributions, that are 78 per cent. (77·89) higher than ours.

Hammond and Morris, assuming 2 per cent. growth, calculate that by the year 2040 5·4 per cent. of total wages and salaries will be required to pay SERPS.[14] Again, the relative size of those earnings makes the bill seem more affordable. On their assumptions, total real earnings in 55 years will be three times ours (2·97 per

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[8] *Supra*, note 1, Vol. I, p.18.
[9] *Ibid.* at para. 5.4.
[10] *Ibid.* at para. 5.5
[11] *Ibid.* at para. 5.4.
[12] "Population and Pension Costs: Note by Government Actuary's Department," Table 5, exhibited as Annex B to "Social Security Expenditure: Past Growth and Projected Future Growth," Reform of Social Security Background Papers, Cmnd. 9519. The figures quoted in this paragraph and the next two refer to joint employer and employee contribution levels and assume that if contributions were not made by the employer, the employees' contribution rate would have to increase correspondingly or, if the reduction in the employer's contribution rate reflected decreased pension provision, that there would be a corresponding increase in employees' pay. This approach allows us to ignore the ability of different employers and employees to pass the burden of contributions on to each other (through changes in the wage rate) or to third parties, *e.g.* consumers. Working out who really pays for SERPS over the next half century, makes the debate impossibly complex.
[13] D. Piachaud, "Can We Afford SERPS?" *New Society*, June 14, 1985, p.407.
[14] E. M. Hammond and C. N. Morris, "A Simulation Model of the State Earnings Related Pension Scheme," Institute of Fiscal Studies, Working Paper 66, p.12.

cent.). Further, the transition proposals contained in the Green Paper will absorb 3 per cent. of total wages and salaries by 2010.[15] Thus if SERPS were to be retained in its present form the burden would be increased by a further 2 per cent. over 30 years, during which time real earnings increase by 81 per cent. On the Government actuary's worst assumption real earnings growth is only 1 per cent. and the contribution rate is 25 per cent.[16] But even this leaves future workers with earnings net of national insurance contributions for pensions 36 per cent. higher than ours. At levels of growth below 1 per cent. we move to the point where even basic retirement pensions at today's level cannot be maintained without decreasing worker's standard of living below that enjoyed by ourselves. At around 2·5 per cent. SERPS can be paid for without increasing the contributions attributable to pensions above the current rate. Neither of these assumptions appear particularly plausible. Our present rate of growth (1979–83) is only 0·1 per cent. However, even as recently as 1973 to 1979 it was 1·3 per cent. For SERPS actually to depress workers' living standards the present recession would have to continue for another 40 years. At the other extreme, we have had economic growth at around 2·5 per cent., but this was in the boom years of the 1950s and 1960s. To avoid raising the contribution rate we would have to experience similar levels of growth but for twice as long.[17]

In summary, if you believe that what matters for workers is not the rate of contribution but the gradual improvement of living standards, then we can afford SERPS. If you believe that we have hit the long-term ceiling for acceptable contribution levels, and that pensions can only be paid for through contributions, then SERPS probably cannot be afforded. Only if you believe that there is a contribution rate attributable to pensions somewhere between 12·5 per cent. and 19·9 per cent. or above that is unacceptable, do you need to consider what measures can be taken to avoid imposing such a rate. It is to these measures that we now turn.

(c) *Reducing the Cost of SERPS*

There is no requirement that a State pension scheme must be financed through national insurance contributions. Capital taxes, or increased indirect taxation may when the time comes prove more acceptable methods for meeting at least some of the costs of SERPS.[18] International comparisons suggest that the United Kingdom could sustain a much higher tax burden than exists at present (see table below).[19]

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[15] *Ibid.*

[16] Unemployment is 10 per cent., fertility 1·8 and mortality decreases by 37·5 per cent. Figure 1(a) *supra* note 12.

[17] See "Growth in the Long Term" Annex 3 to "The next ten years: public expenditure and taxation in the 1990's," Cmnd. 9189.

[18] See M. Reddin in "Can We Afford our Future?," Age Concern 1985.

[19] K. Newman "International Comparisons of Taxes and Social Security Contributions in 20 OECD Countries 1972–82," *Economic Trends*, February 1985, No. 376, Table A.

Taxes and social security contributions as a percentage of gross national product at factor cost

TABLE A

	1972		1977		1982	
	Percentage	Rank	Percentage	Rank	Percentage	Rank
including social security contributions						
Sweden	49	3	58	1	57	1
Norway	54	1	56	2	56	2
Denmark	50	2	49	3	54	3
Netherlands[1]	48	4	49	4	51	4
Belgium[2]	39	8	46	7	50	5
France	40	7	44	8	50	6
Austria	45	5	47	5	49	7
German Fed. Rep.	42	6	47	6	46	8
United Kingdom	38	11	39	10	45	9
Italy	30	13	35	12	42	10
Finland	38	10	43	9	41	11
Canada	38	9	37	11	38	12
Australia	28	14	34	13	36	13
Greece[2]	28	15	31	15	33	14
Switzerland[2]	25	16	32	14	31	15
United States	31	12	31	16	31	16
Japan	22	17	25	17	30	17
Excluding social security contributions						
Denmark	48	1	49	1	52	1
Norway	39	2	41	3	42	2
Sweden	39	3	43	2	42	3
United Kingdom	32	7	32	9	38	4
Australia	28	9	34	5	36	5
Belgium[2]	27	11	32	7	36	6
Finland	32	6	36	4	36	7
Austria	34	4	34	6	34	8
Canada	34	5	32	8	33	9
Netherlands	30	8	30	11	29	10
France	25	13	26	12	28	11
German Fed. Rep.	28	10	30	10	28	12
Italy	18	16	21	16	27	13
United States	26	12	25	13	24	14
Greece[2]	20	15	22	15	23	16
Switzerland[2]	20	15	22	15	22	16
Japan	17	17	18	17	21	17

Further, the costs of SERPS, and the basic pension, can be reduced by raising the age of retirement. Given the increased health that has accompanied increased longevity of life, people could be expected to retire later than they do at present. The increasing prevalence of early retirement, and the decreasing numbers working on after retirement, suggest that people may not be willing to do so. However, there is some evidence that the move towards early retirement has been involuntary,[20] and that pensioners are discouraged from working after retirement by the reduction in their pension if they take up new employment.[21] Thus, if we, as a generation, do turn out to have promised overgenerous pensions to ourselves, then the Government of the day might reasonably alter the age of retirement to make the reckoning a little more even. Alternatively, this Government could follow the example of the United States, which plans a phased increase in the retirement age to 67 by 2025.[22] Announcing such an increase now has two advantages. First, it gives today's workers plenty of time to adjust their plans for retirement. Secondly, if economic growth by 2025 reveals that such an increase is unnecessary, workers could always be encouraged to retire by offering generous early retirement pensions. This Government is planning to alter retirement ages although not in order to afford SERPS. They propose that individuals should be able to retire between the age of 60 and 70.[23] The amount of State pension received will increase for every year, within this period, that retirement is delayed. Those retiring before 65, or some other pivotal age, will not be able to go straight on to means tested benefits.[24] For women, this represents an increase in their pension age, since they can presently expect to receive a full retirement pension from age 60. More generally, it provides a fail-safe device if British pension funds, in the next century, cannot afford to pay adequate pensions. People can simply work longer. However, if these proposals lead to expectations of early retirement, and those expectations are transformed into earlier mandatory retirement ages fixed by employers or between unions and employers, then workers may find it difficult to continue in employment if their pension proves inadequate. To avoid this risk, it would be more prudent to follow the approach of the United States and create expectations of later retirement.

Another measure which would go some way to increase our ability to afford pensions, is to increase the number of women in the workforce. The Government Actuary's figures assume that contributions to national insurance remain a constant proportion (65 per cent.) of adults of working age. If over the next 40 years,

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[20] See "Age of Retirement," Third Report of the Social Service Committee, 1982, Vol. I, para. 17.

[21] The so-called "earnings rule": for five years after minimum retirement age, workers who earn more than a certain amount, currently £70 a week, have their basic pension withdrawn at the rate of 50 per cent. for the first £4 and then pound for pound. There is evidence to suggest that many pensioners wrongly believe that the earnings rule prohibits all, or virtually all, paid work with retirement, "Age of Retirement," *supra* note 18 at para. 121.

[22] *Supra* note 1, Vol. 2, para. 1.74.

[23] *Ibid.* para. 7.25.

[24] *Ibid.* at para. 7.26.

the proportion of people of working age who contributed rose to 80 per cent., the national insurance rate would rise to 15·3 instead of 19·9.[25] Unlike mortality rates and other demographic features, the ability of women to work is something which governments can influence through tax reliefs, child care facilities, etc.

Whilst it seems hard to imagine increasing the numbers of elderly and women workers given current levels of unemployment, part of the basis for our concern over SERPS is that we expect a future *shortage* of labour when the large cohort of persons born during the 1950s and 1960s reaches retirement.

Before leaving the question of our ability to afford SERPS, we must consider one further complication. The effect of SERPS is to produce State pensions of widely varying amounts. For those retiring before 1998 SERPS offers only a limited although growing prospect of improving the inadequate income represented by the basic retirement pension. For those who retire before 1998 it offers nothing. For example, a single male retiring aged 65 in 1982 could expect a pension of around £30 and an earnings related addition of around £3, whilst a similar retirer in 1998, when the 1982 retirer will be 81, will be receiving an additional component nearer £30, and so will have double the retirement income. The Select Committee on Social Services was convinced that some sort of assistance for these older and poorer pensioners was inevitable, for which future governments of whatever political complexion would have to find the necessary money.[26] A full costing of SERPS requires some estimate of the resources this is likely to involve.

(d) *Is SERPS Desirable?*

Even if SERPS can be afforded in the sense that workers are unlikely to refuse to pay the necessary contributions, this does not mean that we wish to commit their resources in this manner. For example, the resources committed to SERPS by 2033/34 could instead be used to increase the basic pension by just over a half if it continues to be uprated with prices between now and then, or by just over one third, if it is uprated in line with earnings.[27] Concentrating on increasing basic pensions could do more to tackle poverty and redistribute income than SERPS.[28] If SERPS were fully operational today, its abolition could finance a 60 per cent. increase in national insurance benefits.[29] When SERPS was brought in, it was widely believed that an earnings related system of contributions without giving earnings related benefits was impossible.[30] This Government, having already abolished short

[25] *Supra* note 13 at p.408.
[26] *Supra* note 20 at para. 44.
[27] *Supra* note 1, Vol. 2, Table 2.10.
[28] See J. Creedy, *State Pensions in Britain* (1982), p.30.
[29] J. Kay & C. Morris, *The Reform of Social Security* (1984), p.60.
[30] R. Crossman, *The Diaries of a Cabinet Minister* Vol. 3, (1977), pp.53 and 151 and Creedy, *supra* note 28 at p.31.

term earnings related benefits in 1980[31] is demonstrating the feasibility of such a system.

There are three reasons why we might retain SERPS instead of introducing a scheme which increased the basic pension. First there is the position of women. Without a scheme like SERPS, men and women cannot enjoy pensions that bear a similar relationship to their respective average real income whilst in full time employment.[32] Indeed, it is unlikely that women will receive pensions representing a similar percentage of their total lifetime incomes. (The reasons for this are discussed in the section dealing with the consequences of the Government's proposals.)

The second reason for retaining SERPS despite its poor redistributive qualities is its low administrative costs. Some critics have questioned why the managing director of I.C.I. should receive an earnings related pension from the State.[33] But if SERPS or another State scheme can produce pensions for people who would otherwise make private provision, but at a fraction of the cost, it is unclear why it should not do so. The fact that Sainsbury's can achieve considerable economies of scale does not mean that only poor people should be allowed to shop there.[34] Provided that higher paid workers are sold SERPS pensions at a price which is neutral when compared to the price (net of administrative costs) of obtaining equivalent pensions through the market, then there is little difference between this and the Government issuing long dated stock.

Last, there is little point in abolishing SERPS because higher basic pensions do more to alleviate poverty, unless you have some confidence that such pensions will be paid. This Government is not offering a new pension scheme with pensions fixed as a percentage of average wages, only the hope that with SERPS abolished, basic pensions might be increased when the savings of abolition make themselves felt which, given the Government's generous transition arrangements, will not be until after 2010.[35]

Another important argument against SERPS centres not on its poor redistributional qualities but its reliance on "pay-as-you-go (PAYG) instead of funding. Persons who know that their pensions are being provided by the next generation on a PAYG basis will, it is argued, either save less, or save in forms that are less easily converted into long-term investment capital. Requiring people to save for their own pension, either through institutions or by direct

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[31] Social Security (No. 2) Act 1980, s.4.

[32] Under present occupational schemes, a typical woman might expect to have half the pension entitlement of a man with a similar final salary. See Third Report from the Social Services Committee 1982, *supra* note 20 at para. 43.

[33] Hemming & Kay, "The Cost of the State Earnings Related Pension Scheme" (June 1982) 92 *The Economic Journal* 300, 314.

[34] M. Reddin, "Beveridge, Fowler and the Minimalist Approach" *Times Higher Education Supplement* June 21, 1985.

[35] *Supra* note 14.

investment, and preventing them from realising those savings during their working lifetime, creates a pool of long-term investment capital which can expand the economy.

The benefits of funding are difficult to measure. Reducing consumption now does not increase our ability to finance pensions or anything else in future unless that decreased consumption results in an increase in real investment, *e.g.* research and development, manufacture of capital goods and the training of personnel. To be certain that funding increases real investment we have to be sure of three things: first, that funding increases the flow of total savings; secondly, that increased savings result in increased real investment; thirdly, that insurance companies and pension funds are the most effective mediums for engaging in real investment. Each of these three contingencies is a matter of acute economic debate. The relationship between saving levels and social security systems was analysed in a recent book by H. A. Aaron, who concluded[36]:

> ". . . that a person determined to find a respected theoretical argument to support a preconception can find one, and that a person without preconceptions will find a bewildering diversity of answers in economic theory about whether social security is more likely to raise or to lower consumption or labor supply.
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> To get by this theoretical impasse, one turns with hope to empirical research for measures of observed behavioral responses. As will become clear, most of these hopes remain unfulfilled. Empirical research to date suggests that no one model explains the behavior of all households, and it has not succeeded in producing reliable estimates of the effects on behavior of any of the major policies."

If savings increase, real investment may also increase (ignoring any short term deflationary effects) but the rate of increase in real investment may not be very great. This is because increasing the quality of capital used in production (which is what real investment seeks to achieve) is not simply a function of having more money available for investment. Factors such as the state of technology also matter: for example, the enormous current investment in software may be financed through savings, but it is made possible by developments in the use of silicon chips. Last, saving through pension funds or insurance companies may not be the most efficient method for channelling savings into real investment. These institutions invest most of their funds in the stock exchange, both here and abroad. The ability of the Stock Exchange to promote real investment is itself a matter of controversy.[37] Investing directly from one's own savings, either by setting up businesses or by reinvesting in existing ones, may be more efficient, as may capital formation undertaken by government.

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[36] H. A. Aaron, *Economic Effects of Social Security* (The Brookings Institution, 1982), p.28.

[37] R. Minns *Pension Funds and British Capitalism* (1980).

Unless there is economic growth, either due to increased real investment or an increase in the size of the labour force, then the annuities which can be purchased in the second and third decades of the next century are likely to be less generous in real terms than those sold today. The effect of large numbers of pensions spending out of accumulated savings is likely to cause inflation, and hence to reduce the real purchasing power of a given annuity. This is because an increased number of pensioners will be seeking to buy rights to an unchanged amount of output. However, economic growth (whether or not due to funding) does not automatically lead to each pensioner receiving an increased pension. The level of private pensions is determined by the amount and financing of contributions, the real rate of return on investments during the period before retirement, and the condition of the market for annuities at the point of retirement (itself a function of expected real rate of return). This makes private pensions something of a lottery.

A second benefit claimed for funding is that it enables the present generation to experience the cost of providing the pensions which they have promised to themselves and thus prevent excessively generous promises. This same experience can be provided through a PAYG scheme, by paying the present generation of pensioners benefits equal in value to those we have promised ourselves. (If we paid basic retirement pensions financed from all the contributions we presently commit to income in old age, they could be as high as £120 per week for a single person and £200 per week for a couple.)[38] However, insistence on discipline through making equivalent payments to a PAYG scheme means that future pension levels must always remain at what this generation can afford. One of the advantages of a PAYG system is that, assuming growth in the economy, the next generation can afford to pay higher benefits than this one. However, if discipline is required, it is better for existing pensioners if it is provided through increased PAYG pensions since requiring the current workforce to fund their own pensions reduces their ability to finance the present State pension.

One of the benefits claimed for SERPS as a PAYG scheme is the ability to provide indexed pensions. Certainly PAYG schemes can provide indexing fairly easily, as contributions increase automatically with inflation. However, funded schemes can provide indexing. Contracted out schemes under SERPS provide GNPs that are indexed to earnings as they accrue, although the Government blames this commitment in part for the failure of occupational schemes to increase their coverage. Funded schemes could, if they wished, provide a much greater degree of indexing by for example, keeping a greater proportion of their assets in cash

[38] *Supra* note 18 at p.45.

or invested in short-term loans whose rate of interest correspond closely with inflation.[39] However, this would involve a sacrifice of the hope of higher rates of return from the kinds of portfolio pension funds presently hold and would undermine somewhat the pension funds' claim to be a source of long-term real investment capital.

Whilst the benefits of funding may be speculative, the administrative costs are certain to be higher than a State PAYG scheme. The cost of administering the National Insurance Fund in 1983/84 was only 3·8 per cent. of total benefit spending.[40] The administrative costs of occupational pension schemes range from 6·5 per cent. to 8 per cent.[41] The cost of individual pension plans are expected to range from 13·6 per cent. to 23 per cent.,[42] and to average around 20 per cent.[43]

Part Two

(a) *The Green Paper proposals*

SERPS is to be phased out from 1988. Men aged between 50 and 64 and women aged between 45 and 59 at that date will continue in SERPS through to retirement. No one else earns new entitlements although people up to 10 years younger than this group will be credited with extra SERPS entitlement ranging from one year to seven and a half years.[44] SERPS is to be replaced by compulsory minimum contributions of 4 per cent. of salary into private schemes which includes employers' schemes, industry wide schemes and individual pension plans. Part-time workers with earnings below a minimum, probably equal to the basic single retirement pension, will be exempt, as will casual workers and persons under 18 years of age.

There are no guarantees as to what pensions these contributions will earn. Hammond and Morris estimate that 4 per cent. contributions could provide pensions for males aged 45 and above that were as high at retirement on average as those promised by SERPS.[45] Younger male employees would require contributions of 5·5 per cent. in order to reach this level. (The position for women is discussed below.) Hammond and Norris's estimates were based

[39] Hemmings & Kay "The Future of Occupational Pension Provision in Britain" in M. Fogarty (ed.), *Retirement Policy: the next 50 years* (1982). The Social Service Committee expected that over the next decades the majority of pension funds would move towards index linking pensions in payment, *supra* note 20 para. 30.

[40] Cmnd. 9143, II, Government Expenditure Plans 1984–85 to 1986–87, Table 2.12.8.

[41] Occupational Pension Boards "Portable Pensions." Advice given by the Board on February 29, 1984 to the Secretary of State's inquiry into provision for retirement. Annex D Administrative Changes for existing pension contracts.

[42] *Ibid.*

[43] Actuary Hyman Wolanski, Speech at Westminster and City Programmes Conference, "Personal pensions: the next steps," London July 3 and 4, 1985.

[44] *Supra* note 1, Vol. 2, Table 1.3.

[45] *Supra* note 14.

on investments achieving a real average rate of return of 3·5 per cent. However, a particular generation of workers runs the risk that conditions for them will be below average,[46] *e.g.* the annuity market will be depressed at the time they retire. To reduce such risks, they need to save in excess of 4 per cent. (or 5·5 per cent.) in order to ensure SERPS level pensions.

As well as variations in the rate of return received by different generations of workers, there will also be variations within each generation, and it is likely to be those workers with least contributions who also receive the least rate of return. This is due to the particularly high expenses of providing pensions to the kind of workers who are contracted-in under SERPS; the low paid, the irregularly employed and employees of small businesses. If the employers of these workers do not provide pension schemes they will have to take out personal pension plans and will need to find institutions willing to collect small irregular payments from a vast number of sources. Insurance companies and unit trusts are likely to make high administrative charges for handling this business. The Green Paper refers to "controls and safeguards" to ensure a fair distribution of administrative charges,[47] but if this leads to insurance companies being unable to charge more for dealing with the least attractive accounts, they may simply avoid them. Building societies and banks are used to this type of account, and may be expected to charge less, but they also pay lower rates of return. The Government wish to maximise occupational pension scheme coverage, and in those industries where individual employers have proved reluctant to offer pensions they hope to promote industry schemes. However, even if more of the least attractive workers do come within occupational schemes, the economies of scale and investment opportunities which they enjoy will still be less than those afforded to the kinds of workers already in schemes: the higher paid, the regularly employed and employees of large companies.

Women, as a group, are certain to be worse off under these proposals than with SERPS. Because women live longer than men, private pensions are unable to offer them the same level of pension for equal amounts of contribution. The Government, in line with the draft EEC Directive,[48] are considering making schemes ignore mortality differentials and offer the same terms to both men and women. If they do, this may lead to more subtle forms of discrimination, *e.g.* schemes sold through employers to mainly male workforces will offer better terms than schemes sold through employers of mainly female workforces.

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[46] *e.g.* from 1963 to 1977 average rates of return were actually negative. M. Fogarty, "Retirement Age and Retirement Cost," Policy Studies Institute London, 1980.

[47] *Supra* note 1, Vol. 2, para. 1.59.

[48] *Official Journal* 1983, C134, p.7.

The draft Directive only covers occupational schemes, *i.e.* it ignores individual pension plans ("personal pensions"). Thus unless the Government's proposed legislation goes beyond the Directive, women who take out personal pensions will be disadvantaged. Personal pensions could also be very attractive to male workers within predominantly female workforces. If these workers opt for personal pensions, because they offer better terms,[49] the benefits offered to the remaining workforce will correspondingly be depressed. Again, if equal terms are mandated, there is likely to be evasion, *e.g.* the most advantageous personal pensions may be targeted only at male workers. Women also receive worse terms because they retire earlier. If the Government implement their proposal to end discriminatory retirement ages within the State scheme then, provided the draft Directive comes into effect, they will also have to pass legislation prohibiting employers from running schemes with discriminatory retirement ages.[50] However, if women continue to retire earlier, for whatever reason, they will continue to earn lower pensions.

Whilst equalling the terms offered to the sexes assists women who pursue a career instead of raising a family, it does not help those women who take time off to have children or to care for elderly relatives. Private schemes cannot offer these women terms as generous as SERPS.[51] It would require contribution levels similar to those which have led this Government to question our ability to afford SERPS. In deference to this the Government propose to require schemes to offer widows the right to inherit only half their husbands' pensions. An employer's scheme which fixed benefits by reference to the best 20 years earnings would result in one employer paying pensions calculated by reference to a higher salary, earned with another employer. Not only does this make it difficult for employers to calculate their pension costs but, if we assume that employees who receive higher salaries provide more valuable services there is a considerable element of cross subsidy between employers. Money purchase[52] schemes penalise

[49] As they will unless the requirement for equal pay (Article 119) requires employers to pay extra contributions for women employees to ensure that benefits are equal. This question was addressed by the Advocate-General in *Worringham* v. *Lloyds Bank* [1981] 2 All E.R. 434, 443 who was of the opinion that men and women must make equal contributions to pension schemes and receive equal benefits. If women's benefits cost more to provide, the employer must make a greater contribution on their behalf. However, the Advocate stressed that the scheme in question was adopted by the employer. Personal pension schemes will be chosen by the employee. The European Court based its decision on the narrower ground that an addition to salary designed to compensate for employee contributions into a pension scheme was within Art. 119.

[50] *Supra* note 48, Art. 9.

[51] Given the higher administrative costs of funding, and the difficulty of funding assets which match liabilities, the average contribution levels over the next decades may be higher than under SERPS. They would certainly be higher initially, since PAYG allows a small contribution level whilst the number of pensioners remain small, whereas funding principles require an even level of contributions throughout the life of the scheme.

[52] This is where a scheme provides benefits the amount or rate of which is calculated by reference to the contributions paid from time to time by the member or by the employer in respect of him, and to the member's age at the time when contributions are paid.

women with family responsibilities particularly heavily. Contributions made early in life are worth more in terms of the eventual pension than later ones, since they have longer to accrue interest. This makes it difficult for women to restore their pension levels, even with increased contributions, when they return to the workforce full-time after raising children.

The Green Paper states that all accrued SERPS will be "fully honoured."[53] This has several possible meanings: first, that all SERPS entitlements will be frozen and paid at retirement without further indexing; secondly, that frozen SERPS entitlement will continue to be increased by reference to average earnings up to retirement and continue to be indexed to prices thereafter; thirdly, that frozen SERPS will be indexed to prices throughout; fourthly, that SERPS will be indexed to earnings or prices up to retirement but not thereafter; fifthly, that frozen SERPS will be indexed to earnings or prices only after retirement. Of these possibilities, only the second complies with the original promises made for SERPS. If the variety of methods of indexing seems complex, calculating the entitlement to be indexed is even more so. The years credited could be based on the nine years of qualifying earnings since 1978. This penalises those employees for whom these were not all "best years." They expected nine-twentieths of their State earnings related pension to be based on years in which they earned more. On the other hand, those workers who had more than 20 years from 1978 to retirement could expect to work some years in which they did not earn any more pension, *e.g.* persons working 30 years would have 10 "worse" years in which they contributed to SERPS without increasing their pensions. This suggests that younger workers should receive frozen pensions of somewhat less than nine-twentieths of their qualifying earnings since 1978.

(b) *The Effect of Green Paper Proposals on Occupational Pension Schemes*

The Green Paper proposes that all employees should have a right to opt out from their employers' scheme and have a 4 per cent. contribution paid into a personal pension plan with a minimum 2 per cent. contribution from the employer. There is to be no right to receive a transfer value of accrued rights whilst the employee continues to work for the scheme employer. The effect of these requirements on occupation pensions schemes depends on each scheme's generosity and the manner in which contributions are structured. Where schemes are funded by contributions from both employees and employers and the employees' contributions exceed 2 per cent. there is an immediate increase in take home pay from

[53] *Supra* note 1, Vol. 2, para. 1.41.

opting for a personal pension.[54] Employers who wish to discourage this may switch to "non-contributory" pensions, *i.e.* where all contributions are made by the employer. Where employees' contributions are below 2 per cent., the advantage of the personal pension option depends on whether they are currently accruing benefits at a rate which can be exceeded by a 4 per cent. money purchase scheme. Within final salary schemes there is a considerable cross subsidy from young to old. Older employees tend to have higher salaries, and they also have fewer years before they are to enjoy their pensions. Therefore the benefits which they accrue each year tend to be worth more than those accruing to younger employees.

If contributions were apportioned between workers by reference to the value of the benefits accrued in each year, then in some schemes the notional contribution received by younger employees will be less than 4 per cent. In these schemes younger employees could gain from insisting on personal pensions. Whether in fact they gain depends on the respective rates of return of the personal pension and the employer's scheme and the length of time they remain in the same employment. If they exercise their option and yet remain with the employers then they will miss out on the cross subsidy which they could have expected to receive when they, in turn, became "older" workers.

Because the minimum contribution is so low, and only the minimum need be paid into a personal pension plan, the employee's right to opt out of the employer's scheme should pose no threat to the solvency of most existing final salary schemes.[55] Nor should the right to receive a transfer value on leaving employment equal to the benefit that a 4 per cent. money purchase scheme would earn. The Social Security Act 1985 provides that employees can receive a transfer payment equal to the value of their accrued rights, and in most final salary schemes this will be worth more than a benefit calculated by reference to 4 per cent. contributions. However, informing younger workers of the existence of cross subsidies and the notional contributions paid on their behalf may encourage a move to money purchase schemes. First, because younger workers, especially if they do not see themselves remaining with one firm, may wish to end the cross-subsidy. Secondly, because in order to persuade younger workers of the value of their pension when

[54] In 1984 the average contribution rate for employees, where contributions depend on salary was approximately 4·5 per cent. of eligible earnings for staff schemes, 3·6 per cent. of eligible earnings for works schemes and 4·6 per cent. for combined schemes. National Association of Pension Funds, 10th Annual Survey of Occupational Pensions Schemes, Tables 18–30.

[55] In 1984 and within contributory schemes, the average company contribution rate per member was approximately 12 per cent. for staff schemes, 7·3 per cent. for works schemes and 10·5 per cent. for combined schemes. In non-contributory schemes the figures were 17·2, 6·8 and 16 per cent. approximately. In contributory schemes it is unlikely that the notional employer's contribution rate for younger workers falls below 2 per cent., or below 4 per cent. in non-contributory schemes. *Ibid.* Tables 24–32.

compared with money purchase schemes, and to calculate minimum transfer values, it will be necessary to work out benefits on a money purchase basis. Given this extra administrative work, and the difficulties of explaining a final salary scheme in money purchase terms, it may be easiest to change to a money purchase scheme.

The abolition of SERPS will aggravate the problems facing those people who change jobs before retirement: "early leavers." SERPS entitlement is unaffected by job changes. If an early leaver is contracted-out, his preserved GMP is indexed by reference to average wages, or increased at 8 per cent. compound per annum.[56] In either case the State has to make up the difference between a GMP and a State earnings related pension. Private pensions other than GMPs are indexed to prices up to a ceiling of 5 per cent. in any one year. Where an employee has less than five years' pensionable service, he is only entitled to a rebate of his contributions plus interest. If this forms the basis for preserving the pensions that replace SERPs then many more workers will discover that they could have earned a much larger pension by never changing jobs.

Last, there is the question of contracted-out employees who are within 15 years of retirement. The Government has offered to continue the rebate, presently 6·25 per cent., for this group. This rebate is calculated by the Government Actuary as an average of the widely differing costs of providing pensions to male and female employees of different ages. In practice the cost to employers of providing a pension is less for younger employees than for older ones. Older employees are more likely to draw their pensions than an equal number of younger employees, some of whom will die before reaching 50 (men) or 45 (women). They are also more likely to be sick in the intervening years, making it more expensive to earn their pensions. They accrue their GMP at the same rate as younger men but the rebate for older employees has fewer years to earn interest. The upshot of all this is that, unless the contracting-out rebate or the accrued rights premium (the price of contracting back in) are substantially increased, large numbers of these employees will be returned to the State scheme. Because the accrued rights premium cannot be altered without giving two years' notice,[57] the Government's most likely action is to increase the rebate.

(c) *Investor Protection: The Legal Framework*

The Green Paper proposals will increase the number of persons relying on private pension provision. They will also require people to take greater risks, as their pension is no longer to be guaranteed

[56] Social Security Pension Act 1975, ss.33 and 45.
[57] *Ibid.* ss.44 and 46(5).

by the State. (Under SERPS, contracted-out employees received SERPS level pensions even if their scheme earned inadequate returns or failed completely.)[58] The Government also proposes to allow banks, building societies, and unit trusts to offer the kinds of tax relieved schemes that are at present available only through insurance companies and friendly societies.[59] The justification for these changes is that individuals should have increased choice.[60] This section examines the existing framework for investor protection to access whether that choice will be an informed one, and whether the institutions concerned can offer sufficient security to the individuals who save with them. It begins with a discussion of the provision for solvency and disclosure within occupational pension schemes. It then examines the equivalent arrangements for insurance companies. The section ends with a brief look at the measures necessary for building societies, banks and unit trusts to offer a similar degree of security to that currently provided by insurance companies.

(i) *Occupational schemes*

In their 1982 report entitled "Greater Security for the Rights and Expectations of Members of Occupational Schemes," the Occupational Pensions Board did not propose legislation on funding and investment controls, as they believed that such controls were unnecessary unless there was significant danger to members' pension rights which could not be averted by voluntary action.[61] The Occupational Pension Board indicated a number of reasons why a statutory system of funding controls would prove difficult. Requiring all occupational schemes to be funded at an unchanging contribution rate on the assumption that they will continue indefinitely places considerable restrictions upon the employer. Increasing benefits by, for example, crediting older members with extra years of pensionable service or raising pensions in payment, would require a large single payment into the fund. Not surprisingly, employers prefer to spread the cost of such increases by raising the contribution rate and funding the extra benefits over a number of years ("back funding"). Also, actuaries periodically revise their assumptions

[58] On a scheme ceasing to be contracted out then, unless the Board approves arrangements for providing a preserved GMP, an accrued rights premium becomes payable, in return for which the employer is no longer liable for the GMP. If the scheme has insufficient funds to pay that premium then, unless the default is due to that employee's connivance or negligence, the unpaid portion of accrued rights premium will be waived. (Occupational Pension Scheme (Contracted-out) Regulations 1984, S.I. 1984/380, paras. 23(1)3(b), (5).)

[59] The only method of providing tax relieved retirement provision for those outside pensionable employment is governed by sections 226 to 228 of the Insurance and Corporation Taxes Act 1970, as amended. In very broad terms this provides for relief on premiums payable within certain limits for specially approved annuity contracts with a life assurance company or friendly society. See Hoskings, *Pension Schemes and Retirement Benefits* (5th ed., 1985), p.158.

[60] *Supra* note 31, para. 3.1.

[61] Cmnd. 8649 (HMSO, 1982), paras. 6.20, 6.21.

about future earnings and rates of return. Such revisions do not ordinarily lead to the payment of a single large sum into or out of the pension fund, but to an alteration in the contribution rate, which allows the deficiency or surplus to be absorbed over a number of years. Given this background, funds will differ in their degrees of solvency. The Occupational Pension Board accepted the value of this flexibility in funding and, in place of a statutory scheme regulating funding, placed their faith in a system of disclosure which allowed trustees and members to monitor the funding level determined by their employer. Their recommendations[62] are expected to form the basis of regulations to be made under Social Security Act 1985[63] (discussed below).

If a scheme is wound up with insufficient funds to meet all liabilities, the order of priority depends on the rules of the particular scheme. The only statutory requirement relates to contracted-out benefits, which must be given priority over all other benefits except those provided to persons already over normal retirement age and their dependants.[64] Where an employer has guaranteed the scheme then, provided the employer has sufficient funds, there will be no need for abatement. However, such guarantees are rare. Where the employer is insolvent then, whether or not the scheme is guaranteed, it will have certain priorities in the employer's insolvency. All employees' contributions deducted in respect of the last four months earnings but not paid over to the trustees are a priority debt,[65] as are employers' contributions in respect of contracted-out benefits over the past 12 months.[66] There is no requirement for insolvency insurance, although where the scheme has invested with an insurance company and the company becomes insolvent, the scheme will ordinarily receive 90 per cent. of the value of the policy under the Policyholders Protection Act 1985.[67] But even if a scheme is adequately funded, this does not protect members from receiving pensions considerably below their expectations. Most schemes allow an employer to discontinue the scheme, usually on giving six months' notice.[68] Pensions are then payable by reference to members final salary at the date of discontinuance. This salary is likely to be less than that paid at retirement, due in inflation, promotion etc., which means that the benefits paid on discontinuance are likely to be considerably less than the members expected.[69]

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[62] *Ibid.* paras. 11.3 to 11.17 inclusive.

[63] Social Security Act 1985, s.3.

[64] *Supra* note 56. S.40 as amended by Occupational Pension Scheme (Contracted-out) Regulations 1984, S.I. 1984/380, para. 40.

[65] Social Security Pensions Act 1975, Sched. 3, para. 1.

[66] *Ibid.* para. 2.

[67] Policyholders Act 1975, s.10 provides for cash payments. S.11 provides for another company to take over responsibility for providing 90 per cent. of future benefits.

[68] W. Phillips, *Pension Scheme Precedents* (1957), para. 2501.

[69] On winding up, members below retirement age, who have five years' pensionable service, must receive preserved pensions. The Social Security Act 1985 requires a member's preserved pension in excess of the GMP to be indexed, but only up to 5 per cent. per annum. Thus inflation over 5 per cent. per annum erodes their value.

Because discontinuance reduces the benefits, a scheme that has been funded on the assumption that it will continue to exist is likely to show a considerable surplus on winding up. This surplus will not necessarily go to the members. If the trustees have no power to augment benefits or to pay enhanced transfer values into a new scheme, then all the surplus will, according to a rule insisted upon by the Revenue as a condition of granting tax relief, be returned to the employer.[70] If there is a power to augment but this requires the employer's consent, then a failure to consent leads to the same result as before. Even where the trustees have a discretion to increase benefits, this may be limited to Inland Revenue maxima. Last, even where trustees have unlimited discretion, this may not prevent some part of the surplus being returned to the employer. It can be argued that the employer, being entitled to any eventual surplus, is a residuary beneficiary, and is therefore as much an object of the trustees' discretion as the members. Without authority on this point, some trustees may be persuaded that they should not exercise their discretion wholly in the members' favour. Further, the employer usually appoints the trustees. Trustees who consider themselves wholly responsible to the members may find themselves replaced by others less committed to this view.

If a member ceases to work for his employer, his pension is calculated on the basis of his final salary at the date of leaving. Again, this will earn less pension for the same number of years' service than a pension calculated by reference to final salary at retirement. Thus, if a member is to make an informed estimate of his likely occupational pension he has to consider a number of factors that are almost completely outside his control: how adequately is his scheme funded; will the employer discontinue the scheme; and is he likely to be dismissed or made redundant? Against this background, we turn to consider the quality of information provided to members.

The Social Security Act 1985 gives the Secretary of State power to make regulations regarding information to be given to members and their trade unions.[71] The Regulations proposed will require that they receive copies of an annual report setting out the contributions paid and a statement of whether these concur with the recommendations of the scheme's actuary, together with a review of the funds investment performance and the nature, disposition, marketability, security, and valuation of the scheme's assets.[72] The report will include a set of audited accounts giving a breakdown and valuation of all the scheme's assets, identifying any investment valued at more than 5 per cent. of the total net assets

[70] "Occupational Pension Schemes. Notes on approval under the Finance Act 1970 as amended by the Finance Act 1971," I.R. 12, para. 15.4.

[71] *Supra* note 63.

[72] "Proposals for regulations on disclosure of information by occupational pension schemes," D.H.S.S.. August 5, 1985.

of the scheme and any self investment in excess of 5 per cent. Self-investment is to mean investment in the business of the scheme employer or a connected company or person. It will include shares and securities of the company, mortgages on real property owned by the company, freeholds and leaseholds owned by the scheme but leased to the company; and secured or unsecured loans to the company. Every three and a half years, a scheme is to be the subject of an actuary's report, setting out the scheme's expected future contribution rate and funding level. The actuary will certify whether the scheme could meet its existing liabilities if it were discontinued, and if not, he will state the extent to which different categories of liabilities could be met: pensions in payment, preserved benefits, etc. The actuary will also certify whether, in the normal course of events, the scheme will be able to meet future liabilities on the assumption that it continues in being. This certificate will state the assumptions on which that calculation is based. The report and certificate are to be made available on request to any member, beneficiary or recognised trade union.

The greatest weakness in the Government's reliance on disclosure is the absence of any mechanism for members to act upon the information provided. If the disclosures reveal a breach of trust, then it may be possible to commence litigation, but this is a costly and lengthy undertaking for a member. In any case, if the trust is widely drawn the disclosures may reveal policies being pursued or financial returns being made which are unsatisfactory rather than illegal. Here the members' options are somewhat limited. They can opt for a personal pension in future but this only requires that their employer pay 4 per cent. into such a scheme which, as discussed above, is likely to be less than the employer presently contributes on their behalf. Furthermore, leaving the scheme will result in a member getting a preserved benefit calculated by reference to his current salary which only needs to be indexed up to 5 per cent. per annum.[73] Thus he immediately loses much of the more generous benefit he expected to receive under the employer's scheme.

The OPB have placed their faith in the ability of members to influence their schemes through the operation of "normal industrial relations."[74] This seems optimistic for two reasons. First, members and trade unions may be unable to monitor and react to pension scheme policy. Trade unions cannot presently serve as a surrogate Department of Trade checking the returns of every scheme in which their members have an interest, although they can provide advice whenever trustees or members bring matters to their attention. However, not all schemes have members who belong to trade unions, and even where they do, the members may not know what to expect of their scheme's management. Secondly, even

[73] *Supra* note 69.

[74] Occupational Pension Board, "Greater security for the rights and expectations of members of occupational pension schemes," Cmnd. 8649 (HMSO, 1982), para. 11.4.

where members or their trade union can identify a scheme which fails to live up to accepted standards of design or management, what pressures can they bring to bear to ensure rectification? Relying on normal industrial relations suggests that industrial action might be required. This envisages an extraordinary degree of understanding and commitment on the part of ordinary scheme members.

(ii) *Insurance companies*

Whereas any employer may set up an occupational scheme, insurance companies must be authorised by the Department of Trade and Industry.[75] The Department may intervene if persons who are not fit and proper become the controller, managing director or chief executive of a company.[76] It may also prevent the appointment of such a person to these positions.[77] Companies must submit annual accounts to the department, and every 12 months their long term business must be the subject of an actuarial report.[78]

The Department sets out mandatory margins of solvency.[79] The company is required to keep its long-term business (which includes the provision of annuities) separate from its general business.[80] The Department's responsibilities go beyond ensuring that liabilities can be met. The holders of "with profit" policies are not concerned only that the bonuses presently declared can be paid for, but that future bonuses can be expected. The Insurance Companies Act 1982 specifically authorises the Department to intervene where there is a risk that the "reasonable expectations" of long-term policyholders may be disappointed.[81] The Act prevents surpluses on the long-term account from being distributed to shareholders or used to subsidise general business: first, a company with long term business may not voluntarily be wound up[82]; secondly, the long-term policyholders must share in any surplus in at least the same proportions (less 0·5 per cent. of the total surplus) as they shared in the last surplus[83]; thirdly, when calculating the long-term liabilities of the company, and thus its surplus or deficit on long-term business, the actuary is required to adhere to standard valuation regulations.[84] Conflict of interest is limited by restricting self-investment to 5 per cent. of a company's long-term funds

[75] Insurance Companies Act 1982, s.3. Companies authorised before the 1982 Act are covered by s.4.

[76] *Ibid.* s.60. Controller is defined in s.7.

[77] *Ibid.* s.17.

[78] *Ibid.* s.18(3).

[79] *Ibid.* s.32.

[80] *Ibid.* ss.28, 29. S.6 prevents companies authorised since 1982 from carrying on both general and long-term business.

[81] *Ibid.* s.37(*a*).

[82] *Ibid.* s.55(2).

[83] *Ibid.* s.30.

[84] *Ibid.* s.18(4).

(unless the Secretary of State specifies a higher amount).[85] In the event of insolvency, the long-term policyholder may claim up to 90 per cent. of the value of his policy under the Policyholders Protection Act 1975.[86] This is subject to a power to reduce benefits where, in the opinion of an independent actuary, they were excessive.[87]

One's first impression is that the protection for persons saving their pensions with insurance companies appears better than that afforded to members of occupational schemes. However policyholders may still find themselves with considerably less retirement income than they expected, and they face great difficulty in making an informed choice between different insurance companies, or between an employer's occupational pension scheme and that offered by an insurance company. The insurance industry relies heavily on illustrations or "projections" of expected yield in selling its policies, both "with profit" policies and "linked" policies (where the value of the policy is fixed by reference to a real or nominal fund of assets held by the insurance company). These projections do not form part of the sum the insurance company has contracted to pay, and therefore are not covered by the Act.[88] Under a "with profits" policy, the company's liability to the policyholder increases whenever bonuses are declared by the directors. The practice has arisen in recent years of awarding a large part of the overall bonuses at the end of the term, rather than by way of periodic bonuses, usually annual, declared during the course of policy, These "terminal" or "final" bonuses decrease the protection offered by the 1975 Act, and make it difficult to monitor the insurance companies' performance, since the annual bonus will no longer indicate the level of pension which can be expected by the end of the policy. Even where monitoring a policy's performance is possible, acting on that information can be very costly. Insurance companies have to recoup the costs incurred in securing a policy. As well as administrative charges, there will be advertising expenses and commissions. Commissions on a pension policy are approximately 50 per cent. of the first year's premiums and 1·25 per cent. of each subsequent year's premiums. If the pension policyholder remains with a single company these charges can be spread over a long period. If the policyholder changes companies, they have to be taken out of the premiums paid up to that time. The effect can be dramatic. In some cases, no pension is payable if the policy is discontinued before the second year. A person who switched companies several times would find

[85] *Ibid.* s.31(1).
[86] *Ibid.* ss.10 and 11.
[87] *Ibid.* s.12 There is some confusion as to whether actuaries must consider all the circumstances when deciding if the benefit is excessive, or whether they must form their judgment solely by reference to the premium paid. Report on the Policyholders Protection Act 1975. Department of Trade, H.C. 363, 1980/81, p.9.
[88] *Supra* note 67, s.11(2).

his pension significantly reduced. If a policyholder wishes not only to discontinue premiums, but to transfer his existing investment to another company, he will require a surrender value. This is likely to increase his disappointment. The surrender or transfer value will be less than the value of bonus declared since those are based on the assumption that a company would have retained the policyholder's investment through to his retirement. Further, where a large number of policyholders wish to change companies, surrender or transfer values may be depressed by the company actuary's need to increase reserves to maintain solvency. Whilst these practices may be eminently reasonable from the point of view of the insurance companies, and they could not be altered without decreasing the returns to policyholders who do remain with a particular company, they increase the need for the policyholder to make an informed choice at the time he first takes out a policy.

The projections included in insurance companies sales literature are unlikely to be explained except by a statement (where appropriate) that: "The amounts of bonus shown in the illustrations are those which would accrue if the rates of bonus most recently declared (excluding special additions) were to continue until the pension becomes payable." This is likely to be accompanied by the general warning that "bonuses cannot be guaranteed"[89] and that high levels of inflation produce high projections. The warnings do not compensate for the lack of explanation since the potential policyholder does not need to know what will affect the insurance industry generally, but how this particular company estimates its own performance, and how this compares with the estimates of other companies. Policies whose value at maturity is linked to assets purchased for the policyholder with his premiums are easier to monitor than "with-profits" policies. However, the initial sales literature may be just as misleading.[90]

One suggested reform is to require insurance companies to show two figures: the yield that the maturity value represents to the policyholder, allowing for the cost of life insurance; and the investment return needed on future investments to maintain the bonus rates shown in the projection.[91] The first of these would not only enable a policyholder to judge for himself whether such a quotation is optimistic, but would enable direct comparisons with other forms of saving such as building society shares. The second

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[89] Such warnings are required by the Code of Practice on Life Assurance Selling issued by the Life Offices Association, Associated Scottish Life Offices and Industrial Life Offices Association. (Available on request from the Association of British Insurers.)

[90] The Consumer Association found that of the eight "unit linked" policies they considered only one was matured with an assumed yield used for projection anywhere near that obtained in the past, and some companes were assuming that they were going to earn over 25 per cent. per annum more for their new policyholders than they have done for the policyholders whose policies had just matured. E. Rutingers, *What Will My Pension Be?* (Consumer Association, 1985), p.133.

[91] See E. Short, "Personal Life Assurance: What the Past Tells Us," Paper presented to the Institute of Actuaries Students Society on February 2, 1982.

figure would go beyond the general warning that interest rates might fall by giving some indication of the likelihood of this occurring.

If informed choice between insurance companies is difficult, choosing between insurance companies' and employers' schemes on an informed basis approaches the impossible. The projections of insurance companies are in cash terms, and are not discounted to take account of inflation, whilst the preserved benefits offered by occupational schemes are partially indexed and are calculated by reference to final salary. An ex-employee comparing the purchasing power of his preserved pension with that of a future cash sum may fail to appreciate that his preserved pension will increase with inflation (up to 5 per cent.). However, finding a common basis for projections is difficult. Simply requiring insurance companies to state the value at today's prices of projected cash sums unduly favours the occupational schemes, since the purchasing power of a preserved pension will be eroded by inflation in excess of 5 per cent. The choice lies between requiring both occupational schemes and insurance companies to quote pension benefits at today's prices, or for both to quote benefits at future cash values. In either case they must assume the same rate of inflation or the comparison loses meaning.

Even if the presentation of information is improved, few people have sufficient financial experience to make an informed choice between retirement saving institutions without advice from impartial experts, and few experts are impartial. Insurance intermediaries such as tied agents, insurance company employees and insurance brokers and consultants, all receive commissions which differ both between companies and between different policies offered by the same company. Intermediaries who are not tied also receive overriding commissions fixed by reference to the volume of work placed with a particular company. Professor Gower recommended that commissions be standardised within the industry, something which he felt to be impossible without legislation.[92] The Government, in their White Paper, rejected this in favour of a system of disclosure coupled with an extension of the present provision for policies to remain ineffective until a statutory cooling-off period has elapsed.[93] They propose to require non-tied agents to reveal the commission earned on the policy sold, or to provide a statement that commission paid complies with a voluntary agreement. Existing regulations already provide for policyholders to receive a statutory notice that they can cancel their policy within 10 days,[94] and the Government propose to extend this arrangement to single premium

[92] Review of Investor Protection Report, Part I, Cmnd. 9125 (1983–84), para. 8.57(j).

[93] "Financial Services in the U.K. A new framework for investor protection" (Cmnd. 9432, 1985), paras. 10.7–11.

[94] The Insurance Companies Regulations 1981, S.I. 1981/1654, para. 70. Schedule 10 and 11 set out the form of notice.

policies[95] (which will protect ex-employees who require a transfer value to be paid from their occupational scheme to an insurance company). Professor Gower felt that the disclosure requirements could not be enforced, and that a universal voluntary agreement on standard commissions was unlikely.[96] He also doubted whether revealing "tied" status was sufficient warning of an agent partiality.[97] Even if it were, it is unclear how potential policyholders can act upon that knowledge, except by seeking advice from other equally partial intermediaries. The cooling-off period merely increases their ability to take this rather unsatisfactory course of action.

The problem of partiality is compounded by a lack of expertise on the part of many of these intermediaries. According to Gower:

> "Members of the sales force are recruited largely from those without relevant prior experience or educational qualifications. They are given a short (sometimes only 2 days or thereabouts) initial course and, unless then weeded out as unsuitable, are sent out to build up a clientele in their district, under the loose supervision of an area manager who, in most cases, is himself self-employed."[98]

(iii) *Banks, buildings societies and unit trusts*

In their White Paper on Financial Services, the Government have proposed that all providers of personal pensions should come under the supervision of the new Securities and Investment and Marketing of Investments Boards.[99] As these proposals have yet to be finalised, it is difficult to assess whether the controls are likely to be adequate. The Government have still to decide whether providers of personal pensions will be subject to statutory requirements restricting the range of permitted investments or increasing the coverage of compensation arrangements. These two concerns cannot be considered in isolation. Unless there is a means of regulating solvency, a compensation scheme financed by contributions from the members of an industry quickly becomes a system whereby the more prudent companies underwrite the less prudent ones. However, assuming effective controls can be devised, there is a case for increasing the compensation arrangements in banking, and building societies. Banks and building societies are considered by the Government to be institutions where the investor should expect his investment to be at little or no risk.[1] Yet the Banking Act 1979 only provides for deposits up to £10,000 to be covered by the Act's compensation arrangements, and even here

[95] *Supra* note 94, para. 12.8, as interpreted by Gower, Review of Investor Protection Report, Part II (HMSO, 1985), para. 5.9. Single premium policies are excluded from the Insurance Company Regulations 1981 (*ibid.*) by para. 71(i).

[96] *Ibid.* para. 5.06.

[97] *Ibid.*

[98] *Supra* note 92 at para. 8.11.

[99] *Supra* note 93 at para. 11.8.

[1] *Ibid.*

[2] s.28.

only 75 per cent. of a deposit is guaranteed.[2] The building societies have no statutory scheme, but the Building Societies Association has introduced a voluntary scheme whereby member societies guarantee 100 per cent. of all depositors' accounts, 90 per cent. of the share accounts of member societies, and 75 per cent. of the share accounts of non-members.[3] Unit trusts have no scheme of compensation, nor do they have a system of solvency regulation. The Government propose to restrict the range of underlying investments available to those trusts which can be promoted directly to the public.[4] Whether such restrictions provide adequate security for persons saving for pensions, remains to be seen.

CONCLUSION

The author's own conclusions are that the arguments for abolishing SERPS are unconvincing, and that the system intended to replace it will result in lower pensions (particularly for women) with little benefit by way of increased choice. It will also create pressures to increase investor protection, which may result in the private pension sector becoming more regulated, and less private, than it is at present. The proposed transitional arrangements will postpone any major savings in government expenditure until the second decade of the next century. In these circumstances the present Government may be persuaded that there is no case for the abolition of SERPS.

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[2] s.28.
[3] Introduced, March 1982.
[4] *Supra* note 93 at para. 9.7.
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