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Pension Reform, Financial Literacy and Public Information: A Case Study of the United Kingdom

Edward Whitehouse

January 2000

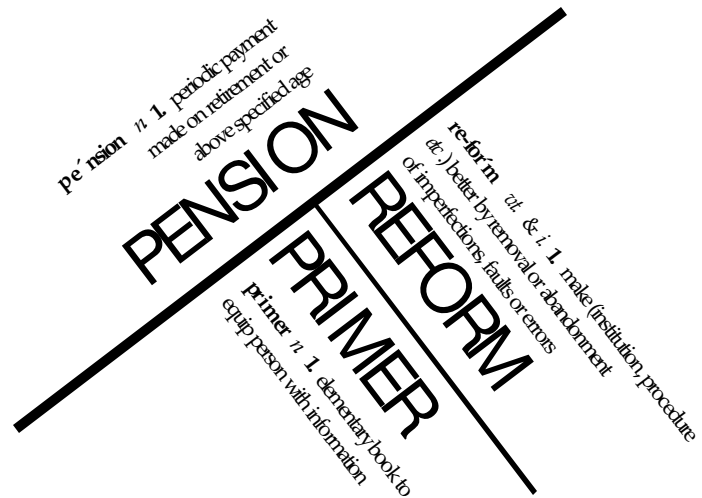
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Pension reform, financial literacy and public information: a case study of the United Kingdom

Edward Whitehouse*



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First draft, May 1999

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This paper is part of a broader project on pension systems, financial literacy and the role of public information that will examine a range of different countries' experiences.

The public-information project is part of the World Bank's Pension Reform Primer. Details are available from the Social Protection Division (HDNSP), World Bank, 1818 H St NW, Washington D.C. 20433; telephone +1 202 458 5267, fax: +1 202 614 0471, e-mail: socialprotection@worldbank.org, web: <http://www.worldbank.org/pensions>.

Richenda Solon, Deborah Hankins and colleagues at the Department of Social Security, Richard Disney of Nottingham University, Paul Johnson of the Financial Services Authority, Robert Palacios of the World Bank and Agnieska Chlon of the Polish Plenipotentiary for Pension Reform gave helpful comments.

Preface

Consumers in most countries are generally not well informed about pensions. Both general facts about the structure of the pension system and specific data on their own pension entitlements are lacking. Many people, as a result, might have unrealistic expectations of their retirement incomes. But apathy and indifference to pension planning (and personal finances in general) form a large barrier to improving people's knowledge of the pension system and how it affects them. Indeed, many people form no expectations of their retirement income at all. These problems are probably general to pension systems of all types.

Pension systems involving privately managed retirement savings accounts place greater responsibility on individuals for planning their retirement income. At the very least, people must choose which of a range of competing funds should manage their pension assets. In many, they have a choice over whether to join the defined-contribution pension scheme or to remain in a public, defined-benefit scheme. In some countries, there is also considerable choice over how much to contribute to retirement accounts. Moreover, defined-contribution pensions, because of the compound-interest effect, reward early pension planning to a greater degree than defined-benefit schemes. Some general level of financial literacy and involvement with financial services would seem an essential pre-requisite for a fundamental pension reform involving a move to individual, funded pension accounts.

The project on public information and pension reform will explore these issues by examining a range of countries' experience. This, the first paper in the series, looks at the experience of the United Kingdom. A number of interesting initiatives to improve general and individual pension information are described and assessed.

Robert Palacios
Edward Whitehouse
Editors,
World Bank Pension Reform Primer

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Pension reform, financial literacy and public information: a case study of the United Kingdom

Edward Whitehouse

'Old age is the most unexpected of all things that happen to a man' (Leon Trotsky)

The United Kingdom government proposed, in its own words, 'a radical reform of the whole pension system' in December 1998. The consultation document admitted that 'people are confused by the many pension options and have lost faith in the system'. The lack of confidence is unsurprising: personal pensions were mis-sold, the assets of occupational schemes were mis-used, in one celebrated case, fraudulently, and the government mis-informed people about their future state-pension rights. Also, the level of compulsory pension provision has declined over the past two decades, meaning that individuals are increasingly responsible for making their own retirement-income arrangements. Many of the government's recent reform proposals aim to help people understand how they can achieve the level of retirement income they want and to rebuild trust and confidence in the pension regime.

This paper begins with a brief introduction to the UK's pension regime. The system is very complicated by international standards, involving a mix of public and private provision, defined-benefit and defined-contribution formulae, mandatory and voluntary coverage, and funded and pay-as-you-go financing. Some schemes are provided by employers, some by the state and some by financial-services companies. The subsequent section assesses consumers' knowledge of the pensions system, highlighting the gaps. An examination follows of consumers' use of different financial products. The next section sets out the public-information problem: lack of confidence in a complex and rapidly changing pension system, indifference to retirement-income planning and problems in getting

trustworthy advice. Current and planned initiatives to improve both general pensions and financial knowledge and information about individual pension rights — from government, financial regulators and the private sector — are then assessed. The conclusions draw out the lessons for other countries.

1. A brief guide to the UK pension system¹

The UK pension system, summarized in Figure 1, is a ‘multi-pillar’ régime. The first pillar or tier is a mandatory, publicly provided ‘basic state pension’. This is paid at a flat rate to all with an adequate contribution record, and can be topped up with means-tested benefits. The second tier is also mandatory, but people have a choice of scheme. The default option is the state earnings-related pension scheme, known by its acronym Serps. People can ‘contract out’ of this scheme into personal pensions, which are individual, defined-contribution², retirement-savings accounts. Employer-run ‘occupational schemes’ can also contract out these members. Occupational pensions can have either a defined-benefit³ or a defined-contribution formula. Some employers offer group personal pensions instead, which tend to have lower administrative charges than individually purchased plans.

The government’s recent reform proposals include a new second-tier option, called ‘stakeholder pensions’.⁴ Timmins (1999*d*) describes them as ‘the Treasury’s pet version of the US 401(k) savings plans’, and they do share many features both with these and Australia’s superannuation system. They are defined-contribution accounts, but are designed to be a lower-cost option than personal pensions, and so more suitable for people with low earnings. Employers who do not offer an occupational plan will be required to make a stakeholder plan available to their employees. The Serps scheme is to be reformed and renamed the ‘state second pension’, which will target benefits on the lower-paid.

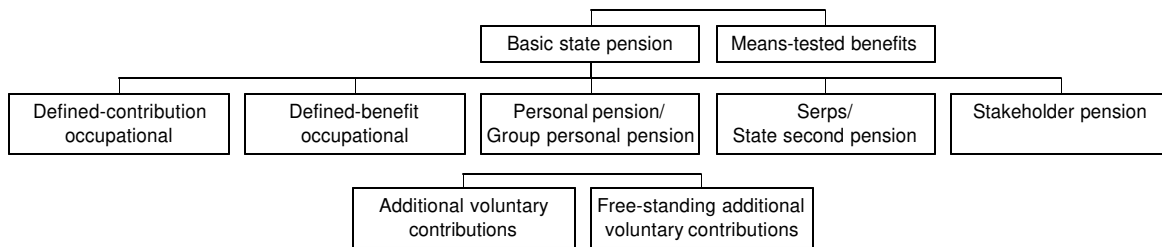
¹ See Whitehouse (1998) for a detailed description.

² The value of a defined-contribution pension depends on the amount of contributions made and the investment returns they have earned

³ The value of a defined-benefit pension is set by a formula, typically including some measure of earnings and years of coverage.

⁴ Department of Social Security (1998*b*) describes the proposals and Disney, Emmerson and Tanner (1999) provide an assessment. The details of stakeholder schemes are being spelled out in a series of consultation documents: Department of Social Security (1999*d,e,f*).

Figure 1. The UK pension system



The third tier — voluntary retirement-income savings — also includes a number of options. People can pay more than the mandatory minimum into their personal pensions. They can make so-called ‘additional voluntary contributions’ to an occupational plan, or set up a separate defined-contribution account and make ‘free-standing additional voluntary contributions’.

The UK system, even as summarized in Figure 1, is extremely complex by international standards. Even the mandatory element offers people a wide range of options. The system combines defined-benefit and defined-contribution pensions, with some components run by the state, some by employers and some by financial-services companies. Many rules vary between different options. The mandatory second-tier, for example, can involve either a minimum contribution (personal pensions and most defined-contribution occupational schemes) or a minimum benefit (defined-benefit and some defined-contribution occupational plans) or just the Serps pension. The restrictions to tax privileges also vary. Defined-benefit plans can offer a maximum accrual rate of 1/60th of final earnings per year of membership up to an earnings ceiling. A tax-free lump sum of up to 1½ times earnings⁵ can also be withdrawn. Defined-contribution schemes have a maximum contribution rate, which varies with age between 17½ and 40 per cent of earnings. One quarter of the fund can be withdrawn as a tax-free lump sum. Some pension has to be annuitized at state pension age, while some can be drawn down until age 75.

I have simplified the description of these rules substantially, yet even in this abbreviated form they are undoubtedly complex. And this complexity, I will argue, is central to the pensions public-information challenge.

⁵ Or 2¼ times the initial annual pension if this is greater.

2. Consumer knowledge of pensions

How much do consumers know about this complex system? The Office of Fair Trading (1997) conducted a survey of 3,800 consumers' knowledge of the pension system and their attitude to their own pension provision. Tables 1 and 2 show people's answers to seven main questions. There are some worrying examples of ignorance. For example, less than a third of people can estimate the value of the basic pension for single person within a range of ± 7 per cent (and ± 10 per cent for a married couple's entitlement). Another recent survey found that 55 per cent of people admitted to having no idea of the value of the basic state pension.⁶

Table 1. Consumer knowledge of the pension system

<i>Question</i>	<i>Correct</i>	<i>Incorrect</i>
Weekly value of basic pension, single person (£61)	32% (£55-64)	29% above £64 27% below £55 (13 % do not know)
Weekly value of basic pension, married couple (£98)	28% (£90-104)	19% above £104 37% below £90 (16% do not know)
Entitlement to basic pension	20% (based on contribution record)	77% (based solely on age)
How is the basic pension indexed?	48% (prices/cost of living)	25% government whim 12% average earnings 4% European Union rules (7% do not know)
What does the acronym 'Serps' stands for?	21% (state earnings-related pension scheme or close)	5% mentioned pensions 8% mentioned other word 8% all incorrect (57% do not know)
Are personal pensions defined-contribution?	83% of employees with personal plans	9% said based mainly on earnings and tenure 3% hybrid

Source: Office of Fair Trading (1997)

Note: Row totals may not sum to 100 due to rounding

Less than half of people knew that the basic pension is price-indexed. A quarter thought that uprating was discretionary, and 12 per cent that the pension increased in line with average earnings. (The pension was earnings-indexed between 1975 and 1981; before that, uprating was discretionary, but the increases tended to approximate average earnings.)

⁶ An NOP survey of nearly 1,000 adults for the Nationwide Building Society (Pensions World, 1998b).

Over three-quarters of people, incorrectly said the only entitlement condition for receipt of the basic pension is age. Only a fifth, correctly, said it depended on the individual's contribution record. This inaccuracy is probably not very significant. The vast majority of people will receive the full pension based either on their contribution record or because of credits received for periods of unemployment or home responsibilities (e.g. caring for children or the elderly).

Turning to second-tier pensions, only 21 per cent of people were close to knowing what the acronym Serps stands for. Indeed, only 34 per cent could guess one or more of the words. Knowledge of private pensions was mixed. More than four-fifths of employees with a personal pension knew that it would provide a defined-contribution pension, while 9 per cent thought that personal pensions are defined-benefit. On occupational pensions, the proportion that told the Office of Fair Trading survey that their plan was defined-benefit was significantly below the proportion found in surveys of pension funds (Table 2).⁷ Interestingly, an earlier study for the Department of Social Security found a higher proportion saying that their pension benefits would be related to earnings. Only four per cent of public-sector workers did not know the benefit formula or (incorrectly) said it was defined-contribution, according to this survey. In the private sector, the proportion saying their plan was defined-contribution was only around five per cent more than the administrative figure. These studies point to very different conclusions on people's knowledge of their pension benefits. I am at a loss to reconcile these different findings.

Table 2. Benefit formula in occupational plans: survey and administrative data

<i>per cent of employees with occupational scheme</i>	<i>Defined benefit</i>	<i>Defined contribution/ other</i>	<i>Do not know</i>
Consumers' views			
Office of Fair Trading survey	63	30	6
Department of Social Security survey	85	12	4
Administrative data	95	5	—

Source: Office of Fair Trading (1997), Hawkes and Garman (1995), Whitehouse (1998)

⁷ This comparison will, of course, understate the true level of error. Starr-McCluer and Sunden (1999) found the numbers in the United States that said that their pension plans are defined-benefit or defined-contribution matched the aggregate figures, but 20 per cent of people were incorrect.

Table 3 summarizes peoples' views about their pension coverage. The first column divides people into those who think they have a personal plan, an occupational pension and no private coverage. (Most of this last group will default to Serps.) Column two divides people by whether they thought they were contracted into Serps, contracted out or did not know their status. The third column gives survey data, the last, administrative data for comparison.⁸ The percentages add up to more than 100 because some people have both an occupational and a personal scheme.

The most interesting divergence is on the issue of contracting out. For occupational schemes, the overall proportion that said that they had a plan is close to the administrative data. Nevertheless, only a third or so of people with an occupational plan said that they were contracted out. A further one in six did not know, while administrative figures show that over 90 per cent of occupational scheme members have in fact left the Serps scheme. Similarly, many people without a private pension said that they were contracted out and nearly half did not know, while contracting out is impossible without either a personal or an occupational plan that meets certain rules.

Table 3. Pension status: survey and administrative data

<i>Private pension</i>	<i>Contracting out</i>	<i>Survey</i>	<i>Administrative data</i>
Personal pension	in	8	9
	out	18	25
	do not know	4	
Occupational pension	in	16	3
	out	22	39
	do not know	7	
None	in	7	33
	out	9	0
	do not know	13	
Do not know		2	

Source: Office of Fair Trading (1997), Whitehouse (1998). See also Department of Social Security (1998c)

⁸ These results are similar to the analysis of private-pension coverage in Barrientos (1998). Also, Hawkes and Garman (1995) report that 25 per cent of employees said they had a personal pension, 47 per cent claimed they were in an occupational scheme, while 34 per cent said they had no private provision.

There are significant differences between public- and private-sector occupational-scheme members' knowledge of contracting out, according to a Department of Social Security survey.⁹ All public schemes are contracted out, but around three in ten members thought their scheme replaced Serps and a quarter did not know whether they were contracted out or not. In the private-sector, three out of five people per cent said they were contracted out. This is closer to the administrative figure (85 per cent) than public-sector workers' views, but still substantially lower. Again, a quarter of workers in the private sector did not know whether they were contracted out.

Awareness of the Serps scheme among those without a private pension is low, according to Hawkes and Garman (1995). For example, 42 per cent of full-time employees who either said their private pension was contracted in or that they had no private pension reported that they were definitely not building up a Serps entitlement and a quarter did not know. But the vast majority will be earning a Serps pension.¹⁰ Furthermore, 17 per cent of people who said their scheme was contracted out claimed definitely that they were still earning Serps.

Less than half of employers believe their employees understand their occupational pension, according to a study by Towers Perrin (1999). Far more employees claim they do understand their pension, but as Tammy Mattson of the employee benefits consultancy says, they 'do not understand as much as they think'. For example, two-thirds think the cost of fringe benefits, including holidays and pensions, are worth only 20 per cent of pay or less, while the true figure exceeds 30 per cent on average. '73 per cent [of employees] may understand that they have a pension plan in place', says Ms Mattson, 'but if you ask them if it will be adequate, they clearly do not understand what their income will be or...what will happen when they move jobs'.¹¹

Qualitative research for the Department of Social Security also shows widespread ignorance.¹² For example, few people knew that contributions attracted tax relief and many

⁹ Hawkes and Garman (1995).

¹⁰ Only employees earning below the national-insurance lower earnings limit do not earn Serps. But that the low level of this limit (around a fifth of average pay at the time of the survey) means this condition affects part-time workers almost exclusively.

¹¹ Pensions World (1999a).

¹² Hedges (1998). The study is based on 16 discussions held with a total of 97 people in the Fall of 1997.

were confused about the structure of pension payouts (lump sums or annuities). The terminology, particularly acronyms such as ‘Serps’ and ‘AVC’, were seen as bewildering. The principle of contracting out was fairly well known, but people often admitted to researchers that they did not understand the implications. For example, some assumed that contracting out meant that they would not receive the basic state pension.

3. Patterns of use of financial services

The vast majority of consumers in the United Kingdom have some experience of financial services. Table 4 shows that nearly 90 per cent have a checking account¹³, two-thirds have access to some kind of commercial credit and three-quarters, some kind of savings.

Table 4. Use of different financial services

<i>per cent of households with:</i>	
Current (checking) account	87
Commercial borrowing (mortgage, loan, overdraft, credit card, retail credit)	66
Home contents insurance	81
Savings (deposits, equities, bonds, unit trusts)	76
Life insurance (non-mortgage endowment policy)	12
Personal pension	19

Source: Atkinson (1999). See also Office of Fair Trading (1998) for a discussion of technical issues in the survey

Table 5 focuses on the characteristics of consumers with low take-up rates of different financial services. (The first line shows again coverage for the population as a whole from Table 4.) In every case, income is a very strong determinant. Other important differences reflect characteristics associated with low income. (Unfortunately, this is not a multivariate analysis, so we cannot isolate the separate effect of income and other characteristics.)

¹³ A larger survey by the Association of Payment Clearing Services found a slightly lower proportion of households with a current account: 84 per cent.

Table 5. **Use of financial services by different types of consumers**

(%)	<i>Current account</i>	<i>Home-contents insurance</i>	<i>Savings</i>	<i>Personal pension</i>
All	87	81	76	19
Income				
Very low	54	46	46	2
Low	70	68	61	2
Housing tenure				
Social rent	60	51	45	6
Private rent		55	66	
Household type				
Single no children		65		
Lone parent	69	54	49	
Pensioner single	71			0
Pensioner couple				2
Education				
Basic school leaving		68	58	
No qualification	74	75	66	8
Labor-market status				
Unemployed	62	36	39	8
Carer	70	64	59	9
Disabled	68	58	48	5

Note: shows groups with take-up rates ten or more percentage points below the overall mean. Basic school-leaving qualifications are GCSE grades D-G and CSE grades 2-5.

Source: as for previous Table

People who rent their homes either from a local authority or from a housing association ('social renters') are much less likely than the population as a whole to have any of the four financial products. Lone parents, another low-income group, exhibit low take-up of current (checking) accounts, contents insurance and savings instruments. Their take-up of personal pensions, 11 per cent, is below the population figure. (The Table only shows differences of ten percentage points or more.)

Coverage of financial instruments among pensioners is around the population average: the only exception is that single pensioners are less likely to have a current account. Personal pension coverage is very low, reflecting the fact that personal pensions were only introduced in 1988. Finally, people with fewer or no educational qualifications and those who are not working have relatively low rates of involvement with the financial sector.

4. **The public-information problem**

The Office of Fair Trading (1999) has called these groups with low coverage of financial services 'vulnerable consumers'. This demonstrates the extent of the public-information problem. Pensions, as shown by the first section of this paper, are extremely

complex, with much convoluted jargon. It will be difficult to ensure that this substantial minority makes informed choices about pensions when it has such little experience of simpler financial services, such as current accounts.

Even more experienced and sophisticated consumers have problems understanding pensions. One individual told a recent survey conducted for the Department of Social Security:

I haven't got a clue, not a clue — because when my insurance man comes round he says, "Oh yeah just pay this in" — and they don't want to explain to you.¹⁴

Most people told a National Consumer Council (1994) survey that they wanted clear, easily understood information on financial services. However, only 22 per cent said they received a comprehensible explanation when they had bought financial products. Just 10 per cent of people polled by Mori for the Plain English Campaign said they found the language in pension literature 'very clear'. Occupational plans were considered easiest to understand, with Serps and personal plans thought to be more complex.¹⁵

4.1 *Confidence in the pension system*

A series of well-publicized cases have undermined people's faith in all parts of the pension system:

- Many personal pensions were 'mis-sold' to people for whom they were not suitable. (See separate section below.)
- The late Robert Maxwell stole £420 million from pension plans under his control. This undermined confidence in the security of the pension promise in occupational schemes.¹⁶
- Companies have often used surpluses of assets over liabilities in defined-benefit occupational plans to cut their contributions.¹⁷ Others have used takeover as a mean of liberating surpluses immediately. Members would, naturally, have preferred either increases in benefits or cuts in their own contributions. But Trustees tend to prefer to

¹⁴ Hedges (1998).

¹⁵ Mori (1997). Studies for the Department of Social Security report similar findings: see Williams and Field (1993) and Hawkes and Garman (1995).

¹⁶ The plight of both pensioners and workers who lost their pension rights was well publicized. There was no mechanism for compensating them for this fraud. The government set up the Pension Law Review Committee in response. Its report underlies the reforms in Pensions Act 1995, see below. These include statutory compensation arrangements.

¹⁷ The Inland Revenue requires Trustees to submit proposals for reducing surpluses when assets exceed 105 per cent of liabilities. This is to prevent companies using their pension fund as a tax avoidance device.

dissipate surpluses in ways that do not increase future liabilities of the scheme. National Grid and National Power used around £350m of pension-fund surpluses to finance redundancy programs, although, as privatized firms, these cases are not typical.¹⁸

- The government appropriated a £168m surplus from the occupational plan of National Bus when it privatized the company. The pensions ombudsman ruled that this was ‘a breach of trust and a fraud on power’.¹⁹
- The government repeatedly cut the value of state pensions in the 1980s and 1990s. (See the following section.)

These cases involve every sector of the pension system. They suggest that pension schemes are run not for the benefit of members, but for their providers: government, employers and financial-services companies.

4.2 *Instability in the pension system*

A related problem, also undermining confidence, is the instability of the pension system. Reforms have occurred regularly over the last two decades, and seem to be becoming more frequent. This list is by no means exhaustive:²⁰

- | | |
|------|---|
| 1978 | Serps introduced |
| 1981 | Price indexation of basic state pension |
| 1985 | Proposal to abolish Serps and replace with private, mandatory provision |
| 1988 | Personal pension option introduced |
| | Defined-contribution occupational schemes encouraged |
| | Serps replacement rate cut from 25 to 20 per cent, survivors’ benefits halved, earnings measure changed from 20 best years to lifetime average; overall, long-run cost halved |
| 1995 | Technical change to Serps indexation; long-run cost cut by a third |
| | Women’s state pension age to increase from 60 to 65 by 2020 |
| 1996 | Mandatory contribution to defined-contribution plans related to age |

¹⁸ The High Court ruled in June 1997 that the two companies had the right to use 70 per cent of the surpluses since the companies paid 70 per cent of the contributions (Cowie, 1997). Thirty per cent of the surplus had already been spent on increased benefits for members. However, the Appeal Court overturned this ruling in February 1999, but the legal position was not clarified. Martinson and Mason (1999) argue: ‘Those looking for enlightenment on the thorny issue of whether and employer or an employee owns a company pension fund surplus will be disappointed’. The two firms are appealing again to have this ruling overturned (Montagu-Smith, 1999). All 17 of the privatized electricity-supply companies used a total of £1.5bn of surpluses to finance 40,000 redundancies.

¹⁹ The then Conservative government backed a legal action to seek the clarification of the High Court on the legal situation of pension-fund surpluses. The new Labour government has been more sympathetic to the bus-company pensioners’ cause (see Financial Times, 1997, 1998), but the Treasury is limiting the offer for an out of court settlement to £100m, compared with the current estimated value of the funds taken of £225m (Harper, 1999).

²⁰ See Whitehouse (1998) and the references therein for a more detailed summary of changes between 1978 and 1997 and Disney, Emmerson and Tanner (1999) on the most recent proposals.

- 1997 Outgoing Conservative government proposes 'basic pension plus', moving the whole of state pension provision onto a private, defined-contribution basis
- 1998 State second pension to replace Serps
Stakeholder schemes announced
Social assistance and basic pension merged into new 'minimum income guarantee', to be uprated in line with earnings
- 1999 Treasury launches pooled-pension-investment vehicle

The changes to the regulatory regime have been still more confusing. Financial Services Act 1986 established the Securities and Investments Board (SIB). The SIB in turn licensed a series of self-regulatory organizations (SROs) for different sectors of the industry. Some of these SROs subsequently merged, making more contributions to the alphabet soup. The new Financial Services Authority, established in 1997, has taken over the work of the SIB, the SROs, smaller organizations, such as the Friendly Societies' Commission, and the supervisory responsibilities of the Bank of England (banks and systemic risk) and the Treasury (insurance). There is, however, a different regime for occupational pensions. The Occupational Pensions Regulatory Authority (Opra) was established by Pensions Act 1995, in the wake of the Maxwell fraud. This remains independent of the FSA. Opra also encompasses the Pension Schemes Registry, and an Occupational Pensions Advisory Service (Opas) is also involved. Stakeholder pensions will be regulated in part by Opra and in part by the FSA (Department of Social Security, 1999*h*).

A qualitative study of attitudes to the pension system concluded that changes to the pension system had 'destabilized peoples' perceptions, and left many feeling uncertain and confused and sometimes anxious about the future'.²¹ The reform introducing stakeholder pensions is likely to be just as disruptive.

4.3 *Personal-pension mis-selling*

The case of personal-pension mis-selling is worth exploring further, because lack both of information and of impartial advice was a major cause of this debacle.

The government introduced the personal-pension option in 1988. It expected 0.5 million to take out a personal pension within two or three years, although a contingency plan

²¹ Hedges (1998).

allowed for up to 1.75 million participants. In fact, 3.2 million took out a personal pension in the first year, rising to 5.7 million after five years.

The introduction of a new, unfamiliar instrument in an already complex pension environment would, perhaps inevitably, have meant that some people would make the 'wrong' choice. (Indeed, this concerns critics of the new stakeholder scheme — see below.) However, the problems caused by the complexity and unfamiliarity of the new option were compounded by lack of clear information about the value of different pension options and the charges levied by personal-pension providers.

There were four main types of consumer who bought personal pensions inappropriately.

First, older workers who, because of compound interest and complex transitional arrangements, would most probably have been better off remaining in the defined-benefit Serps scheme.²² This feature of the pension system seems to be well understood. Take-up rates among the over-50s were only 0.2 per cent in the first couple of years of the scheme. Since then, the rate has risen to over 2 per cent, reflecting people who have remained in their scheme over time.

The second mis-selling problem relates to charges. Fees usually have a fixed as well as a variable component. A standard rule-of-thumb in the finance industry is that these mean a personal pension is not a good deal for someone earning less than £10,000 a year (around two-thirds of average pay). The evidence suggests that a substantial minority of personal-pension holders earns less than this figure, but this may reflect people who have lost their job or moved to lower-paid employment since they took out a personal pension. This will also affect the self-employed with personal pensions, because their incomes tend to fluctuate more than employees' do.

More significant are the last two types of case, where people took out a personal pension instead of an occupational plan. Some were eligible for their employer's

²² See Disney and Whitehouse (1992*a,b*), Dilnot *et al.* (1994), Whitehouse (1998) and National Audit Office (1991) for a discussion. The general issue of the relationship between age and returns in different pension-scheme types is covered in Palacios and Whitehouse (1998) and Disney, Palacios and Whitehouse (1999).

occupational scheme, others transferred out of a scheme that they were at the time or had previously been a member.

In the first case, it is very difficult to work out whether, and by how much, people's pension rights were reduced. The value of a defined-benefit pension depends on final earnings and on tenure in the scheme, neither of which is known *ex ante*. The main reason employees would lose by taking a personal instead of an occupational scheme is that they usually forgo the employer's contribution. Only 15 per cent of personal pensions receive an employer's contribution, and only 5 per cent of employers with an occupational scheme say they will pay into an employee's personal plan instead. Employers' contributions make up, on average, 70 per cent of the flows into occupational schemes.²³ However, unlike defined-contribution schemes, the benefits in occupational plans do not bear a direct relationship to the flow of contributions. Even with the loss of the employers' contribution, some younger workers who do not plan to stay long with their employer would be better off in a personal scheme, which is more portable between jobs.²⁴ One solution to this problem would be to make employers' contributions portable: *i.e.*, to require those who offer an occupational plan to make some contribution to personal schemes taken up by their employees.²⁵ Tying the employer's contribution to a defined-benefit scheme is a significant restriction of individual choice.

In the other case, people had been members' of an occupational scheme, usually in a previous job. The new regulations allowed people to transfer these so-called 'preserved' rights into a personal pension. People might lose from this transaction in three ways. First, the administrative charges for the personal scheme might be onerous (see above). Secondly, the returns earned by the personal pension fund's investments might not perform as well as assumed. Finally, occupational schemes have considerable leeway in the actuarial assumptions used to compute the lump-sum present value of the preserved pension right. Most, for example, use a less generous assumption for transfers out of their scheme than they charge for transfers into the plan.

²³ General Household Survey data, National Association of Pension Funds (1994) and Government Actuary (1994).

²⁴ See Disney and Whitehouse (1994, 1996) for a detailed discussion. Also Blake and Orszag (1997).

²⁵ The Office of Fair Trading (1997) and the Institute for Fiscal Studies (Dilnot *et al.*, 1994) have both proposed this solution.

There are around 645,000 potential cases of mis-selling (*i.e.*, around 11 per cent of personal pensions sold). Of these, 255,000 have been settled, and the total compensation paid by personal-pension providers totals £1.2 billion, or £5,300 per case (FSA, 1998*b*). There has been some criticism of this compensation, and not all of it from the industry paying it. Normal rules of *caveat emptor*, or ‘buyer beware’, appear to have been suspended. Buyers of other inappropriate financial products — such as ‘low-cost’ endowment mortgages or home-income plans — have found it much more difficult to obtain redress, as did the victims of the Maxwell occupational-pension fraud.²⁶

What is undisputed is that the widespread publicity²⁷ around the mis-selling issue has tainted personal pensions and, by association, the whole of the pensions sector. Attitudinal studies find extensive concerns and perceptions of ‘pushy’ pensions salesmen who sell products that are profitable for them rather than what the buyer really needs.²⁸

4.4 *Financial advice*

People do not seem to know where to go to get trustworthy, impartial advice about pension issues. The Office of Fair Trading’s (1997) survey showed that only 44 per cent of people had sought information before making their pension arrangements. These were mainly people who had taken out a personal pension. Of these, 82 per cent had taken some advice, compared with half of people with an occupational plan and only a fifth who had no private arrangements (and so mainly default to Serps).

Table 6 shows the sources of advice used.²⁹ Most common are agents of pension providers and independent financial advisors with 34 per cent each.³⁰ Financial Services Act 1986 established the principle of ‘polarization’ for the financial-services industry. All people giving financial advice have to decide whether to be a tied agent, selling only one provider’s products, or to be independent, offering products from all firms. And they have to declare

²⁶ See, *inter alia*, Lex (1998), Riley (1998) and Whitehouse (1998).

²⁷ Including the regulator’s own campaign: see FSA (1998*b*).

²⁸ Hedges (1998).

²⁹ Other studies show slightly different patterns. NOP Research Group (1999) found similar proportions (16 per cent) using IFAs and informal sources. Banks were the most popular source of advice. Interestingly, just 2 per cent said they had or would turn to the Internet for information. This study, however, related to general financial issues, not just pensions.

³⁰ Data collected by the Association of British Insurers show a similar 50-50 split in the market between independent financial advisors and tied agents, based on sales of plans rather than advice. IFAs have a 65 per cent share of single-premium and a 40 per cent share of regular-premium business.

their status to potential customers. All of the big four banks, all of the building societies that have recently converted from mutual status to banks, and the largest remaining building society, Nationwide, are tied agents of either their own insurance subsidiaries or a single, external provider.³¹ Around 450 companies are registered as tied agents, employing some 51,000 advisors. There are 3,500 firms of independent financial advisors, with 22,000 registered individuals. Around one third of these belong to networks, which provide centralized research on the different financial-services providers. This sector has been growing rapidly: the two largest networks doubled in size between 1992 and 1998.

Returning to the sources of advice used in Table 6, significant numbers also consulted banks and employers. Only a few people used informal sources, such as friends, relatives or colleagues. There are significant differences in the sources consulted between people with different pension arrangements. (Although the causality probably works both ways: it seems likely that employers will recommend an occupational plan if they have one, and tied agents and independent advisors a personal scheme.) People with personal pensions were far more likely to use an agent of a pension provider (43 per cent) than people with occupational plans or no private arrangements (29 per cent). Personal pension holders were also much less likely to use advice from their employer (4 per cent) than others (20 per cent). Finally, most of those who used their solicitor or accountant were self-employed.

Table 6. Sources of pensions advice

	<i>sources used (%)</i>	<i>average satisfaction score</i>	<i>source of unbiased advice (%)</i>
Tied agent	34	1.0	13
Independent advisor	34	1.1	28
Bank	18	1.0	20
Employer	14	1.1	11
Informal	6	1.1	11
Trade union	3	1.2	
Solicitor/accountant	3	1.2	
Other sources	5	1.0	
Do not know			17

Source: Office of Fair Trading (1997)

Note: satisfaction scores on a scale of +2 (very satisfied), +1 (fairly satisfied), -1 (fairly dissatisfied), -2 (very dissatisfied), 0 neither

³¹ Office of Fair Trading (1999*a*).

Whether advice from tied agents or employers is impartial is a moot point, and 85 per cent of those seeking advice use only one source. There have also been widespread concerns with the independence of 'independent' financial advisors. The vast majority of their income comes from commission on life insurance, pensions *etc.* Only a small part of business is based on fees for work done, regardless of the products bought, and some is on a rebate basis, where any commissions on purchased products is offset against the charge. Philip Telford of the Consumers' Association explains: 'if you go to a Ford showroom the salesman does not call himself a "car advisor" and the public understand[s] that he will try to sell them a Ford. It would be more honest if most financial advisors called themselves "financial salesmen".'³²

The government has also admitted that advice given at the moment 'is of variable quality'.³³ The Consumers' Association found between a fifth and a quarter of advisors gave bad advice. The association concluded: 'There was one common feature of bad advice: commission. Bad recommendations were nearly all for products that would earn the advisor or their employer more money up-front.' The payment of up-front commission (out of the first couple of years of contributions) means financial advisors have little incentive to sell products that consumers will stick with. The Personal Investment Authority (1998) finds that many people cash in or cease contributing to life-insurance and pension policies after only a few years, despite the fact that this is costly. Indeed, much of the personal-pension mis-selling problem has been blamed on commission-hungry advisors.

The IFA Association, the collective voice of independent financial advisors naturally disputes this analysis. The association argues that tied agents, which again earn most of their incomes from commissions paid by their employers, are more of a problem. The IFA Association says: 'The commission paid by providers to this sector [tied agents] is generally at a higher level than would be paid on the same business if introduced by an IFA. This increase can be as high as 25 per cent.'³⁴ The Personal Investment Authority (1996) finds little evidence of bias in which companies' products are recommended by IFAs. 'For the IFA sector, the range of commission offered by different companies is fairly narrow. Therefore, the scope for company bias is not great. Moreover, IFAs make returns to PIA

³² Financial Times (1999k). See also Financial Times (1999f,l).

³³ Department of Social Security (1998b).

that should identify cases where a lot of business is being placed with one particular provider'. But this does not prove that people were sold the right type of product — which is the central problem — just that the provider was a reasonable choice.

Despite this defense of commissions, the IFA Association has proposed a move to fee-based charging to underline their independence.³⁵ Currently, only one third of the sector will do *any* business on a fee basis, and the share of advice given in this way is much smaller.³⁶ There is considerable resistance to paying fees. Consumers seem to prefer charges to be 'disguised' through commissions on their contributions.

People are generally well informed about the status of advisors they use, according to regulators. More than three-quarters of recent purchasers of financial products identified life insurers and banks as tied and 80 per cent said that IFAs were independent (see also Figure 2). But the Personal Investment Authority (1998*b*) went on to comment that 'it is far from clear whether they understand the significance of the fact.' For example, one third of people agreed that 'a bank is the best place to get independent financial advice' even though banks are all tied agents who mainly sell their own products.

Notwithstanding the justifiable concern about the activities of both independent advisors and tied agents, the data in the penultimate column of Table 6 show that people are, on average, fairly satisfied with the advice they receive. Moreover, there is only a small difference in satisfaction with different sources.

When asked to suggest a source of impartial guidance (the final column of Table 6), the largest number proposed an independent financial advisor. But a third of people suggested tied agents or banks (which are almost all tied to their own subsidiary or a single, separate provider).³⁷ Worryingly, 17 per cent either did not know where they could get unbiased advice or refused to name any source.

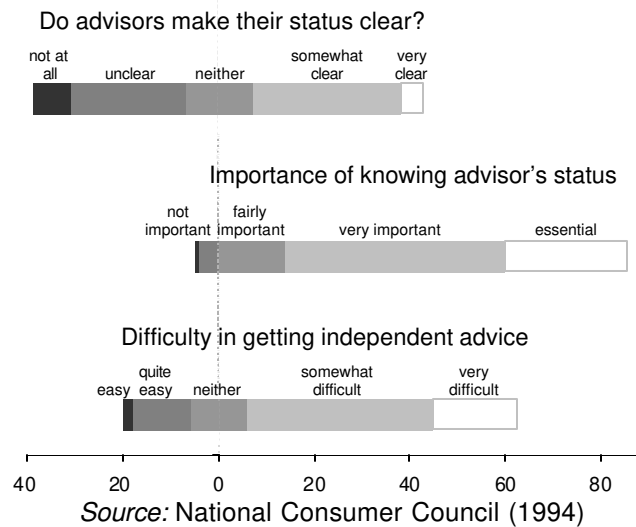
³⁴ Original emphasis. IFA Association (1998).

³⁵ Financial Times (1999*d*).

³⁶ There is also a tax disincentive to paying fees (which are subject to 17½ per cent value-added tax unless they are related to the sale of a particular product) rather than commissions (which do not attract VAT). Customs and Excise, the VAT collection agency, has recently cracked down on fee-based advisors who blur this distinction (London, 1999). Still, contributions to a personal pension, including the commission, attract income-tax relief at the individual's marginal rate.

³⁷ These results are very similar to a Mori survey for the National Consumer Council (1994). The only significant difference is that the Mori poll found far fewer people suggesting a bank or building society as a source of information.

Figure 2. **Consumers' views of financial advisors**



Pension contracts are, of course, long-term arrangements. The long duration to maturity severely limits the speed and effectiveness with which people can learn from experience: you only save for retirement once and the experience of older workers and current pensioners is of limited value because of frequent changes to the system. Moreover, it is difficult for consumers to assess the competence of advisors and the quality and value of advice given.

4.5 *Government mis-information*

The media and pressure groups have recently used the term 'mis-selling' with reference to the government. The 1988 pension reform, described in section 4.2 above, reduced the Serps survivors' pension from the whole of the member's pension to one half for any member dying after April 2000. Unfortunately, the Department of Social Security failed for over a decade to amend leaflets to tell people about the change. Even after 1996, some people writing to the department with specific questions about survivors' benefits were misinformed. The Liberal Democrats (the center party) have proposed delaying the change for a decade, but the government is unlikely to take this route because of the cost — some £5bn.³⁸ Some compensation for those who can show that they were mis-advised is likely.

³⁸ Financial Times (1999*i,j,m*).

A second charge of mis-information has recently been made against the government. Age Concern has argued that the budget statement was misleading in its presentation of the planned rise in the new minimum income guarantee for pensioners. Telephone callers to the charity for the elderly had interpreted this as an increase in the basic state pension, not in the means-tested benefit formerly known as income support. The parliamentary ombudsman has been asked to decide if the government misled the public.³⁹

Both of these cases were again widely publicized, undermining confidence in the government both as a pension provider and as a source of impartial pension information.

4.6 *Contact with private-pension providers*

Sales approaches from financial-services companies are increasingly common. Four-fifths of respondents to an Office of Fair Trading (1997) survey said they had received a sales approach in a 14-month period, with an average of nearly five approaches. Over half had received solicitations about credit cards, with loans and insurance received by around 40 per cent. Personal-pension information was rather rarer: received by only a quarter. Only savings, endowment policies and current accounts were less publicized. This suggests consumers are exposed to intense private-sector financial marketing. Media Monitoring Services reports that financial advertising reached £600 million in 1998. Adding in marketing expenditure, industry experts reckon that total promotional expenditure exceeds £1 billion a year, according to the FSA (1999c).

However, the Office of Fair Trading's study found some significant gaps in the coverage of financial marketing. Taking credit cards as an example: only a quarter of people with very low incomes received a solicitation (and a third of those on low incomes), compared with two-thirds of those not on low incomes. (The relationship between sales approaches and income is very similar for other financial instruments.) For personal pensions, providers approached 34 per cent of people not on low incomes, compared with 14 per cent of low-income and 11 per cent of very-low-income consumers. This suggests a substantial gap in the private-sector information and publicity received by 'vulnerable' groups.

³⁹ Eaglesham (1999).

4.7 *Information on individual pension rights*

Individuals can request a forecast of the value of their state pension (both the basic state pension and Serps) from the Department of Social Security, and 600,000 people a year ask for such a statement. The Defined-contribution schemes, both personal and occupational, are required to give annual benefit summaries. However, these usually only show the value of the accrued fund. Some provide illustrative projections of the likely pension at retirement, but these are not widespread and the calculations often use different bases and different assumptions. Defined-benefit occupational plans can provide projections, assuming the individual remains in the same job until retirement.

Most people will have a variety of different pensions: personal pensions, Serps, and maybe one or more occupational schemes. It is arduous to collect this information together from these different pension providers and valuations often use widely differing assumptions. The Serps mis-information problem (section 4.5 above) along with the bugs in the Department of Social Security's new computer system have both probably undermined public confidence in government forecasts.⁴⁰ Even if they are accurate, a consistent picture of pension rights already accrued, let alone a projection of retirement income based on future provision, is very difficult to obtain.

4.8 *The declining value of mandatory pension provision*

These problems are compounded by the increasingly voluntary nature of the pension system. The indexation of the basic state pension to prices rather than earnings since 1981 has already cut its real value by over third compared with the previous policy of uprating with the higher of earnings or prices growth. The 1988 and 1995 reforms cut the long-run cost of Serps to about a quarter of the original forecast. Mandatory private pension provision was also cut in line with the reduction in Serps. The basic state pension will be worth around 7½ per cent of average earnings by 2025. The Serps entitlement for someone with a full career at average earnings will be another 7½ per cent of earnings or so. This low mandatory replacement rate makes either a long period in a defined-benefit occupational plan or above-minimum contributions to a personal plan imperative. Otherwise, people will have a very low retirement income, relative both to living standards in the economy as a whole and to their own in-work income.

Awareness of personal responsibility for retirement planning is widespread. Most people under 40 no longer count on getting a state pension at all, according to Hedges (1998). 'They typically assume it will either disappear, be limited to people in poverty or too small to be of much use.' Only 26 per cent of workers are happy with their retirement-income arrangements, according to another survey.⁴¹

It is not difficult to see why when we examine people's current pension provision. Thirty per cent of the 35 million people of working age are members of occupational pension schemes. These plans provide greater benefits than Serps: the minimum they must provide is half of earnings after 40 years membership. These people will probably achieve the highest pension savings, but many will fall short of the half or two-thirds of final salary target. Lack of portability of defined-benefit schemes (see the discussion in section 8 below), retiring early and gaps in provision, due to periods out of work, in uncovered jobs, delaying joining schemes *etc.*, will all reduce the pension value. People have the opportunity to make up for these gaps or to finance earlier retirement with 'additional voluntary contributions'. But only 19 per cent of members, mainly in their late 40s or early 50s, pay extra amounts into their pension funds. More worryingly, 17 per cent told a Department of Social Security survey that they had no option to make additional contributions, and 14 per cent did not know whether they could. In fact, all schemes are obliged to accept additional voluntary contributions.⁴²

Similarly, of the 16 per cent of people of working age with personal pensions, two-thirds are contributing only the mandatory minimum, averaging £450 a year. This is sufficient, for a person on average earnings, to buy a pension of around 7½ per cent of pay (and the individual forgoes their Serps entitlement). The average contribution of the third of people who make additional payments into their personal pension is £950 a year.⁴³ Many personal-pension scheme members contribute only for short periods. Fifteen per cent drop out after one year, and 40 per cent who took out a personal pension in 1993 were not

⁴⁰ Scott (1999).

⁴¹ Mintel (1996).

⁴² Hawkes and Garman (1995).

⁴³ Office of Fair Trading (1997) and Inland Revenue (1996). Disney, Emmerson and Tanner (1999) found that 47 per cent of people with a personal pension contributed for just one of four years they were surveyed by the British Household Panel Study. Only 27 per cent contributed in each of the four periods. See also Money Management (1997) on this issue.

contributing four years later.⁴⁴ Since the burden of many pension providers' charges are borne most heavily in the early years of contributions, the consumer may see little net benefit from these short-term contributions. Unfortunately, there is no evidence on why people pull out so early: for example, whether changes in circumstances, or lack of understanding or information about the consequences, were more important.

The vast majority of people seem to be aware of the extent of their personal responsibility for retirement-income planning. Unrealistically high expectations of state pension entitlements are not therefore a barrier to increased pension savings. Indeed, people are probably unreasonably pessimistic about the amount they will receive from the state (see also Figure 5, below).

4.9 *The growing role of defined-contribution pensions*

Until 1988, pension provision in the United Kingdom was almost wholly defined benefit.⁴⁵ The dramatic growth of personal pensions since this option became available has increased the emphasis on defined-contribution arrangements. In addition, the number covered by defined-contribution occupational plans has risen from 100,000 in the mid-1970s to one million now. The number covered, however, remains small, particularly compared with the 'stampede' in the United States (Gustman and Steinmeier, 1992).

Most of the growth in defined-contribution provision has come from group personal pensions and employers contributing to employees' personal pensions on their behalf. Forth and Millward (1999) found that these two kinds of personal pensions accounted for 85 per cent of pension arrangements set up in the last five years in larger firms, and

Looking into the future, a recent survey found that only 21 per cent of senior human resources managers expected their pension scheme to be defined-benefit by 2018, compared with 88 per cent of current plans.⁴⁶ More than a third expect to offer group personal

⁴⁴ Personal Investment Authority (1998). The figures relate to pension sold by company representatives. The drop-out rates for pensions sold by independent financial advisers are lower: 8½ per cent after one year and around 30 per cent after four years.

⁴⁵ The exceptions were voluntary plans for the self-employed (the forerunner of personal pensions for employees) and for employees (e.g. free-standing additional voluntary contribution plans), along with a small number of defined-contribution plans.

⁴⁶ Bacon and Woodrow (1999). A survey for the Confederation of British Industry (1994) found that fewer than a third of senior managers expect to offer defined-benefit schemes in 2010. This issue is also analyzed in Disney (1995) and Disney and Stears (1996). Casey, Hales and Millward (1994) report that 90 per cent of defined-contribution schemes at that time had been set up since 1978.

pensions in twenty years' time. Offering occupational pensions is, of course, voluntary for employers.

The new stakeholder plans — also defined-contribution — might accelerate this process. The government says it wants 'to build on the success' of occupational schemes, 'one of the great welfare success stories of this century'.⁴⁷ Alistair Darling, the secretary of state for social security, recently told the *Financial Times*: 'We are determined to ensure that the regulatory and tax regime and everything else bolsters the position of occupational pensions and does not undermine them'.⁴⁸

However, the Confederation of British Industry has argued that stakeholder pensions 'may inadvertently affect and possibly undermine support for occupational schemes'. Most large occupational schemes — 62 per cent — also believe that stakeholders will substitute for occupational plans. Only 3 per cent expect they will expand overall coverage of private pensions.⁴⁹ Two of the largest employee-benefits consultancies — Watson Wyatt and William Mercer — expect employers to switch low-income workers into stakeholder plans to take advantage of the simpler regulatory regime and the increased rebates of social-security contributions.⁵⁰ Richard Malone of William Mercer has said that stakeholder pensions will compete directly with occupational schemes. He has argued for 'an effective policy of ring-fencing them and preventing stakeholder pension from intruding in their territory'.⁵¹ Nevertheless, the government is unlikely to constrain the development of stakeholder schemes, the 'flagship' of its pension reform.

4.10 *Starting pension provision early*

The significance of this shift to defined-contribution pensions for public information and education is that the benefits are 'front-loaded'. Compound interest means that contributions made when young are worth more than payments later in the working life. In contrast, defined-benefit plans — both Serps and earnings-related occupational schemes — are 'back-loaded'. The majority of pension entitlements are earned when the worker is older.

⁴⁷ Department of Social Security (1998b).

⁴⁸ Timmins (1999d).

⁴⁹ Capita, a professional support organization, surveyed 200 of the largest occupational plans. *Financial Times* (1999b).

⁵⁰ *Financial Times* (1999g).

⁵¹ *Financial Times* (1999a).

The growing role of defined-contribution provision (personal pensions, occupational schemes and the new stakeholder pensions) means that people need to start thinking about pensions younger. For example, the promotional organization for independent financial advisors argues that, if starting pension contributions is delayed from age 20 to 30, then half of the eventual retirement fund will be lost.⁵²

Table 7 shows that the youngest workers are much less likely to be covered by private pensions. For example, only a fifth of 18-24 year olds in employment have an occupational pension, compared with around half of all employees. The Department of Social Security's administrative data show only 2 per cent of 16-19 year old workers have a personal pension. However, the data suggest that take-up of both personal and occupational pension coverage approaches the population average for workers in their late 20s. This implies that workers do delay making private pension arrangements for a few years after entering the labor market. But this is to be expected: the youngest workers have low earnings, more urgent financial priorities than retirement savings and shorter job tenures (meaning that defined-benefit occupational pensions will deliver only modest pension values).

Table 7. Private pension coverage by age, survey and administrative data

<i>per cent</i>	<i>Personal pension</i>	<i>Occupational pension</i>
Survey data: total	23	49
Age 18-24	10	20
Age 25-34	31	54
Administrative data: total	29	
Age 16-19	2	
Age 20-24	30	
Age 25-34	41	

Source: General Household Survey data. Administrative data from 1 per cent sample of social security contribution records: see Department of Social Security (1997a). Data on employment by age from the quarterly Labour Force Survey

⁵² IFA Promotion (1999). My own back-of-the-envelope actuarial calculations suggest this something of an exaggeration. Assuming a level real age-earnings profile and a 4 per cent real return on contributions, the loss of ten years' delay would be 40 to 45 per cent of the projected pension. A more realistic, rising age-earnings profile would cut this to around a third.

The Department of Social Security's qualitative research found that 'the advantages of early investment are usually only vaguely recognized at best and probably widely underestimated.'⁵³ One respondent told researchers:

'We've got to think about tomorrow and it's something we all put off, the government has to keep shouting at us, giving us information, we have to be educated.'

4.11 *Public interest and confidence in financial planning*

This quotation raises a final problem: people's lack of interest in pensions and indeed, in financial issues generally. A Mintel survey asked people their attitude to 'financial matters, such as saving, investment, borrowing, insurance and pensions.' Less than 30 per cent said they were 'very interested'. More than 10 per cent said they never thought about finance and around 60 per cent said they think about it only when 'absolutely necessary'. The lack of interest is more pronounced among the young: 60 per cent more people over age 55 report themselves as very interested than people aged 15-34. More enchantingly, Mori asked people which they thought was more unpleasant: changing a dirty nappy (diaper) or organizing their personal finances. Only 6 per cent chose financial planning as the most attractive activity.

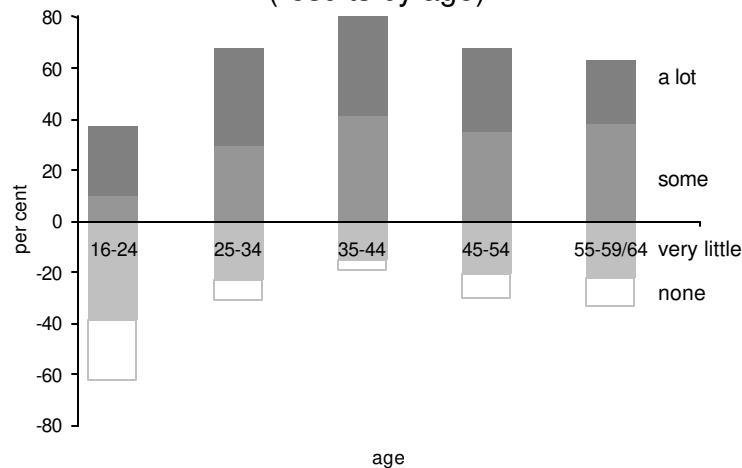
Among financial issues, pensions are perhaps among the least likely to attract the interest of much of the working age population, particularly the young. They have more pressing financial concerns: paying off student debts, buying a house, saving for their own children's education *etc.* Furthermore, Vass (1998b) argues that the words 'retirement' and 'pensions' do not generate 'aspirational imagery' (see also Hedges, 1998). Lunt and Disney (1998) posit that the prejudice of the young towards the old explains why 'the young do not like to think about when THEY will be old' (original capitalization). Trotsky's aphorism cited at the beginning of the paper is also appropriate: old age, despite its chronological inevitability, still appears to sneak up on people.

The majority of the population claims to have given at least some thought to their retirement-income arrangements, according to a study by the Department of Social

⁵³ Hedges (1998).

Security.⁵⁴ Overall, just fewer than 30 per cent said they had given pensions a lot of thought, and just over 30 per cent, some thought. The pattern by age is interesting (Figure 3). It might be expected that younger workers delay thinking about retirement income (as argued and evidenced in the previous section). But the oldest workers have also, on average, considered their pension income less than those of prime age have. My feeling is that the introduction of personal pensions, aimed mainly at younger workers, has encouraged younger cohorts to give more thought to their retirement-income arrangements. This is due both to the proliferation of pension options and to the increased rewards to earlier financial planning in a defined-contribution system (section 4.10 above). For example, around half of people with only state pensions claim to have given their retirement income a lot or some thought, compared with nearly 90 per cent of people with an occupational or personal pension.

Figure 3. How much thought have you given to arrangements for a retirement income?
(results by age)



Note: final age category covers men aged 55-64 and women aged 55-59
Source: Hawkes and Garman (1995), Table 2.3

A Mori survey for a study of adult financial literacy also found people more enthusiastic for financial learning than some other studies suggested.⁵⁵ Three-quarters of the general population cited at least one financial-planning issue they would like to know more

⁵⁴ Hawkes and Garman (1995).
⁵⁵ Schagen and Lines (1996).

about. People mentioned pensions most out of the 12 topics listed by pollsters (31 per cent of the sample). Even 42 per cent of young people (16-21 year olds) in work or training felt they needed or wanted to know more about pensions. Again, surprisingly, this was the highest scoring category, ahead of income tax or social security contributions (40 per cent), savings (32) and mortgages (30). Higher education students also ranked pension information highly among different financial facts about which they felt they needed to learn: after student loans, income tax and social security contributions. Among other groups, such as lone parents or families with children living in rented accommodation, more immediate concerns came ahead of pensions: budgeting, avoiding debt, and low-income benefits.

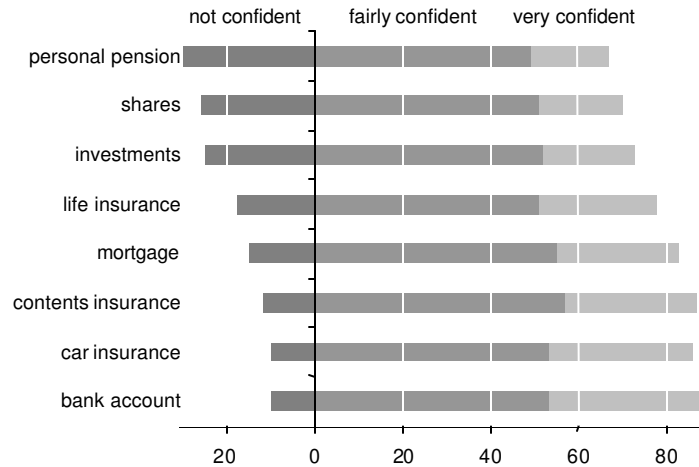
Despite this apparent interest in learning about financial services, few seemed willing to exert themselves. Nearly two-thirds preferred to talk to someone and a third said they would read a leaflet. Just 15 per cent would think about taking an evening class and 8 per cent, a correspondence course. Nevertheless, people were reluctant either to pay for courses or to travel to attend them. In similar vein, the collective marketing organization for independent financial advisors, IFA Promotion, piloted some short adult-education courses in 1996-97. Around 1,700 people attended courses, taught by financial advisors, but the scheme was abandoned the following year. The new Financial Services authority has held a series of town meetings (FSA, 1999c). Around half of people (in work) attending them worked in financial services, suggesting that they are not a good source of 'remedial' financial education. The Personal Investment Authority (1996, Annex 6), one of the forerunners of the FSA, found a gulf between the numbers who said they were interested in investments and those who actually behaved as 'hands-on' financial consumers.

The National Foundation for Educational Research polled people involved or potentially involved in financial education, in addition to consumers, as part of their financial-literacy study.⁵⁶ Further-education colleges and adult-education centers said they offered a range of 'life-skills' courses, but few of these addressed financial issues directly. Most recognized the need for more opportunities for learning, but were usually reluctant to offer them. They often doubted the appeal of the courses and demand for them (cited by 41 per cent of survey respondents), and budgetary limitations meant it was difficult to provide teaching that did not lead to an accredited qualification.

The study also examined Citizens' Advice Bureaux (CABs), a national network of advice centers staffed by volunteers. The authors contend that CABs focus mainly on solutions to short-term difficulties (such as debt arrears). They have insufficient resources to build financial-planning skills to avoid future problems and provide for retirement.

Along with a lack of interest among consumers, notwithstanding people's claims to pollsters, there is a lack of confidence in buying some financial services, especially pension plans. As few as 10 per cent told a Mori survey for the National Consumer Council that they were not very or not at all confident when picking a bank account. For some more complex instruments, such as insurance and mortgages, this figure was still under 20 per cent. People were least confident about buying a pension of all eight financial services considered, with a third confessing to lack of confidence (Figure 4).

Figure 4. **Confidence in choosing financial services**



Source: National Consumer Council (1994)

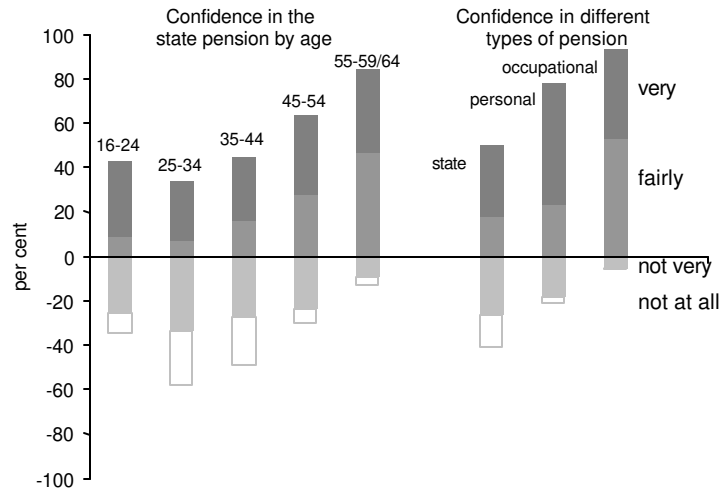
4.12 Conclusion: the public-information problem

The public-information challenge is that people need to make adequate provision for themselves and, in an environment increasingly dominated by defined-contribution provision, to begin early. But the pension system is complex. People are disinterested and indifferent. They lack confidence about the decisions they need to make and in the security of the pensions promise in all parts of the system. Only a minority of the young, for example, expects to get a state pension when they retire (Figure 5). Impartial, quality advice

⁵⁶ Schagen and Lines (1996).

and consistent information about the value of pension rights are difficult to find. Many have unrealistic expectations of their retirement income or, often, no idea at all of its value.

**Figure 5. How confident are you that you will get a state pension?
How confident are you that you will get the benefits you expect from a
personal or occupational plan?**



Source: Hawkes and Garman (1995), Tables 3.18, 5.6, 6.4

5. Improving general financial and pensions information

The government has implemented or proposed a number of initiatives to tackle the public-information problem and improve awareness of pension issues. These involve a range of actors: regulators, employers, unions, financial-services companies, schools and the public employment service. Some private sector companies and groups are already running a number of programs, many aimed at general financial literacy. This section describes and assesses these schemes.

5.1 *The pensions education working group*

The Department of Social Security established a pensions education working group in July 1997 to

‘raise awareness of pensions and improve the level of financial education so that people understand the importance of saving for retirement and make the right choice about which pension product is best for them.’

The group's report, issued in 1998, argues that provision of information alone is not enough to ensure that people make appropriate pension decisions: 'understanding and knowledge are scarce while at the same time there can be information overload'.

The group proposed a comprehensive publicity program to improve understanding of pension issues and to encourage early consideration of retirement income. The program should involve government, employers, financial services companies and interest groups. The group stressed the role of government, both as an information provider and in standardizing the information provided by financial companies *etc.* They proposed that pension contracts should be written in 'plain' English, and the Plain English Campaign (1999a,b) has responded with two guides to the jargon.

The report argued for an approach that targets particular groups (*e.g.*, women, the self-employed). An interesting suggestion is enhancing the effectiveness of publicity by linking information to other important life-cycle events, such as leaving full-time education, changing jobs, marrying, divorcing, having children *etc.* Researchers in the United States have similarly stressed the role of major birthdays (*e.g.* 30th, 40th) as a savings-information opportunity. Linkage with these events would both increase the targeting of information and catch people at points when they are more receptive to new information and, perhaps, more susceptible to changing their financial behavior.

The Trade Union Congress (TUC) operated a pensions telephone help-line in 1997 aimed at women. Demand for the service was huge, with 4,000 calls answered and 140,000 unable to get through. The pilot was extended from one week to two. Detailed study revealed widespread ignorance about the pension system, but a strong desire for advice and information.

The pensions education working group proposed a pilot of a general help-line, aimed at both men and women. The government took up this suggestion in its *Partnership-in-Pensions* proposals. The 'Pension-power-for-you' help-line ran for six weeks in July and August 1999. The demand for this service and its effectiveness is being evaluated from this pilot.⁵⁷ The government also adopted the proposal for improved automatic individual information on pensions: this issue is covered in section 8 below.

⁵⁷ Bunt, Adams and Vivian (1999) provide a preliminary assessment.

5.2 *A role for the financial regulator*

The new unified regulator, the Financial Services Authority (FSA) has a statutory responsibility to promote public understanding of money matters. Clause 4 of the Financial Services and Markets Bill 1998 says the role includes

‘promoting awareness of the benefits and risks associated with different kinds of investment or other financial dealing, and the provision of appropriate information and advice.’

Clause 87 charges the FSA to ‘issue guidance...with respect to any...matter about which it appears to the authority to be desirable to give information or advice.’

This legislation provides for a very broad scope for the FSA. It has issued a consultation document on the interpretation of its statutory remit (FSA, 1998a) and a response to comments (FSA, 1999c) and appointed a senior program-maker from a television company as head of consumer education (FSA, 1998c). The authority argues that ‘consumer education should help empower consumers and enable them to use their “buying power” more effectively.’ It even suggests that it could ‘over time, reduce the need for detailed intervention.’⁵⁸ The government has also argued that ‘better awareness is good for competition.’⁵⁹ The FSA proposes an initial consumer-education budget of £1.5 million for 1999-2000, with a range of £2 million to £5 million in the medium term.

The FSA divides its consumer role into three main parts:

- Consumer education in financial literacy: ‘Specific education programs to enhance knowledge and skills, thereby empowering consumers to shop around and make informed decisions which meet their needs and personal preferences’. An important first step is research on consumers’ current financial literacy, with plans for regular updates.
- Consumer advice: ‘Giving guidance to consumers...while not being prescriptive or recommending specific products or services’.
- Consumer information: ‘The provision of facts and basic information’. Initially, this will involve explanatory materials explaining the basic characteristics of different financial products. Standardization and simplification of the information on pension products is also proposed.

Eventually, the authority proposes to publish a range of indicators of the cost and quality of different financial products, in discussion with consumer and industry

⁵⁸ The government uses exactly the same phrase in its response to the House of Commons Treasury Committee (1999b).

representatives. The chancellor of the exchequer (finance minister) backed this proposal in his 1999 budget speech. 'The FSA will now publish league tables of costs and charges in savings, insurance and pension products, to guarantee a better deal for the consumer and avoid the mis-selling of the past,' he announced.

The FSA has so far backed the Office of Fair Trading's (OFT) proposal for a simple rating regime with five categories from A+ to C-. The OFT recommended that long-term products, such as pensions and life assurance, should be assessed over different policy terms. To avoid exaggerating small differences between providers, the OFT based its ratings on standard deviations around the mean, rather than quantiles of the distribution. The B rating would be ± 0.5 standard deviations of the mean. A+ (C-) would be 1.5 or more (less) standard deviations than the mean. The authority has commissioned Bacon and Woodrow, the actuarial consultants, to advise them on the project. A consultation paper, to be issued in September, will review existing league tables in the United Kingdom and overseas and propose methods for collecting and disseminating indicators of charges and quality. Consumer research will play an important part in the project.⁶⁰

The analysis above and the limited surveys of consumer knowledge currently available show a great need for improvements in financial literacy. The range of initiatives at present is very broad.⁶¹ However, there remains a need for co-ordination and for basic information comparing different products. Particularly in the area of pensions (where the government still plays a large role as provider), this is probably best carried out by a public-sector or quasi-public organization. Nevertheless, there are a number of reasons why the regulator may not be best suited to this task, and that the present agenda is too broad.

First, drawing the line between a non-prescriptive, guiding role and advice that is more specific will be very difficult. For example, the consultation document says:

'advice and information from an independent, non-industry source could help many consumers decide how much to save or spend, determine their attitude to risk, clarify their long-term objectives, and identify which sort of financial product or service might best meet their particular needs and preferences.' (FSA, 1998*a*)

⁵⁹ House of Commons Treasury Committee (1999*b*).

⁶⁰ FSA (1999*a*).

⁶¹ See below and Vass (1998*a, b*).

The agency presents this as 'helping consumers decide'. However, there is a risk that it results in the FSA deciding how much it thinks consumers should save, what financial products best meet their needs, and providing information that ensures this outcome. For example, the FSA's telephone help line receives 2,500 calls a week at the moment, and this figure has increased rapidly. If advice remains generic, not recommending either which product or which provider might be appropriate, there is a risk that consumers will be disappointed. People who buy unsuitable products might blame the FSA, with the risk that this undermines confidence in its regulatory activities. At the least, this centrally provided information could result in a sclerotic market for financial services. The FSA's approval of existing products and providers might act as a barrier to competition with the education program exerting too strong an influence on the types of products offered.

Secondly, there are potential conflicts between the FSA's many different activities. 'The FSA will not just be a new regulator, but a new kind of regulator. Its new role will cover improving market confidence; protecting savers and investors through increased financial literacy...as well as by regulating those involved in financial services; and reducing financial crime', says Patricia Hewitt. The economic secretary to the Treasury is very optimistic about resolving the trade-offs the authority will face: 'It will offer regulation that works with the grain of consumer needs and industry innovation and development: a winning formula for both.'⁶²

Thirdly, there are already many private-sector providers of cost and quality ratings. The regulator's efforts could therefore be wasteful duplication. Some commentators have argued that many league tables are already produced and 'the overall impact of this on consumers is not a lot'⁶³, so there is little reason to expect much improvement in the market from the new regulator's efforts. Perhaps more likely, rather than duplicating private provision of cost and quality information, the regulator will drive out private providers. The regulator's imprimatur will have superior cachet to private brands. More dangerously, this could be perceived as some kind of guarantee.

⁶² HM Treasury (1999b).

⁶³ Comments from the Director-General of the Association of British Insurers to a parliamentary committee. Joint Committee on Financial Services and Markets (1999).

Any comparison of costs between companies depends critically on the assumptions used. In personal pensions, for example, the burden of charges depends *inter alia* on:

- the level of contributions;
- the age at which contributions begin;
- the age at which people draw their pension;
- the returns earned by the investments;
- whether the member purchases an annuity from the personal-pension provider or from another financial services company;
- whether they have any gaps in contributions, due to unemployment, caring responsibilities or membership of an employer's scheme.

It is unlikely that a rating scheme could incorporate all of these variables without making it impossibly complex. The FSA is aware of these problems. 'The Government has set us a challenging task', says Howard Davies, who chairs the authority. 'We need to be careful about how indicators and products are chosen, and make sure that what we produce is useful to consumers and practicable to implement.'⁶⁴

Although there is a need for public intervention to promote consumer understanding of financial services, especially in the complex area of long-term retirement-income planning, I am not convinced that the financial regulator is the appropriate body to run this initiative. Of 103 responses to the FSA's consultation paper, 10 per cent, mainly from the financial services industry, were against the authority having an educational role. Most thought that existing initiatives should be strengthened instead.

5.3 *Information for people taking new jobs*

The public employment service (known as Job Centers) will be equipped to provide information on pension issues to people moving into employment and direct them to sources of detailed advice. As noted by the pensions education working group, this might be a time when people are susceptible both to new information and to changing their financial arrangements. Most people, however, do not find new jobs through Job Centers, although they do tend to be lower-income workers who are less likely to have private pension arrangements.

⁶⁴ FSA (1999*a*).

5.4 *Information in the work place*

Another program aims to improve pension information in the workplace and enable employees to make informed decisions about whether or not to join their employer's occupational pension scheme. The government is drawing up a draft 'good practice workplace code' for pensions in consultation with a number of interested parties, including:

- the employers organization, the Confederation of British Industry (CBI);
- the Trades Union Congress;
- the umbrella group for occupational plans, the National Association of Pension Funds; and
- the club for life assurance and pension companies, the Association of British Insurers.

This initiative will now be part of the 'best practice guidelines' described in section 6 below. The CBI is also developing a general human resources good practice code, called IMPRESS, which will include a pension component. Only 29 per cent of senior human resources managers told a Bacon and Woodrow (1999) survey that they currently offered their employees financial advice. However, 45 per cent expected they would by 2018.

5.5 *Stakeholder pensions and work place access*

The regulations for the new stakeholder pensions will take workplace information much further. Employers that do not offer an occupational plan will be required to identify a stakeholder pension (in consultation with employees or their representatives) and facilitate access to it. This will involve both providing information and 'allowing the nominated scheme a reasonable degree of access to the workforce to promote the scheme.'⁶⁵ The employer will also have to deduct contributions from earnings and transfer them, within a reasonable, specified period, directly to the nominated stakeholder plan.

Workplace access is designed to reduce marketing and administrative costs compared with personal pensions and, most importantly, to ensure that a broader range of people come into contact with pensions information.

The criticism of stakeholder plans has focused on the burden of the statutory requirement to operate a plan. The government's own 'regulatory impact assessment' suggests a one-off cost of £50-£3,000 per employer to alter payroll systems and to select a

⁶⁵ Department of Social Security (1998b). See also Department of Social Security (1999e) on this issue.

stakeholder scheme plus an ongoing annual cost of £10-£25 per employee to transfer contributions. Less than a fifth of employers without occupational plans told a survey that they were willing to be involved actively in setting up stakeholder schemes.⁶⁶ The Confederation of British Industry (1999) has argued that small employers 'lack the skill or resources to know which is the best scheme for their staff'.

The Office of Fair Trading (1999*a,b*), approaching the issue from the consumer angle, is concerned about the agency problems raised by employer choice of stakeholder fund. The process for employee consultation and the legal position of the employer as a fiduciary in choosing the fund have not yet been spelled out. The government argues that 'it is very unlikely that an employer would be regarded as negligent if a scheme chosen in good faith subsequently performed poorly or experienced problems.' This may set out the legal position, but, in practice, employees may well blame the employer who has the responsibility for designating the scheme. The government has tried to pass responsibility back to the employee: he or she can choose not to join a stakeholder plan at all or can choose a stakeholder plan other than the designated one. Yet the government, the stakeholder provider and sometimes the employer will all be encouraging the individual to join. And since payroll deductions, workplace access *etc.* are not required for schemes other than the designated one, the individual's options are biased strongly in favor of the designated scheme. Both the OFT and the CBI favor individual choice of stakeholder plan to avoid employers' facing a legal or moral fiduciary responsibility.⁶⁷

While initially all employees of a particular company might be in the same stakeholder scheme, over time, as people move jobs, each employer will be transferring contributions to a range of different providers. The administrative benefits of paying into only a single stakeholder plan will only be short-lived. Therefore, employee choice of stakeholder plan would not significantly raise administrative costs in the medium-term. The government initially proposed a clearing house for additional contributions to stakeholder schemes but has since backtracked. The main reason seems to be the perceived risk of a

⁶⁶ Hales and Stratford (1999).

⁶⁷ Conservative members of the House of Lords, the second chamber of parliament, have tabled a raft of amendments to the welfare reform bill that would reverse the clauses compelling firms to recommend a stakeholder plan (Bennett, 1999). These were defeated, but a government amendment was passed making it clear that employers were not under an implicit obligation to look at performance when selecting a scheme. Axia Economics (1999c) discusses these issues in detail.

large information-technology project, given recent high-profile failures,⁶⁸ relative to using an existing system.

5.6 *Financial education for adults*

A number of private-sector organizations offer financial education. The Pre-Retirement Association provides a range of publications, 'pensions-for-beginners' seminars, and courses to train other information providers. However, as its name suggests, older workers, particularly those facing redundancy, are the focus of the association's work.

The Money Management Council has a broader remit. It is involved in developing qualifications for schools (see below), provides tutors for financial-planning courses, and operates a 'quality mark' scheme to assess and reward clear financial information.

The Trades Union Congress produces a range of explanatory leaflets, but member trustees of occupational pension schemes and industrial-relations negotiators are the organization's principle targets.

5.7 *Financial education in schools*

A personal financial education group, including educationalists (and observers from the Qualifications and Curriculum Authority, or QCA), regulators (the FSA), government, consumer and industry representatives, has investigated ways of developing basic financial literacy in schools. Research has shown huge gaps even in older children's knowledge: around half, for example, are unaware that there will be deductions from their earnings for income tax and social security contributions when they start work. School teaching of personal finance has broad support among adults: 87 per cent responded favorably to the idea in a recent NOP survey. In addition, the Department of Social Security commissioned qualitative research on teachers' attitudes to introducing school children to the idea of pension planning. The study, carried out by Education and Youth, a specialist communications company that has worked for various financial-services organizations, had

⁶⁸ See Department of Social Security (1999*f*) and Axia Economics (1999*d*) on the clearing-house proposals. The Department of Social Security provides one example of a disastrous public-sector information-technology project. Andersen Consulting was supposed to replace the national-insurance records system by February 1997 and operate the new system, known as NIRS2, for seven years. At the beginning of 1999, there remained 1,500 'bugs', many of them crucial to operations, with a backlog of seven million benefit awards or rebate payments and 17 million contribution payments that had not been credited to people's records. See the

mixed results. School pupils, however, seem very keen. Managing money came top of a list of subjects secondary school pupils would like to see covered in more detail in school, mentioned by 48 per cent of respondents to a survey by Mori for the QCA. Only one in ten thought this was currently well covered in their lessons.⁶⁹

The personal finance education group, an industry consortium established in 1996, has developed a 'learning framework for personal finance'. The group piloted this scheme in schools during 1998. Good practice guidelines in the design of industry-sponsored materials and a directory of teaching resources have also been issued. Building on this work, the FSA is now negotiating with the QCA to include financial education in the national curriculum. The major barrier is that the curriculum is already crowded, and personal-finance teaching needs to dovetail with 'personal and social education', covering a wide range of issues. A second problem is the current lack of an accredited qualification in money management.⁷⁰ The City and Guilds of London Institute, which examines a range of vocational qualifications, offers a 'profile of achievement' scheme. Nevertheless, this is simply a record of money-management skills learned. The Money Management Council, a charity aimed at improving financial literacy, is presently developing units in personal finance that would count towards a GNVQ (the main vocational qualification).

Many financial-services companies and associations already provide materials for schools.⁷¹ The largest program is *Face 2 Face with Finance*, operated by NatWest, one of the four major banks.⁷² The scheme, co-ordinated by the NatWest Financial Literacy Center at Leicester University, targets secondary school students (age 11-18). More than 130,000 pupils have participated, involving over half of all secondary schools in the country. The program includes resource packs, classroom simulation exercises and videos.



NatWest's schools program

Regional co-ordinators and local staff volunteers go into schools to address students directly. The bank is strongly committed to this initiative: its erstwhile chief executive, Derek

reports of the House of Commons Public Accounts Committee (1998, 1999) and the National Audit Office (1997).

⁶⁹ Questionnaires completed by 3,500 pupils aged 11-16 in 142 schools. FSA (1999a).

⁷⁰ Schagen and Lines (1996).

⁷¹ These are summarized in Vass (1998a).

Wanless, has said: 'Business must help to prepare our children for a changing world...By doing this we are investing in all our futures.'

The National Foundation for Educational Research evaluates the program and materials to maintain high standards. Around 2,000 students were surveyed before they participated in the program and immediately afterwards. The study followed up some groups one and two years later. They found significant increases in conceptual and computational skills in money management. The students were on the whole positive about the experience: most felt they had learned at least a bit about finance. NatWest's Derek Wanless again: 'This evaluation has shown that *Face 2 Face with Finance* does make a measurable difference. We are proud of that finding.'

Most other banks have similar to, albeit less ambitious offerings than *Face 2 Face with Finance*. These initiatives, and those of other financial services companies, are very useful, but they do raise concerns. The borderline between education, information and marketing can be blurred. Companies' objectives in offering these resources might include marketing their products, recruiting staff in local labor markets, developing staff's skills in addition to more charitable motives, as part of 'community action programs'. Nat West's motives for the *Face-2-Face-with-Finance* program, examined in a study by the Corporate Citizenship Unit at Warwick, are very broad.

Many of these resources cover a large range of topics, including budgeting, careers advice, student finance. Saving, let alone pension provision, is often covered only tangentially although NatWest's program includes a module — 'It's your life' — which covers long-term financial planning and the importance of savings and pensions.

⁷² Copyrights of NatWest group acknowledged. Logo appears for illustration only.

5.8 Pension leaflets from the Department of Social Security and the Financial Services Authority

The Department of Social Security's new pension leaflets, launched last year, have been promoted in a nationwide campaign. There are eight in the series (listed at the end of the references), covering different parts of the pension system. The department is proud of these leaflets. It has said they 'are concise, accessible and relate information directly to decisions people need to take at various life stages'.⁷³ They have been awarded a 'Plain English crystal mark' and the Money Management Council 'quality mark'. They are available on the Internet, by postal request and by calling a 24-hours-a-day 'pensions info-line'.



The Family Guide to the National Insurance Scheme was sent to 14 million households to explain the new system introduced in 1948. There were also radio, press and cinema advertisements and over 4,500 'road-show' lectures

The leaflets fill an important lacuna: the lack of impartial, generic pension information. At times, however, they fail to explain important elements of the system. For example, they do not give the value of the basic state pension or say how it is indexed. While they argue that people should make provision above the mandatory level (see next section), they do not explain, for example, how much people might get from Serps or the mandatory minimum contribution to a private pension.



A DSS leaflet from the 1970s

The Financial Services Authority has also now issued a range of leaflets as part of its consumer-education strategy. Surprisingly, given the authority's remit to regulate all financial services, ten of the 13 leaflets address pension issues, with another explaining how to obtain financial advice. Around 2,000 leaflets are ordered each week and they have also won awards for the clarity of their presentation.

Again, many of the problems with these leaflets stem from the inherent complexity of the system. For example, the Department of Social Security's leaflet on personal pensions

⁷³ Department of Social Security (1998b).

explains the need for advice. It then lists a number of questions that people should ask their financial advisor. The complexity is obvious and needs no further comment:

-
- Is your financial adviser independent or tied to a particular company?
 - If you are thinking of not joining (or leaving) an occupational scheme, are you sure that you are making the best choice? *You need to get full details of the occupational scheme.*
 - Will you gain anything by choosing a personal pension plan instead?
 - If you already have a personal pension plan, what are the charges if you want to transfer your fund to the occupational scheme, or leave it where it is? *You cannot usually be a member of an occupational scheme and contribute to a personal pension plan at the same time.*
 - Will your financial adviser carry out a full fact-finding exercise on your circumstances and your attitude to risk?
 - What type of policy do you want? *Remember, some policies may be riskier than others — but may offer higher possible returns.*
 - What is your estimated pension under a particular plan and how has it been worked out?
 - How does it compare with estimates from other plans? *Make sure that you compare plans in a similar way.*
 - How does it compare with the income you think you will need when you retire?
 - How much do you need to pay into your plan to get this?
 - Can you afford it?
 - Have you allowed for what you may earn in the future and inflation?
 - How much of your contributions will be used up in commission and administration costs?
 - Does this change over the lifetime of the plan?
 - What are the pros and cons of starting either a 'regular premium' policy (where you pay regular contributions over a number of years), a 'single contribution', or series of 'single contributions'? *Single contributions may be attractive if your plans and income are not certain - and you have the cash available. Saving through the year and paying in a single contribution may mean the charges are less.*
 - What benefits will you receive as well as the pension itself?
 - Can you get death and disability cover as part of the plan?
 - How much will these benefits cost?
 - Is there a penalty if you retire earlier than you planned?
 - What happens if you become unemployed, or stop work to have children, take a career break, or get sick or injured? *Remember you may have to stop paying into your plan.*
 - When you return to work, can you rejoin your old plan?
 - Will you have to take out a new plan?
 - Does the plan include insurance to pay contributions if you cannot?
 - Have you thought about your family's needs if you die before you retire?
 - Have you enough life assurance?
 - Do you want to check the level of cover that you may receive through a personal pension term assurance?
 - How will this affect the cost of your policy?
 - If you plan to use a personal pension instead of SERPS, what are you giving up?
-

5.9 *Lessons from private pension providers*

A theme throughout this paper has been the difficulty in persuading young people to think about pensions and retirement, issues which Vass (1998b) described as not 'aspirational'. Yet, the growing importance of voluntary contributions as compulsory

pension provision declines in value means that people do have to prepare if they are to avoid a very basic retirement. In addition, the move towards defined-contribution provision puts a premium on early retirement savings.

Lunt and Disney (1998) explain people's reluctance to think about their retirement despite these changes in terms of 'ageism': the prejudice of the young against the old. They analyzed, *inter alia*, a television advertisement from the Prudential, the largest personal-pension provider, which directly confronts this perception. Peter Davis, the company's chief executive, walks down a rainy urban street with an umbrella, saying that, if you were 25-years-old, he would look like a boring, middle-aged businessman. Then the challenge: 'You'd be wrong: I'm your guardian angel'. However, people's prejudices are confronted in a highly aspirational way: the advert then offers 25-year-olds a range of attractive lifestyles for when they become 55. The images and options include a couple on a large, sun-drenched yacht, running a small cheese shop in a quaint rural village, writing a novel *etc*. Lunt and Disney argue that the advertisement's aim is to shorten the gap between the two ages, 25 and 55. The message: a relatively small effort now can open up a huge range of future choices; investment is a means to a desirable end. Other adverts adopt similarly aspirational approaches to retirement planning.

Private-sector marketing probably has an easier goal than public information. A major objective is competition between providers: persuading people to take a Prudential pension rather than a plan from another provider. Perhaps only a limited goal is to encourage people who have not previously thought about pensions to plan for retirement. The latter, more difficult objective is central to public information. Still, it is worth contrasting the private-sector approach with the public-sector. For example, the Financial Services Authority seems to take exactly the opposite approach to the Prudential's adverts. Its pension leaflet has someone looking, presumably towards her retirement, through a pair of binoculars (Figure 5). The image appears to suggest that retirement is far away, while the Prudential promotes the idea that it is just around the corner.

Figure 5. **The long view of retirement:
cover of the *FSA Guide to Pensions***



The Department of Social Security's first, introductory leaflet in its new series also sets out the need to plan for retirement and to plan early. Nevertheless, the approach is far from aspirational — more carrot than stick — as the following extracts show:

'Don't leave your pension to chance...Whoever you are, whatever your circumstances, you should be thinking about pensions. If you want to enjoy your retirement, you need to plan for your pension. And the sooner you do this the better...the decisions you make now will affect how much money you have when you retire...**It's up to you! But we can help.'** (pp. 2-3; all extracts show original emphases)

'The basic state retirement pension is a secure foundation but it was never meant to support the lifestyle most people want today...**Everyone needs to decide for themselves whether the basic retirement pension and any second pension...will be enough to meet their needs when they retire.'** (p. 4)

'Think about your future — now! Most people don't give much thought to their pension but decisions you make now can have a real effect on your life when you retire.' (p. 6)

'If you have this sort [rebate-only] of second pension, it is *only* meant to replace Serps, which might mean it is still not enough to support your lifestyle when you retire. Most people should consider whether they need to pay for extra pension.' (p. 9)

'It's up to you to decide what you can do to help yourself' (p. 10)

'Do I really need a second pension? On its own, the basic retirement pension may not be enough to give you the comfort in retirement you are looking for.' (p. 13)

'Why should I think about pensions? ...If you want to enjoy a secure retirement with enough money for the lifestyle you want, it's up to you to consider your options...you can do a lot now to protect yourself against financial worries in old age.' (p. 29)

The repeated message is that retirement will be uncomfortable and insecure without planning, and that it is individuals' own responsibility. The only real carrot is tax relief on

contributions (mentioned on pages 9, 16-17, 19 and 20). No promise of yachts, however vague (and unlikely they are for most of Prudential's customers). Indeed, the images of retired bowling, hiking *etc.* (Figure 6) seem calculated to confirm rather than challenge youthful prejudices. Participants in the government's consumer research on drafts of the leaflets felt that many of the characters were too old, and the final version does have 15 pictures of younger people as well as the pictures shown. Consumers found the characters varied, representative, that they were 'quite amusing and provided a friendly approach and feel'.⁷⁴

Figure 6. **A caricature of retirement: the Department of Social Security's pension information leaflets**

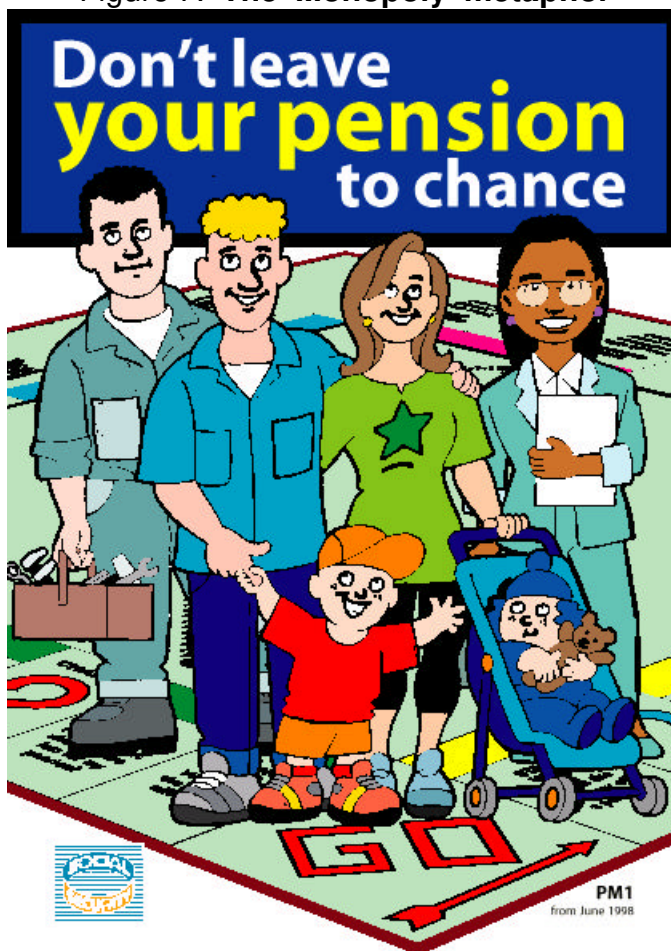






⁷⁴ The research, carried out by a Michael Herbert Associations for the Central Office of Information research department, involved nine focus groups with people aged 18-55 in four English regions. Hankins (1999).

Rather less understandable is the choice of the board game, Monopoly, as a unifying theme for the leaflets (Figure 7). Happy families are shown standing on the Monopoly board on the cover. Inside, retirement planning is shown as a journey round the board, from 'Go' (collect national insurance number) to collect pension (which looks like 'Free Parking' on the original game), via various lifecycle events. The association of retirement planning with a children's game of chance is unfortunate. Still worse, the term 'Monopoly money' is a pejorative one, indicating something worthless despite bountiful promises. Given lack of confidence in the system (from personal pension mis-selling *etc.*), this seems an inappropriate metaphor.

The government's consumer research, however, found that Monopoly was an appealing theme. It was both familiar yet unexpected in a public-information leaflet most of which are (or, at least, are expected to be) very dry. It is known to be a game involving money and, the research argues: 'with "take a chance" the game adequately reflect[s] the changing nature of life — respondents could relate to this when thinking about issues surrounding pensions during a lifetime'.

Figure 7. The 'Monopoly' metaphor



	Get National Insurance number	Leave school or college and start work Does the company offer a pension, and if so what sort?	Leave school or college and start work Will my boss contribute to a personal plan?	Change Jobs Can I keep or transfer my existing pension?	Change Jobs What does the new job offer me?	Chance ?	Change Jobs Am I still saving enough?	Get married or live with someone Am I still saving enough?	Community Chest 	Get married or live with someone Should I rely on my partner?	Get married or live with someone Are we covered if one of us is ill or dies?
	Divorce How will I save for my retirement?	Divorce Can I make up lost years?	Chance ?	Divorce What are the options for my or my husband's or wife's pension rights in a divorce settlement?	Caring for the elderly or sick Can I build up any pension entitlement?	Someone dies and leaves an inheritance How should I invest a lump sum?	Your husband, wife or partner dies Do I and my children have enough cover?	Community chest 	Your husband, wife or partner dies Money's tight, what happens if I save less for my pension?	Long-term illness Can I build up any pension entitlement?	Collect  pension

Note: References to 'Monopoly' are copyright Hasbro Inc. and reproduced here for information only. 'Monopoly' and associated images were licensed to the Department of Social Security by 3D Licensing Ltd.

6. Kite-marking occupational pensions

Pensions Act 1995 set a range of regulatory standards for occupational plans. The Act, policed by a new Occupational Pensions Regulatory Authority (Opra), requires minimum levels of funding, disclosure and member involvement in managing the scheme. Part of the government's reform proposals of last year includes adding a 'quality-in-pensions' accreditation scheme as a means of rewarding best practice in occupational plans and raising standards above the regulatory minimum (Department of Social Security, 1998*b*).

A consultation document fleshed out the initial proposals (Department of Social Security, 1999*b*). The proposed criteria for quality in pensions were:

- governance, including training of trustees and member representation;
- access: schemes must be open to all permanent employees;
- communication, including regular, automatic, high-quality data on individual accrued and prospective benefits and information to enable employees to make informed choices about whether to join the scheme or not; and
- benefit levels: a target replacement rate of 50 per cent or more of final pay.

Schemes will be assessed on a site visit, including meetings with trustees and an audit of casework. The assessor will also provide comments on good and bad practice using examples from other plans. The aim is that accreditation fees, paid by schemes, will finance the program, with the exception of start-up costs. Both defined-benefit and defined-contribution plans run by employers will be able to apply for the kite-mark. (Group personal pensions will not be eligible and the new stakeholder plans will have their own rules.)

6.1 *The role of kite-marking*

Kite-marking, as a supplement to a regulatory approach, is being adopted in the United Kingdom in a number of areas. Some of providers of the new individual savings accounts (Isas) will be granted a 'Cat-mark' if they meet conditions on cost, access and terms. The new stakeholder pensions, described elsewhere, will be similar to group personal pensions, but will have to meet conditions beyond the regulatory minimum on administrative charges and the provision of information to consumers.

Kite-marking is a useful addition to the government's armory for intervention in financial services. Some features in the pensions (and other) markets may be desirable, but not sufficiently so to warrant regulation. Kite-marking can promote simple and fair contracts appropriate for the mass market without outlawing products suitable for more sophisticated consumers.

Surveys of consumers suggest that Cat-marks for Isas will be limited in their usefulness. Almost half said that they would consider a well known institution for their Isa even if it did not meet the Cat standard while only a third would consider a Cat-marked plan from an unfamiliar source. A director of NOP Financial, who conducted the study said: 'the relative lack of interest in the government's own "quality standard" indicates that the Cat is not as important a factor in influencing potential customers as the perceived quality and reassurance of a known provider'.⁷⁵ The Institute of Economic Affairs, a right-wing think-tank, has recently used similar arguments to suggest that reputation and competition can be an effective substitute for detailed financial regulations.⁷⁶

6.2 *Problems with 'quality in pensions'*

The 'quality-in-pensions' proposals raise a number of concerns. Firstly, the government has not assessed how many schemes meet the required criteria and how many fall short. Rewarding best practice has some advantages: companies will be allowed to promote their schemes with the QiP certification. This will be useful for people considering jobs with different employers. The main aim, though, must be to spread best practice. An essential pre-requisite is data on the types of schemes failing to meet the criteria to assess the success in promoting change.

Available survey evidence⁷⁷ suggests that most of the schemes that need to improve are small. Yet, the proposed fee structure would for example, charge £12 a member for plans with 100 members and £0.25 for 10,000 members. This charging schedule, plus the

⁷⁵ NOP Research Group (1998).

⁷⁶ Simpson (1996) and Benston (1998). See Davies (1999) and Llewellyn (1999) for a counter-argument and a defense of financial regulation.

⁷⁷ Data sources include the Government Actuary's quadrennial survey of occupational pension schemes and the National Association of Pension Fund's annual survey of its member's plans (which are mainly large schemes).

large element of fixed costs in complying with the QiP audit, will probably make it uneconomic for small schemes — those with most room for improvement — to apply.

A number of groups linked with employers and pension funds have attacked the QiP proposals.⁷⁸ The National Association of Pension Funds (1999) has argued that ‘raising standards and rewarding best practice will not be achieved by the QiP scheme.’ The association is concerned at the potential for mis-information, with people choosing stakeholder plans rather than occupational schemes outside the QiP program even when it is not in their best interest. Other worries are that unsuccessful applications will cause employers to question the value of providing occupational pensions and the administrative burden of complying both with QiP and with the regulations introduced in Pensions Act 1995. Individual occupational funds views echo those of their collective organization. A survey of 450 plans found that 78 per cent opposed QiP and 87 per cent believed it would fail to improve member communication, or administration and governance of plans.⁷⁹

The employers’ organization, the CBI, says QiP is ‘unlikely to add any value, and will not lead to better pension provision’. William Mercer, the leading employee-benefits consultant, argues that QiP could give members ‘a false sense of security’. The company says that ‘it will be perfectly possible for an accredited scheme to become insolvent, fall foul of regulatory and legislative requirements or fall short of members’ expectations in other ways’.⁸⁰ Only 58 per cent of managers of firms with large occupational schemes told a survey by Capita (1999) that they supported the QiP proposal, although this is rather higher than surveys of pension fund managers.

The government, after consultation, shelved the QiP proposal and has opted instead for best-practice guidelines only, with the medium-term aim of moving to an accreditation scheme should the pensions industry support it in the future.⁸¹ A working group, including representatives of employers, trades unions, regulators and the pensions industry, was established in July 1999 to draw up the guidelines.

⁷⁸ See Financial Times (1999*e,g,h*).

⁷⁹ Survey by Lane Clark & Peacock, actuarial consultants. See Mackintosh (1999) and Trueman (1999*b*).

⁸⁰ See Axia Economics (1999*a*) for an extended critique of the Quality-in-Pensions proposals.

⁸¹ Department of Social Security (1999*g*) and Timmins (1999*e*).

7. Stakeholder pensions and the need for financial advice

One of the government's central aims in introducing stakeholder pensions is to keep the charges low compared with personal plans. Means of cutting costs include their collective structure, simpler tax rules, and workplace provision to reduce marketing and contribution-collection expenses. Employers should have greater bargaining power than employees have, and so be able to secure a better deal.⁸² The government has proposed a one-per-cent ceiling on charges as a proportion of fund assets to avoid penalizing low-paid workers. A final method of keeping charges low is reducing the need for individual financial advice. Education and advice, the government believes, could be provided collectively to cut costs. 'We see scope for schemes to make arrangements to offer general advice to members and potential members...by having advisors visit the workplace,' says the *Partnership-in-Pensions* proposal. Cutting costs by avoiding the need for individual advice has proved controversial.

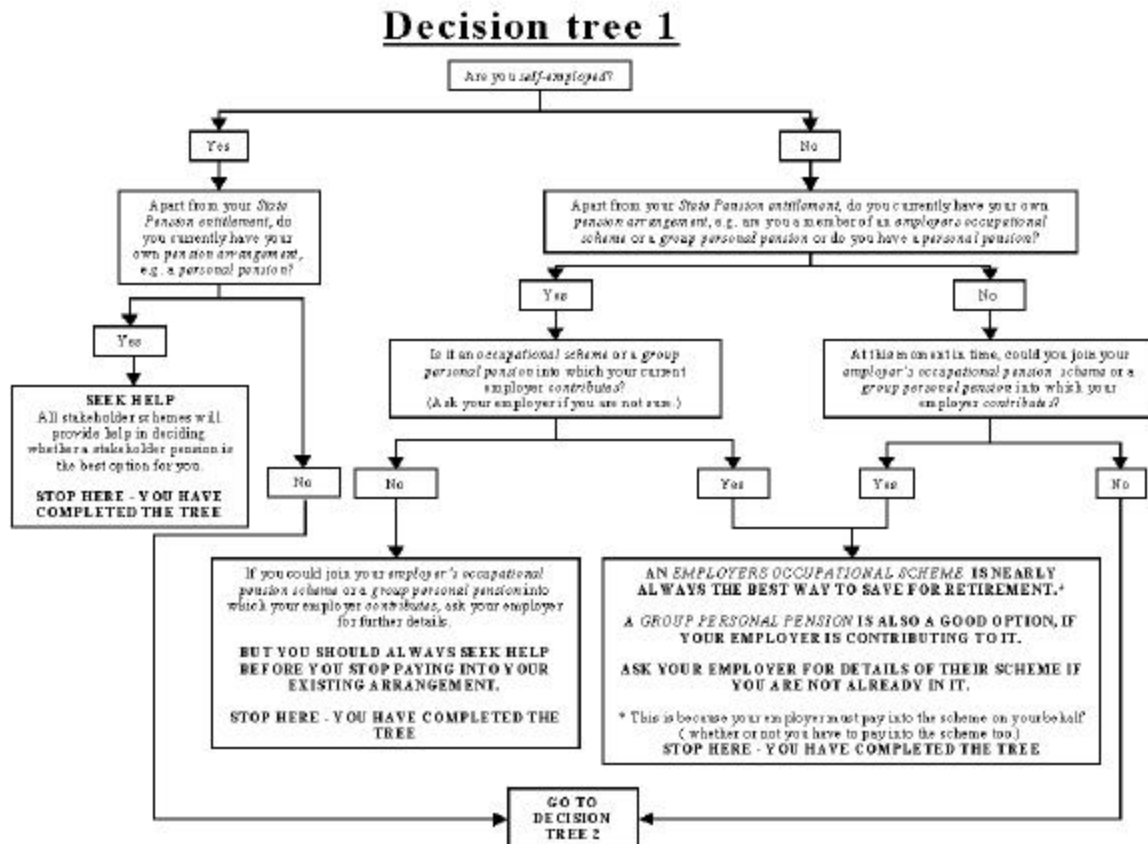
The *Partnership-in-Pensions* document (Department of Social Security, 1998b) argues: 'The reassurance provided by minimum standards and by ensuring [stakeholder] schemes are run in their members' interests will reduce the need for detailed financial advice when people join schemes.' The government proposes to provide 'decision trees' to every potential stakeholder scheme member. These trees consist of a series of standard questions for individuals to work through and would set out different pension options and encourage people to seek advice if and when necessary.

The current draft proposals are in Figure 8. The trees are complicated, but only because the pension system is. Even so, they are still a simplification. For example, the first tree argues that 'an employers occupational scheme is nearly always the best way to save for retirement'. But this is often not the case for younger, mobile workers in careers with rising earnings. The government said in its reform proposals: 'People who often move jobs can do less well in an occupational pension scheme' (Department of Social Security, 1998b). There is no role whatsoever for personal pensions, except for 'group' schemes, organized by employers. Indeed, members of personal pensions are encouraged to seek advice as to whether a stakeholder plan would offer a better option.

⁸² Assuming they have the interests of their employees at heart or, in the economic terminology, that agency problems do not intervene.

The government's belief is that 'It [a pension decision tree] would allow people to make an informed decision without advice in many cases.' Surveys, however, suggest that most people will not be happy with a decision tree. According to the Nationwide building society, 68 per cent prefer to discuss pensions face-to-face with an advisor.⁸³

Figure 8. Pension decision trees



83 Pensions World (1998b).

Figure 8, continued

Decision tree 2



Source: Department of Social Security (1999h)

7.1 *Advice and the choice between stakeholder plans*

The structure of stakeholder schemes and charging schemes will be more strictly regulated than personal pensions. Disney, Emmerson and Tanner (1999), argue that the relative uniformity of stakeholder plans compared with personal pensions (imposed by regulations) will reduce the need for advice over which stakeholder product to take up. Ernst & Young, the accountancy firm, agrees: ‘in theory, this could make tied salesmen and independent financial advisors redundant and strip out must up-front, advice-related costs’.

Ernst & Young also expects stakeholder schemes to lead to a radical restructuring of the financial-services industry. ‘Most UK life assurance companies will be unable to make money from stakeholder pensions without radically changing their current business model. Their expense base is too high to support the proposed charges,’ it said.⁸⁴ Only 20 per cent of personal-pension providers currently meet the one-per-cent ceiling on charges. The

⁸⁴ Financial Times (1999c).

pensions marketing manager of Standard Life, one of the largest insurers said: 'We are heading for a low margin, high volume world.' OSI, a management consultancy, expects a 'tidal wave of mergers' in the industry. The firm estimates the minimum efficient size for a stakeholder plan is 500,000 members.⁸⁵ Alistair Darling, the secretary of state for social security, was recently asked how many stakeholder plans he expected there would be, less than or more than a dozen. 'I don't know at this stage, but I have always seen it as being a lower number rather than a larger number,' he replied.⁸⁶ One firm of consultants expects just seven survivors in the medium term. With fewer plans to choose from, this will again reduce the need for pension advice.

Independent financial advisers (IFAs) confirm this analysis: they expect stakeholder plans will depress their business. One told the *Financial Times*: 'around 25 per cent of IFAs will go out of business in the next two years.'⁸⁷ Cazalet financial consulting expects a larger shakeout, with 25-40 per cent fewer IFAs within four years.⁸⁸

Stakeholder plans will not be launched until at least 2001. Meanwhile, 'consumers are putting off pension decisions' until then and 'the uncertainty is causing chaos in the market place,' according to the chief executive of Direct Line Life, a low-cost, telephone-based provider.⁸⁹ Given the time lags in the publication of pensions data (by both the industry and the government), stakeholder pensions will have been launched before it is possible to confirm or contradict these statements. Until then, of course, they should be interpreted with caution.

7.2 *Advice and the choice between stakeholder and other pension plans*

The Confederation of British Industry (CBI, 1999) disagrees that the choice of stakeholder plan will be relatively easy and so not require direction. The organization thinks the government has 'underestimated the amount of advice needed by someone before they decide which stakeholder scheme to join.' Indeed, at the very least, the new schemes will not reduce the need for advice over which of the four options — the new second state pension, personal, stakeholder or occupational plan — will be most suitable for a particular

⁸⁵ Timmins (1999*a*) and Brown-Humes (1999).

⁸⁶ Timmins (1999*c*).

⁸⁷ Brown-Humes (1999).

⁸⁸ Trueman (1999*a*).

⁸⁹ See Sandler (1999) and Timmins (1999*d*) in addition to the references in the previous five footnotes.

individual. This will depend on age and expectation of individual and economy-wide earnings growth, tenure with the employer and capital-market returns. Moreover, the reforms significantly complicate people's choice by adding a fourth option. In addition, the transition from Serps to the new state second pension will be long, with the latter eventually moving to flat-rate rather than earnings-related payment. People's optimal pension arrangements may well vary over this transition period.

The Pension Provision Group (1999), an independent committee of experts appointed by the government concluded its analysis of the reform proposals that 'an area of great concern...is the need for, and availability of, advice.' The group foresees the possibility of another widespread 'mis-buying'⁹⁰ problem similar to personal-pensions mis-selling. The National Association of Pension Funds also foresees a broad need for guidance: 'the variety of pensions and investment vehicles on offer will make the choice difficult even for a sophisticated investor.' The Pension Provision Group and the CBI have both argued that provision of advice should be included in the charge for a stakeholder pension. The government suggested that extra fees, on top of the stakeholder charge, would be levied for such services. The CBI believes that 'deciding on a pension is likely to be the biggest financial decision an individual makes in their life' and so, that advice will be essential. Finally, the organization is also concerned that the new scheme will mean employers have to act as financial advisors to their staff. Since neither employees nor employers will want to pay for advice, it argues, it should be built into the stakeholder fee, 'even if this means the maximum charge is higher than the government might have wished.'

The government has, in its rhetoric at least, backtracked on its earlier insistence that stakeholder schemes will reduce, if not obviate, the need for financial advice. Alistair Darling, secretary of state for social security, recently told the *Financial Times*: 'I have always taken the view that if someone is buying the most elementary product from the financial-services industry, they probably need advice. Certainly, on something like a pension, which is more important than buying a house, there has got to be provision for advice.' Indeed, he has more recently denied the government's intention was ever to preclude the need for

⁹⁰ The term 'mis-buying', widely coined to describe the potential for consumer detriment with stakeholder plans, contrasts with the phrase 'mis-selling' commonly used with personal pensions. The Independent Financial Advisors Association (1998) makes a related observation: 'It is accepted wisdom that financial products are rarely "bought" by consumers: they are sold to them'.

guidance. 'I have never accepted the view that we could ever have a product that is so straightforwardly wonderful that you don't ever need any advice,' he said.⁹¹ Yet the most recent consultation paper (Department of Social Security, 1999*h*), detailing the stakeholder regime, does not provide for guidance in the standard charges.

8. Improving individual pension information

The Department of Social Security currently provides around 600,000 state-pension forecasts a year. Individuals must request the forecast using a relatively simple five-page form, called BR19. My own pension forecast is shown in Table 8. As well as the summary table, there are five further pages of explanation. These cover the basis of the forecast, the basic pension, automatic credits, home-responsibilities protection, voluntary contributions, additional pension (the official name for Serps), graduated retirement benefit (Serps' predecessor) and the effect of living abroad. For example, here is the explanation of Serps and the accompanying table showing my entitlement:

Additional Pension (AP):

Additional Pension is part of Retirement Pension that is based on full-rate NI contributions you paid as an employee on earnings since 6 April 1978. It is sometimes called SERPS — the State Earnings-Related Pension Scheme.

When we estimate entitlement to Additional Pension:

for tax years between 6 April 1978 to 5 April 1997, we use all earnings on which NI contributions have been paid, including those paid during a period of membership of a contracted-out occupational pension scheme or an appropriate personal pension scheme.

The rules for contracting-out of SERPS changed from 6 April 1997; for tax years from 6 April 1997 onwards, we exclude any earnings on which NI contributions have been paid during a period of membership of a contracted-out occupational pension scheme or an appropriate personal pension scheme

Additional pension earned for tax years between 6 April 1978 and 5 April 1997, is reduced as a result of membership of

a contracted-out occupational pension scheme, or
an appropriate personal pension scheme

This deduction is known as the contracted-out deduction (COD). If you are contracted-out of SERPS you pay a reduced rate of NI.

For members of contracted-out salary related schemes the contracted out deduction is the minimum amount of occupational pension payable by the scheme, and is also known as the guaranteed minimum pension (GMP).

For members of contracted-out money purchase and appropriate personal pensions schemes the contracted-out deduction may be more or less than the pension provided by the scheme. This is because

⁹¹ Timmins (1999*d*).

the pension is based on the value of the fund built up in the scheme (that is the part of the pension that takes the place of the Additional Pension), known as the protected rights.

Contracted-out employment does not affect Additional Pension earned from 6 April 1997. This is because from that date members of contracted-out occupational pension schemes or appropriate personal pension schemes no longer build up entitlement to Additional Pension.

The amount of AP you get from the State may change if in the future you decide to leave or join a contracted-out pension scheme or a personal pension scheme used instead of SERPS>

Additional Pension: present value

Your record up to 5 April 1998 shows that the present value of your Additional Pension is £2.98 a week payable by the State. This is how we worked it out:

- Total Additional Pension to 5 April 1997.....	£ 7.55
- Less Contracted-out Deduction.....	£ 4.57

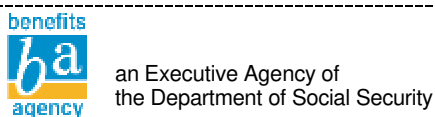
- Additional Pension payable by the State to 5 April 1997	£ 2.98
- Additional Pension From 6 April 1997.....	£0.00
- Plus payable Additional; Pension to 5 April 1997	£2.98

- Total Additional Pension payable by the state	£ 2.98

8.1 A combined pension forecast

Neither the table nor the accompanying explanation are very clear. The Department of Social Security appears to agree. It has promised to revise forecasts of individuals' state pension rights from this year in an attempt to make them easier to understand. The government's aim in the future is to move towards automatic provision of forecasts, rather than providing them on request as now. As shown above, few people have any idea of the value of the basic state pension let alone their entitlement to Serps *etc*. Regular pension statements are an essential pre-requisite for giving people the information and the confidence to make retirement-income decisions.

Table 8. **Current pension forecast**



**MR ER WHITEHOUSE
38 CONCANON ROAD
LONDON SW2 5TA**

**RETIREMENT PENSION
FORECAST**

RPFA (Correspondence)
Pensions and Overseas Benefits Directorate
Tyneview Park, Whitley Road
Newcastle-Upon-Tyne. NE98 1BA
Tel: 0191 2187585
Fax: 0191 2187006

Your reference number is

NR426812C/AY/06/1999

Please quote this number if you contact us
Date: **8 June 1999**

YOUR PENSION FORECAST

DEAR MR WHITEHOUSE,

This is your Retirement Pension forecast.

For retirement pension purposes your working life is 49 years and is counted from the start of the tax year in which you reach age 16 to the end of the tax year before you reach State Pension Age, which will be age 65. To get the full amount of the Basic Pension you need to have or to have been credited with enough full rate National Insurance (NI) contributions in 44 of those years. These are called **Qualifying Years**.

Your National Insurance (NI) contribution record up to the 5 April 1998 shows that you have 11 qualifying years, giving you 25% of the full amount. When a tax year ends, it usually takes up to six months for NI contributions for that year to be credited to your account. Therefore, your Retirement Pension Forecast may not include the value of contributions you have paid in the last tax year. A tax year starts on 5 April one year and ends on 5 April of the next year.

TOTAL WEEKLY PENSION EARNED TO 5 APRIL 1998 **£19.67**

This is made up as follows:

BASIC PENSION UP TO 5 APRIL 1998 **£16.69**

PAYABLE ADDITIONAL PENSION TO 5 APRIL 1998 **£2.98**

GRADUATED PENSION **£0.00**

TOTAL **£19.67**

If the information you gave us on your BR19 application form does not change, and you are paying, or your pension could be improved by paying voluntary contributions, then by the time you are 65 you are likely to have 44 qualifying years giving you the full amount of Basic Pension.

BASIC PENSION UP TO 5 APRIL 2033 **£66.75**

PAYABLE ADDITIONAL PENSION TO 5 APRIL 2033 **£2.98**

GRADUATED PENSION **£0.00**

TOTAL WEEKLY PENSION ESTIMATED TO 5 APRIL 2033 **£69.73**

Defined-contribution plans — both personal and occupational — will in the future be required to provide projections of members' funds at retirement and the value of the annuity that this is likely to buy. Providing annual information on contributions, charges and pension value will also be part of the minimum standards for stakeholder pensions.

The medium-term aim is to move to a single, comprehensive statement of accrued and forecast pension rights. This statement might be provided through employers, the 'pay-as-you-earn' income-tax system or through other pension providers (such as financial-services companies). Table 9 shows the government's illustrative example of a combined pension statement.

Table 9. Illustrative summary of a combined pension forecast

Name	A Smith
Age	58

The contributions you have made so far have built up the following pension entitlements:

<i>State pension</i>	
Your basic pension	£55.00
Your state second pension	£12.50
<i>Occupational/personal/stakeholder pension</i>	
	£62.30
Total current pension earned so far	£129.80 a week

If you stay in your current job your pension at age 65 is forecast to be:

<i>State pension</i>	
Your basic pension	£64.70
Your state second pension	£12.50
<i>Occupational/personal/stakeholder pension</i>	
	£85.70
Forecast pension	£162.90 a week

If you increased your pension contributions by 5 per cent of your earnings from 1 January your forecast pension would increase to:

£170.20 a week

Source: Department of Social Security (1998b)

The Pension Provision Group has argued that there are 'considerable technical problems to be overcome' and that 'it will be some time before this laudable aim can be achieved.' It is worth exploring some of these issues: is a meaningful, simple and understandable, accurate pension statement possible, given the complexity of the system?

The first part of the forecast aims to show pension rights already earned, the second, an estimate of what future rights might be. Predicting future pension accruals is necessarily speculative, but even the value of accrued pension rights depends on a range of uncertain variables. In defined-contribution schemes, we know what the current fund is worth, but we do not know the investment returns it will earn in the future and what annuity rates will be. In defined-benefit occupational schemes, current workers do not know what their final salary will be, and most plans use some measure of final rather than average pay. Changing earnings levels affect the value of pension rights already accrued in the scheme as well as future rights. Moreover, people do not know how long they will remain in the scheme. Most people change jobs regularly. For example, someone joining an occupational pension scheme at age 30 has only a 20 per cent probability of remaining in that scheme at retirement. Even for someone age 40 that probability is less than one half.⁹²

Changing pension schemes still has an enormous effect on pension values, despite frequent policy changes to protect the rights of 'early leavers', as they are known. For example, the earnings measure must be price indexed from leaving the scheme to retirement (to a ceiling of five per cent), rights must be vested after a maximum of two years, and occupational plans must allow transfers of rights into and out of the scheme. Nevertheless, there remains a cost of moving jobs because accrued rights no longer increase in line with the individual's earnings, as the following simple illustration shows.⁹³

Take a scheme that provided two-thirds of final pensionable pay after 40 years' membership. Someone spending 20 years in two schemes would have a benefit of 53 per cent of earnings (on relatively favorable assumptions about age-earnings profiles). Three schemes would give 46 per cent *etc.* The norm for scheme tenure is shorter than even this last example: the median spell is ten years. Moreover, only 10 per cent of men and 3 per cent of women spend 40 or more years in total in occupational schemes.

The relevance of this for pension statements is shown from Table 9: 'If you stay in your current job until age 65 your pension is forecast to be...'. This is a highly unrealistic

⁹² Based on analysis of retrospective employment 'event histories' in the Retirement Survey (see Disney, Meghir and Whitehouse, 1994, Disney and Whitehouse, 1996 and Dilnot *et al.*, 1994, chapters 5 and 7 for a detailed discussion). This survey looked at the cohort aged 55-69 in 1988-89. But cross-section studies of job tenure, based, of course, on incomplete spells, suggest there has been little change over time in average tenures (for example, Meadows, 1999 study for the National Association of Pension Funds). See.

assumption, both because few people will remain in their current scheme to retirement, and most will retire before age 65. The median retirement age is under 55 for people without an occupational pension and just below 60 for people who are in an employer plan.⁹⁴

People probably already have unrealistic assumptions about the benefits that they will receive from defined-benefit occupational pensions. They are often sold on the basis that they will provide 'two-thirds of final salary', yet, as I have argued, few, if any, achieve that target. There is no direct evidence in the United Kingdom of employees' estimates of their occupational pension values. But Ghilarducci (1992) reports that employees in the United States estimated the value of their accrued pension benefits to be 3.6 times the value placed on them by the employer. Also, actuaries' estimates (which presumably reflect the benefits that would be paid) are 21 per cent below the employer's. Employees' valuations are therefore four times as high as the benefit they would receive if they left the scheme or the scheme were terminated. Reinforcing these unrealistic expectations with misleading pension values based on unrealistic assumptions would not be helpful in ensuring people make informed decisions about the adequacy of their retirement incomes.

Forecasts of defined-contribution pensions raise their own problems. What will be the assumptions about how the funds are invested and what investment returns and annuity rates will be? Will there be an analysis of the sensitivity of pension values to these uncertain variables?

Table 9 is currently very simple, but this simplicity is unlikely to survive the translation into a real benefit statement. First, most people have a portfolio of different pensions. They might have different plans from different jobs. Or they might have a personal and an occupational pension at the same time. Or their private pension is 'contracted in', and so they build up both Serps (in the future, state second pension) and personal or occupational pension. The pensions from previous employment continue to grow, as the earnings measure in defined-benefit schemes is updated in line with prices and the investments in a defined-contribution plan continue to earn returns. Secondly, the current statement, to explain basic state pension and Serps, requires five pages of

⁹³ See Disney and Whitehouse (1996) for a detailed discussion.

⁹⁴ Disney, Meghir and Whitehouse (1994) and Meghir and Whitehouse (1996). Retirement is defined retrospectively in the event-history data as the time at which a person leaves their last job before age 65.

explanations. How long will an explanation be of the two state plans plus defined-contribution, defined-benefit occupational, personal and stakeholder schemes?

The statement is denominated in current prices. The Pension Provision Group, for one, has argued that 'governments need to spell out unambiguously the likely future value of state pensions in relation to future living standards'. The group recommends that the statement should be in 'earnings terms', with future nominal values deflated in line with an earnings index rather than a price index. This would reflect the purchasing power of the pension relative to general future standards of living.

In conclusion, the development of a combined pension forecast is a vital prerequisite for improving individuals' retirement-income planning. But the difficulties I have outlined are very large. As with the stakeholder decision tree, they emphasize that the problems with the current system stem mainly from its complexity.

9. Political risk and the future of state pensions

An interesting proposal of the government's independent Pension Provision Group was the establishment of an independent body to spell out the financial prospects of the state pension system. The aim would be to accumulate, analyze and publicize information on current and future pension provision and the policy implications.

Presently, the Government Actuary issues a quinquennial review of the national-insurance fund, including long-term forecasts of demography, spending on national-insurance benefits and the contribution rate required to finance these benefits. These are based on two assumptions about future policy changes: that benefit levels continue to be updated in line with prices or that they are (more generously) indexed to earnings.

A general problem with government demographic forecasts in many countries is their systematic tendency to under-predict improvements in longevity and over-predict future fertility rates. For example, if age-related mortality were to continue to improve at the current rate, life expectancy in the United States would be 85 or more years by 2050. But the Social Security Administration forecasts that the improvement in mortality will slow, and that life expectancy will be 81 by the middle of the 21st century. Some analysts, in contrast,

expect mortality improvements to accelerate rather than slow, with life expectancy perhaps reaching 90 or even 100.⁹⁵

Back in the United Kingdom, the Government Actuary has frequently changed his demographic forecasts, and the revisions are all in the same direction. His 1981 projection was that there would be 10.6 million people of pensionable age in 2020. By 1990, the forecast had risen to 13.4 million and, by 1995, to 14.4 million: an increase of over a third in the space of ten years⁹⁶

In addition, major reforms have been introduced without long-term projections. When Serps was introduced, for example, the published forecasts extended only to 2008, just before the baby-boom generation would retire. On top of these demographic pressures was the impact of the early maturity of the scheme: like many pay-as-you-go plans, accrual of benefits was faster for earlier cohorts, allowing them to earn full returns after 20 years. The scheme looked affordable on the Government Actuary's original medium-term analysis. But subsequent projections by the Institute for Fiscal Studies and, eventually, by the new Conservative government showed an alarming cost increase in the period immediately after the original 30-year projection. Again, it is unclear whether the projections missed the period of rapid growth in spending because of 'conspiracy' (the government did not want to undermine the reform) or 'cock-up' (the actuaries felt unable to make long-term forecasts).

Would an independent body, as proposed by the Pension Provision Group, have done any better at producing accurate demographic forecasts and longer-term projections of financial sustainability? If the new body is genuinely independent then it should avoid politically motivated changes. But it might not avoid any problems of actuarial judgement or competence.

10. Conclusions

The government likes to call its pension reforms 'radical'. In practice, they mainly take the system in the direction it has been going for two decades. They emphasize private, funded rather than state, pay-as-you-go provision. They promote defined-contribution

⁹⁵ Lee and Skinner (1999) and Vaupel and Lundstrom (1996) summarize the evidence.

⁹⁶ Ignoring the rise in pension age for women between 2010 and 2020 to keep the numbers comparable. This will reduce the numbers of pensionable age by around 2 million in 2020.

rather than defined-benefit schemes. State pensions will be targeted still more on workers and pensioners with low incomes. Although state spending on pensions will rise, the increase is small: around £5 billion or 0.5 per cent of GDP in the longer term. Projected contribution rates will remain broadly stable well into the future.

The reforms address many of problems with pension provision. In particular, they should lead to lower administrative charges with private pensions and greater flexibility in stopping, starting and changing contribution levels as family finances require. But the new stakeholder plans are really just re-badged and fixed-up personal plans. Indeed, it is probable that the same companies that offer personal pensions will provide stakeholders, rather than 'affinity groups' or new mutual organizations as originally hoped.

Other issues remain a problem. Mandatory pension provision has declined dramatically, and the retirement savings of the majority are less than adequate. In part this reflects a lack of information about individual pension rights and the complicated regime. A number of initiatives are targeted on this problem, which has sadly been ignored in the past. The Department of Social Security's pension education working group made a number of proposals. Both the department and the Financial Services Authority, the new regulator, have issued a range of leaflets giving impartial, generic advice. Stakeholder pensions will improve access to information in the workplace. The new national curriculum is likely to enhance personal-finance teaching in schools. Finally, the government has promised to clarify forecasts of state pensions and to move to a combined pension statement, including private plans.

Perhaps the most interesting initiative from an international perspective is the consumer-education role for the FSA. There are some *aveats*. The regulator might not be the best home for public-information campaigns because of the trade-offs and confusion between its two roles and the possibility of undermining public confidence in its ability to protect their savings. The authority's budget, at best, will still be well less than 1 per cent of the financial-services industry's advertising spending. Regulating this information flow is surely far more important than the coverage that the FSA's budget will allow. Industry consortia, or some other public body, might offer a better way forward.

These policies will improve access to information, but is that sufficient to promote better retirement-income planning? The government has shied away from the obvious route

to improved pension provision: greater mandatory private coverage. It sees this as overly authoritarian. Also, there is a risk that compulsory contributions, by reducing current income, will be seen as a tax, and so will be unpopular.

However, people are unlikely to save voluntarily in a system unless they feel confident in it. Personal pension mis-selling, government mis-information over Serps, the Maxwell fraud and misappropriation of pension funds assets by government and employers have undermined faith in all parts of the pension system. It is unclear yet whether the improved protection of occupational rights under Pensions Act 1995 and government prompting to speed up compensation for victims of personal pensions have fed through to improved confidence. People are probably over-pessimistic about state pensions. Few expect to receive anything, while in all probability they will get their entitlement, although its purchasing power will be low. At the same time, they are over-optimistic about occupational schemes, widely promoted on the spurious claim that they will pay 'two-thirds of final salary'. Defined-benefit schemes inherently penalize early leavers, despite efforts to increase their portability. And the number of scheme terminations has increased since the minimum funding requirements *etc.* of the Pensions Act were introduced.

A second, over-arching problem with pensions in the United Kingdom is their complexity, with a mix of benefit formulae and providers. It is unsurprising that baffled people make incorrect decisions, or even ignore the issue of retirement-income planning altogether. For example, what should people do with occupational pension rights when they change jobs? One option is to 'preserve' the benefit in the old scheme. A second is to transfer it into a new occupational scheme, if available, either as 'added years' of coverage or as 'additional voluntary contributions'. Schemes have considerable leeway in how they treat transfers. A third option is to transfer the money into a personal pension or a 'free-standing additional voluntary contribution' plan. I need not go on. Most financial advisors, let alone individuals, could carry out the calculations necessary to make the optimal decision. And actuaries are very expensive.

The reform proposals make this still more complex, with stakeholder pensions as a fourth second-tier option (alongside occupational, personal and the new state second pension plans). The Treasury has added to the confusion with its pooled pension

investment scheme. This can be used either as an individual, voluntary retirement-savings plans, or a collective investment scheme for personal, occupational and stakeholder schemes.

Complexity has, in the past, arisen mainly from the need to accommodate existing private-pension arrangements, particularly defined-benefit occupational pensions. This perceived requirement held up the introduction of second-tier pensions throughout the 1960s and most of the 1970s, until the intricate contracting-out arrangements were developed. Occupational plans then dropped their opposition to Serps. At the time, this was sensible: the new public, pay-as-you-go plan would simply have substituted for part of existing private, funded benefits. And some employers might have chosen to close their occupational schemes. Now, it is just a complicating redundancy. A mandatory minimum contribution to all occupational schemes, with the investment return defined as that of the scheme as a whole, would be simpler. The minimum could match the contribution requirement for stakeholder schemes. Secondly, if the government seriously believed in stakeholder plans, it would close personal pensions down now. Its intention seems to be to allow them to wither on the vine. But there will be a long transition to this simpler regime.

What lessons are there for other countries reforming their pension systems? First, public information can have a role in preparing for and promoting reform. In the United Kingdom, the last Conservative government was fortunate that the public was relatively accepting of large-scale benefit cuts, perhaps dimly aware of the need to cut back on unsustainable commitments. There was some outcry at the proposed abolition of Serps in the mid 1980s, but this seemed to mean that its dismemberment was greeted as a reprieve with relief. Other large-scale cuts — equalizing women's pension age, price indexation of benefits and the Serps reductions of 1994 — attracted barely a whimper, although it was Labour Party policy until the 1997 election to restore earnings uprating. Secondly, public-information during a reform is essential to ensure people understand the choices open to them and the decisions they are expected to make. Thirdly, public-information concerns need to be addressed at their source by ensuring the pension system is as simple and easy to understand as possible.

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Useful web sites

Many of the references above are available from the Internet at the following sites

Axia Economics	www.axiaecon.com
Department of Social Security	www.dss.gov.uk
Financial Services Authority	www.fsa.gov.uk
HM Treasury	www.hm-treasury.gov.uk
House of Commons	www.parliament.uk
Institute for Fiscal Studies	www.ifs.org.uk
National Association of Pension Funds	www.napf.co.uk
National Audit Office	www.open.gov.uk/nao
Office of Fair Trading	www.oft.gov.uk
Personal Finance Education Group	www.pfeg.org.uk
Occupational Pensions Regulatory Authority	www.opra.gov.uk
World Bank pensions site	www.worldbank.org/pensions

Pension-information leaflets

The Department of Social Security's new series (all issued in 1998):

- 'Don't leave your pension to chance', no. PM1.
- 'You and state pensions', no. PM2.
- 'You and occupational pensions', no. PM3
- 'You and personal pensions', no. PM4.
- 'Pensions for the self-employed', no. PM5.
- 'Pensions for women', no. PM6.
- 'Understanding contracted out pensions', no. PM7.
- 'Making the most of your personal pension', no. PM8.

Other Department of Social Security products:

- 'Retiring?', FB6
- 'Benefits after retirement', FB32
- 'Giving up your right to retirement pension to earn extra', NI92
- 'A guide to retirement pensions', NP46
- 'Retired or widowed? Benefits you may be able to get', DV4 video cassette

The Financial Services Authority (FSA) also has a number of leaflets:

- 'Personal pensions: your choices before stakeholder pensions', August 1999
- 'FSA guide to the risks of pension transfers', July 1999
- 'FSA guide to the risks of opting out of your employer's pension scheme', July 1999
- 'FSA guide to the risks of pension transfers', July 1999
- 'Joining or re-joining your employer's pension scheme', July 1999
- 'Contracting out of SERPS', February 1999
- 'Your retirement: important information about your Serps opt out', February 1999
- 'FSA guide to pensions', January 1999
- 'FSA guide to boosting your occupational pension', January 1999
- 'Personal pension mis-selling: the facts', January 1999
- 'FSA guide to financial advice', January 1999