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FABIAN PAMPHLET 557

## Making Sense of Pensions



*by Matthew Owen  
and Frank Field*





# Making sense of pensions

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Pamph Coll.  
COLL.  
p 634

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Design: Tony Garrett  
March 1993  
ISBN 0 7163 0557 7  
ISSN 0307 7523

Printed by The College Hill Press Limited (TU), London and Worthing

Published by the Fabian Society, 11 Dartmouth St, London SW1H 9BN

# Types of pension

# 1

The one issue of social policy that we can assuredly say affects us all is pension policy. Even if we never claim a pension, we shall see a substantial proportion of our incomes used to pay state pensions and will, as likely as not, be a member of an additional scheme.

**B**ut for all this personal involvement, pensions remain one of the least understood issues. Standing, as pensions do, on the cusp of welfare and finance it is not surprising that their inclusion in public debate seems limited to the occasional scandal and the pigeon-holed investment specialist. Equally, many of the most revealing facts about the pension industry (such as that it owns and controls half of British industry) are some of the City's best kept secrets.

The first goal of this pamphlet is therefore to cut through the acronyms and jargon and place present-day pensions in a historical context. Without understanding how pensions have developed in response to social and economic changes in the past, it becomes very difficult to appreciate the demands and opportunities that contemporary changes will present.

As with so many pieces of social policy, current pension provision still bears traces of its nineteenth century origins. The most pervasive of these birth marks is not the distinction between private and public pension schemes but the separation of the flat-rate, basic pensions and earnings related schemes. Not only have each been very differently organised but in the minds of the policy maker they also have very different characteristics. The flat-rate pension, for example, was initially conceptualised as an allowance to prevent poverty in old age. In contrast, earnings related schemes were an attempt to spread wage wealth more evenly over the life cycle. This dichotomy continues to dominate all pension issues and confuses any attempt to arrive at a simple description of the pension system. For the purposes of this paper we shall treat these two forms of pension as thoroughly different. This is not simply a stylistic device, however, since the reforms the Government has been pursuing in the 1980s have progressively driven a wedge between the Basic and Earnings Related pensions. It is also easier to explain Earnings Related pensions if they are segregated from other forms of provision.

## *The Basic State Pension*

The contemporary manifestation of the flat-rate allowance for retired elderly people is the Basic State Pension. Although it is paid out universally to those workers who contribute to the National Insurance Scheme, its development is best described in terms of the elimination of poverty. Ever since writers like Charles Booth and Seebohm Rowntree first identified a relationship between poverty and stages in the life-cycle (such as old age or childhood) there has been pressure for the state to support the incomes of the 'deserving poor'. The relative success with which mass poverty among the elderly was overcome in the first half of the twentieth century owes much to the fact that old age pensioners were one of the very few groups considered deserving by polite society. Unlike the working poor or the unemployed there quickly developed a near consensus that retired individuals were worthy beneficiaries of "state charity". In 1908 the Government introduced a means tested non-contributory old age pension of 25 pence per week to people over 70. In 1919 the means-test was relaxed and the rate of pension increased and applications allowed from those receiving assistance under the Poor Law. In 1925 the first non-means-tested contributory pension scheme was introduced by Neville Chamberlain who, in so doing, set the foundations of the system to be adopted for the rest of this century. The scheme provided a flat-rate pension for people aged between 65 and 70 who were covered by the National Insurance scheme into which employees, employers and the state paid contributions.

This tripartite system of funding was endorsed by Beveridge and became the cornerstone of British social policy in the post-war period. Indeed, the Insurance principle remained sacrosanct up until the 1980s when the basic state pension was set according to retail prices rather than earnings. This move alone set in hand a deterioration in the standard of living for those pensioners who relied entirely on it.

Despite the difficulties pensioners have faced in the past two decades, they no longer compose the bulk of Britain's poor. In part, this is because the state pension has been one of the more successful weapons governments have used against poverty. Pensioners, after all, are a relatively easy group to target and the causes of their deprivation are relatively simple to understand. But it must be said that the declining *proportion* of elderly claimants of Income Support (or its forerunners National Assistance and Supplementary Benefit) can equally be explained by growing poverty among other groups. Families with children and the unemployed, for example, have suffered particularly badly amongst low-income group and have made up an increasing proportion of the claimants of income support especially in the last fifteen years.

## *Occupational pension schemes*

From the very start, the state provision of a basic old age pension was only

part of a dual approach to solving the problem of poverty in old age. Independent of state provision was the introduction by employers of occupational pension schemes for elderly, retired employees. For many years paternalistic employers had rewarded loyal and long-serving members of their workforce with discretionary retainers when they retired. These payments did not operate within a formal structure however and they were open to abuse by employers who could discipline employees by threatening to withhold 'pensions'.

The provision by some employers of occupational pensions has a long history. In the same year as the Poor Law Reform Act was passed, the first formal occupational scheme in Britain was initiated. In 1834 a Civil Service Occupational Pension Scheme was founded and, very gradually, others followed. By the end of the nineteenth century schemes existed for white collar employees in banks, railways, schools and some utilities but not to the same extent for manual workers, although some enlightened employers were active on this front. In addition Friendly Societies attempted to cater for the pension needs of skilled manual workers. These occupational pensions schemes were largely Funded Schemes, meaning that the contributions built up over members' working lives eventually paid for pensions. This entailed a long period when funds were built-up. Not surprisingly, when the first reliable national figures were published in 1936 by the Ministry of Labour it was found that while 2.6 million workers were in employers' pension schemes, only 200,000 pensions were currently being paid. In contrast 70 per cent of the three million people aged over 65 were then in receipt of some state pension.

When the basic state pension as we know it today was finally determined by the implementation of the Beveridge Committee's proposals in the 1946 National Insurance Act, fewer than 10 per cent of elderly people then received any income from Friendly Societies, Trade Unions or occupational pension schemes. Though it was little realised then, or by many on the Left now, by setting a flat rate minimum subsistence pension, the 1945 Labour Government's approach can be seen as a continuation of a system of dual pension provision which had characterised the British scene from the earliest days.

Less than a decade later the position was changing. By 1953 6.2 million employees had a right to some form of occupational pension although the coverage was still uneven. Higher paid workers were more likely than lower paid workers to be members of an occupational pension scheme, and many more male workers than female workers were acquiring such pension rights.

It was during this period that personal pensions were introduced with the 1956 Finance Act ensuring that those employees not covered by occupational pension schemes and the self employed could secure individual arrangements via Insurance Companies with similar tax advantages. Although these have boomed significantly in the 1980s, they became an established, if small, part of pension provision during the sixties and seventies.

## *State-run occupational pension schemes*

The other piece of pension provision which we see today was not introduced until 1978, although similar concepts had been touted by both Labour and the Conservatives since the 1950s. The State Earnings Related Pension Scheme (SERPS) was introduced by Barbara Castle and came into effect in 1978.

As a state scheme, the contributions individuals make to SERPS are paid into the same National Insurance fund that finances the Basic State Pension and Unemployment Benefit. Thus SERPS pensions are not technically funded but are operated on a pay-as-you-go basis. Contributions paid by today's SERPS members are hence used to pay today's pensioners. They are not invested for the future as in a personal pension scheme, but simply help the government meet its day to day National Insurance liabilities. For this reason there are potential problems being stored up for the future when present day SERPS members start to retire in bulk. If the future workforce is not paying enough in additional contributions to finance all withdrawals on the National Insurance Fund the government will have to increase its grant from taxation revenues or renege on its duties.

## *Reform in the Eighties*

Such criticisms about the cost of SERPS underpinned the Conservative reforms of the 1980s. In 1985 the Government published a Green Paper which set out proposals for the reform of social security, including changes in provision for retirement. A chief assumption of the paper was that SERPS was either too expensive now or would be in the future: "The certain and emerging cost of State Earnings Related Pension Scheme should give everyone - of whatever persuasion - pause for thought." The Green Paper made clear that alternative provision for retirement needed to be encouraged, and contained a belief that change would be welcomed: "The evidence is that members of occupational schemes place great value on having their own pension and suggests that those without would welcome an extension." The paper proposed changes to occupational pensions, together with new boosts for personal pensions. The intention of the proposals was: "to achieve a new partnership between the state and personal provision, in which the provision by the state and by the private sector are complementary rather than in competition. They will ensure that eventually every employee is able to contribute to his own additional pension to augment the basic state pension...Moreover, the increase in private investment and savings which will arise in the short-term should lead to a build up of assets from which the economy should benefit in the future."

The White Paper proposed to modify SERPS to reduce the emerging cost. In future, SERPS pensions would be calculated on a lifetime's earnings rather than the best twenty years, meaning significantly lower benefits for pension-

ners. The full effect of this change introduced by the 1986 Social Security Act will not be felt until the year 2022/3 for women and 2027/8 for men, as a definition of a "working life" does not begin until 1978. People retiring up until April 1999 will continue to have their pension calculated over the 20 years from 1978.

In addition to changes in SERPS, the Government's strategy included measures to encourage new occupational schemes. Employers would be allowed to contract out of the state scheme in return for a minimum contribution to their own scheme. Previously, an occupational pension scheme could only contract out of the state scheme if they provided a minimum level of defined benefits (known as a Guaranteed Minimum Pension) when a member retired. The 1986 Act introduced a new method of contracting out, establishing Protected Rights Tests for schemes that did not provide defined benefits but instead promised to contribute a defined sum to a pensioner's fund for retirement. This new rule allowed schemes to avoid paying a Guaranteed Minimum Pension as long as they make a minimum contribution to any member whose pension fund would be insufficient to provide a payout equivalent to a GMP. While this may sound confusing it is important to flag what is a fairly obscure piece of pension law since it represents a significant break with the state's previous policy of insisting the private sector provided minimum pensions.

The more familiar side of this innovation is the incentive that Government now gives to those who opt-out. Employers setting up new schemes and individuals taking out a new personal pension have been offered since 1988 a financial incentive on top of a National Insurance rebate that has attracted many millions of people to change the style of their pension provision.

All of these reforms induced important changes in the organisation of pensions, in particular over what sort of schemes people have joined. The biggest growth sector was Personal Pensions where five million people have joined schemes in order to contract out of SERPS. In total there are approximately 7.5 million personal pension contracts, so this sector may well start to dominate the industry; especially if group personal pensions continue to be such a popular form of providing new provision. Before looking at the changes that pension provision will be faced with in the future and highlighting issues for reform, more attention must be paid to how the industry itself actually functions.

# 2 How pension schemes work

As we have already said, the Basic State Pension and the State Earnings Related Pension are both operated by the government and share the same fund of money - the National Insurance Fund.

**A**lthough in character they differ greatly, they share a common and familiar bureaucracy. Both have also experienced a great deal of reform in the past decade and are relatively familiar to the public arena. The same is not however true of Occupational or Personal Pension schemes which remain shrouded in mystery or obscure jargon.

Like the first occupational pension schemes in the nineteenth century the majority of today's are Funded. Contributions are collected on a regular basis and invested in equity markets, government bonds and other capital ventures so at a later date these investments can be redeemed to honour pension liabilities. The major exceptions are occupational pension schemes for public employees such as policemen, local government officers and civil servants which are Unfunded (meaning no specific assets are held against future liabilities). These unfunded schemes require £7 billion to be raised each year to pay current pensions which will mean they are in danger of running into major problems in the next forty years when their liabilities start to boom.

For those schemes that are funded the most pressing question we need to ask is what actually happens to contributions after they pass into the pension fund. This depends on a number of factors, uppermost of which is the sort of benefit the pension scheme members have been promised. Final Salary and Money Purchase Schemes are the two types of scheme available from the occupational pension sector and the different benefits they offer to their members are fundamental to the structure of the pension industry as a whole.

## *Final salary schemes*

Looking first at Final Salary schemes the main point to stress is that the name could be seen as deliberately misleading. Fewer than ten per cent of Final Salary scheme members receive even the two-thirds of their final salary that the Inland Revenue allows. But even if you worked for a single company for forty years, paying contributions regularly into a final salary pension scheme,



it is quite possible that you would receive significantly less than two-thirds of what the scheme's name suggests. This is because the value of your final year's salary is just one of several years of employment that will be averaged. The average that is used as part of the calculation of a beneficiary's pension can cover up to ten years' past service, meaning pension income will often be much less than 'Final Salary'. Equally, the obscurity of the methods used to estimate entitlements and the penalties for early leavers makes it incredibly difficult for beneficiaries to calculate how much their pension will be worth.

A less misleading term for Final Salary schemes is therefore Defined Benefit or Pay Related since whatever else they promise, these schemes do deliver a guaranteed payout on retirement related in some way to the beneficiary's salary experience. Among other things this means that the value of the pension is assessed independently of the performance of the fund. Put another way, the pension member has no stake in the investments that are made with his or her pension contributions. So long as sufficient contributions have been made, members will be entitled to a pension calculated according to a formula arrived at by the fund's Trustees.

The significance of this point is perhaps difficult to grasp unless we know something of pension fund performances. This type of scheme has a number of benefits for members and it still dominates large occupational pension schemes. If, for example, the investments made with pension fund money have been consistently bad - such as during a period of sustained high inflation and sluggish growth - the fund may have to be topped up by the employer to cover its liabilities. In a final salary scheme this will not affect beneficiaries because it is up to the company to honour its commitments. Of course the flip side of this is that when equity markets perform especially well - as in the 1980s - pensioners have no right to share in the wealth creation that their pension contributions have generated. Instead the pension fund can make huge gains putting the scheme in surplus (with little or no extra cash going to pensioners). Pension funds consistently out-performed the FT-SE All Share Index in the 1980s, this index making it difficult for many funds to avoid passing into surplus.

As with so many terms in the pension field surplus is not all it seems. This is because the relationship between a fund's liabilities and its assets are not an objective fact. Instead they are very often in the eye of the beholder - or rather the actuary, who calculates how much the fund will have to pay out in pensions in the future and therefore how much it needs to cover its liabilities. There are, however, a number of techniques available to actuaries for assessing a fund's liabilities so it is quite possible that one actuary could claim a fund is in surplus while another that it is in deficit. Such problems of definition would not be so important if it were not for the effect they have on employers' contributions into their occupational pension fund. This is because if a fund is in surplus under the 1986 Finance Act it is quite legal for employers to take

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what are euphemistically called Pension Holidays - periods when the employer can effectively stop making or reduce any contributions towards his or her employees' pensions. Some observers believe this is fair because a fund in surplus usually means an employer has been over-contributing in the past. But this argument depends crucially on who is considered the owner of the fund. If, as many people (and many legal rulings) believe, pensions are deferred pay, then an employer who stops making contributions is no different from one who decides to stop sending out pay cheques every month. Since surpluses in excess of 105% of liabilities have increased in value from £529m in 1987/8 to £4.2bn in 1990/1, the significance of employees having no legal right to such gains cannot be underrated.

Other ways in which a pension fund surplus can be reduced include improving the pensions of current beneficiaries or reducing the contributions from employee members. While these two mechanisms receive as little publicity as pension holidays, they are obviously very important to the redistributive impact of surpluses. There is a further way of reducing surpluses which is to increase the pay of existing members. This would drive up their future pension entitlements and so reduce the size of the calculated surplus and has the effect of redistributing income wealth away from current pensioners. Again this is very significant in terms of how ownership of pension assets is defined since the members of the scheme have no choice as to how such surpluses are used.

### *Money purchase schemes*

The second type of occupational pension scheme also has two names: Money Purchase and Defined Contribution. The more common label of Money Purchase, like Final Salary, refers to benefits members can expect to receive upon retirement. But unlike a Final Salary scheme, money from the fund is not used directly to pay pensions. Instead, when a member of the scheme retires, a lump sum is taken from the scheme and used to buy Annuities from an insurance company. An annuity in its simplest form is a large block of money which is invested in return for a stipulated income for rest of the purchaser's life. This income comes partly from any investments the insurance company makes and partly from running down the lump sum. Whether or not an annuity turns out to be a good investment depends then on how long the individual lives and when it was purchased. If, for example, the pensioner dies just after retirement all the money goes to the insurance company. Equally if the annuity is bought at a time when interest rates are low - such as now - this can mean the income it can expect to yield will be much lower than if it was bought in periods of higher long-term rates.

The other main difference between Final Salary and Money Purchase Schemes is that money purchase contributions do not just go onto an aggregated heap. Instead, the money is put into individual pots in the name of each

member. This means individual members share proportionately in any investment gains or losses because it can easily be calculated how much money they have made or lost. Although this statement needs some qualification with respect to limits placed on pension income by the Inland Revenue, Money Purchase schemes find it far easier to pass on the benefits of good investment than Defined Benefit schemes. The second consequence of individual 'pots' is that the employer does not have to guarantee a level of benefits. Instead, the pensioners will buy, or have bought on their behalf, an annuity using money from their personal stake in the fund.

In short, the essential difference between defined benefit (Final Salary) and defined contribution (Money Purchase) schemes is that in the former the benefit is known but not the cost, while in the latter the cost is known but not the benefit.

As a percentage of the value of all occupational schemes, Defined Benefit schemes dominate, accounting for 86% of the largest funds. The huge overall value of assets in Defined Benefit funds is a consequence of large companies choosing this type of scheme. These companies have felt themselves large enough and financially stable enough to make guarantees to their workforce about the benefits they will receive and in the past have chosen Defined Benefit schemes. Smaller funds, while far greater in number, do not figure so significantly in fund-value statistics although there are in excess of 700,000 of them. The vast majority of these are Money Purchase schemes.

This dominance of Final Salary is unlikely to endure much longer. In the last twenty years, Final Salary schemes have reached a plateau with few new schemes being created. When such schemes reach maturity (that is to say their liabilities are gradually being paid off as members retire) they are increasingly being replaced with money purchase schemes because companies are now wary of giving long-term guarantees about pension benefits. For small and medium sized companies in particular, Money Purchase presents far less of a burden to the employer while still providing enough capital growth to pay employees pensions. Equally if price stability is maintained, the value of Money Purchase will not be eroded by inflation and they will become even more popular. An estimated 18% of new Money Purchase schemes are set up to replace Final Salary schemes, while only 0.01% of new schemes established during the twelve months to 1 June 1992 were Final Salary based.

## *Taxing pensions*

When occupational pensions were becoming regulated in the 1950s, the Government decided it was right and proper that people making provision for their retirement through private schemes should be encouraged. This was done using fiscal incentives that made pension schemes tax efficient ways of saving. These incentives took the form of tax relief on pension fund capital gains (made through investment) and the lump sum pensioners generally

receive on retirement. The cost of this tax relief to the Treasury now amounts to many billions of pounds. Although contributions into pension funds are untaxed, pensions themselves are taxed (and provided the Treasury with £3,500m in 1990/91).

At the same time as these incentives were being devised, politicians realised that individuals with a lot of spare cash might try and exploit these tax loop-holes by stuffing their pension scheme with money to avoid paying capital gains on any investments. For this reason the Inland Revenue decided limits should be placed on how much money people could put into funds and how successful the funds were allowed to be with investments.

These limits work through regulations on contributions. The first is known as an Earnings Cap and represents the maximum salary that can be taken into consideration for pension purposes, currently set at £75,000. Even more important are a second set of rules controlling the size of Additional Voluntary Contributions. As we have commented, very few pensioners can expect to receive two-thirds of their final salary when they retire because any mobility during their working life penalises their entitlements. For this reason it is possible to top up an occupational pension by paying into an Additional Voluntary Contribution scheme. These are individual money purchase schemes that can be used to boost future benefits. Unfortunately the Inland Revenue limits how much money can be placed in a AVC scheme to 15% of earnings and this includes existing contributions to a company scheme.

Such rules also make it very difficult for people to vary the contributions they might make to their pensions even though it is obvious that the amount of spare cash they have will change from year to year. This is most obviously the case when a pension scheme member wants to alter contributions in accordance with changes in his or her outgoings. The costs of child rearing or savings when children leave home are events most of the work-force experience. Yet present day regulations make it impossible for pensions to adapt. This means many thousands of households are unable to involve their pension contributions in their financial planning. This can paradoxically make pension schemes a very inflexible way of planning for retirement.

In a similar vein the Inland Revenue places limits on the value that a company scheme can climb to. As a condition of pension funds being exempt from investment taxes, surpluses which stand in excess of 105% of scheme liabilities must be eliminated if they are to retain their tax benefits. Put another way, funds are not allowed to be successful beyond a certain point. Liabilities are defined by the Inland Revenue as two-thirds of members, salaries, which is the maximum benefit a pensioner can receive. This means Money Purchase schemes cannot perform past this limit without losing much of the surplus to tax when annuities are actually bought. Final salary schemes do not even try to exceed the limit and simply take pension holidays if there is any danger of doing this. The ways in which excess funds or Over-Funded

schemes are eliminated is also a cause for concern since one of the more popular methods is to give a taxable cash refund to the employer. In such an event it is the employer who benefits from the pension funds capital gains while the members see nothing of the improvement in their assets.

Even in the 1950s this tax structure was considered a clumsy solution, but like so much legislation made in a hurry, it still survives intact. Any substantive pension reform package must include changes to this arrangement.

# 3 Who controls the money?

## *Trustees*

**T**he most important individuals in the pensions industry are the Trustees, the people who are nominated by the founders of the pension fund to control its activities in line with the interests of the fund's beneficiaries. In Britain most occupational pension schemes are set up as irrevocable Trusts. This means the control of pension funds operates under Trust Law, an ancient and inadequate set of statutes that date back to the Middle Ages. In those days, as now, their purpose was to protect the inheritances of individuals who were considered too irresponsible to handle their own money. In the enlightened Middle Ages this meant children and unmarried mothers. Today we have added to this group of irresponsible souls the majority of the British workforce, who are members of occupational pension schemes.

The major consequence of Trust Law is that trustees have absolute control of all assets in a pension fund. They also have the power to wind-up the fund, change member's benefits and nominate people to invest money on their behalf. Difficulties only arise when they decide to forget the interests of the beneficiaries and duly discover how easy it is to do with the pension funds what they wish. For example, under Trust Law, funds are entirely separate from the funds of the employer, so that if the employer becomes insolvent or goes into liquidation, the pension funds are not available to the company's creditors. In practice, however, the picture is not nearly as neat. For example if a company is collapsing there is nothing to stop trustees using pensioners' money to secure suspiciously cheap loans from abroad.

This was the scenario facing the trustees of a well known manufacturer of domestic appliances recently. As with so many occupational pension schemes senior management from the company sat on the board of trustees and hence had access to the funds. When the firm started getting in financial difficulties, it is alleged that these employer trustees, desperate to save the company they had spent much of their life building up, could not resist using pension fund money to secure implausibly cheap loans. It is believed that this was against lawyer's advice and the result was that loan securities of several million pounds were lost. The massive losses incurred by the pension funds of companies owned by Robert Maxwell is an even more famous example of this type of abuse.

Both these examples show that there are inevitable conflicts of interests if unscrupulous employers, or employers who are under great financial pressure, choose to abuse their rights of appointing and removing trustees. The domin-

ance of senior management on boards of trustees has rarely presented any problems. But the lack of legislative safeguards means there are no cast-iron assurances that funds will not be abused. Nor is there any legislation requiring external trustees to be appointed or even representatives of the workforce who own the 'deferred pay' in the pension funds. Indeed it is still not uncommon to find 'boards' of trustees composed of a single individual. These issues are all being studied at present by the Goode Committee which will make proposals concerning the reform of pension law later this year.

### *Investment managers*

In addition to laying down the duties of the trustees, a pension fund's trust deeds also set out their investment powers. Again, there are basically two ways in which fund money is invested. Either the scheme is insured, whereby trustees enter into a contract with an insurance company which in return for receiving a heavy premium will provide returns promised by the contract, or the trustees themselves become responsible for investing the funds. The latter investment strategy was used by both Bellings and Maxwell and is indeed the more common. In the tradition of pension jargon, the name for this type of investment policy - Self-Administered - is a misnomer, since in most instances it is not the trustee who chooses where to invest funds but professional investment managers.

Investment managers can be internal or external to the pension fund. That is to say, if a fund is sufficiently large - such as the pension fund covering the liabilities of postal and British Telecom workers known as Postel - it might employ a group of investment managers specifically to manage that one fund and no others. Alternatively trustees may go to external investment managers who are in the main based in large merchant banks or life assurance firms. Technically these funds are Segregated because they are managed on an individual basis. For smaller pension funds which cannot economically justify having their own segregated investment portfolio (since investment management fees are not modest) there is the option of Pooled Funds. These are also run by banks and life assurance companies which aggregate a number of smaller funds and manage them together.

Once an investment manager is chosen he or she is relatively free to invest the pension funds anywhere. One of the few conditions laid down in law concerning their investment strategies refers to what are called Prejudiced Investments. Prejudiced in this context simply means that investments can only be chosen on the basis of maximising income yield. It is, for example, illegal to avoid investing in South Africa for ethical reasons since this implies a prejudiced decision. Investing in apartheid could however be avoided because of political instabilities and the consequent financial risks. Equally a Coal Board pension fund cannot insist that British Gas shares are not bought, even if doing this will contribute to the destruction of the members' jobs.

## *What do pension funds own?*

The most startling fact about investment managers is the value of the funds they control. Pension funds own a great deal of something.

This 'something' is British industry.

A conservative estimate of the value of pension fund assets is in the region of £250,000,000,000 of which the bulk is invested in the shares of British companies. In addition, insurance funds own assets in excess of £125 billion. To put this in perspective, pension fund assets and insured pension policies make up half of the London stock market which is why we can accurately say the owners of pension funds are the owners of British industry. Half ownership is enough to give a group of investors a lot of power over the market but in the case of pension funds their power is exacerbated because of the disproportionately large stakes they command in Blue-Chip companies. Blue-chips are Britain's biggest and best firms - such as Glaxo, ICI or Sainsburys - that have consistently performed well and very much set the pace of the stock market. We stress power 'over the market' rather than specific companies because it is very rare for pension fund managers or trustees to become directly involved with company decisions. This is in spite of the fact that ownership of shares confers voting rights on the pension funds which means whoever controls them has a say over the management of individual companies.

The use of shareholders' voting rights to exercise influence over company decisions is known as Corporate Governance and its under-utilisation is one of the greatest failings of the British pensions industry. The reason for this neglect is in part apathy on the part of trustees and fund managers who claim it would be too time consuming to attend every Annual General Meeting that the fund has a stake in. In the words of Alastair Ross Goobey, who manages one of the country's largest pension fund and sits on the Goode Committee as an investment management expert: "Most institutional shares are not voted at Annual General Meetings [and] I have only ever had one client who insisted that shares owned by his fund were voted as a matter of course."

Pension funds are at present only concerned with maximising returns on investments in order that future liabilities can be met with the minimum contributions from employers. Furthermore, since this is the basis on which fund managers are assessed by trustees it is inevitable that fund managers will look for short-term gain and high yielding equities. Since reforms in the structure or management of a company usually take many years to institute it is not surprising that fund managers are not particularly interested in corporate governance. More alarming still, when a firm does invest in research and development, it is usually penalised by investment managers. This phenomenon was specifically singled out by Sir Ernest Harrison, chairman of Racal, who complained that he had an infinite number of research and development projects on which he could spend money, but that the effect on



his profit and loss account in the short run would be so severe that the investment managers would suspect that company had hit a particularly sticky patch and perhaps even sell the company out from under him.

Investment managers stand accused of relying upon a limited range of market indicators such as price/earnings ratios and dividend cover which will determine how accurately a share is priced within the market. Since issuing equity is one of the main sources of capital for British industry it is not altogether surprising that company finance managers will endeavour to do everything in their powers to make shares look attractive to buyers (in particular pension funds). This might include maintaining a dividend which is unrealistically high or window-dressing annual reports to conceal structural flaws - both of which force the company to work within a short-term time horizon.

Although this form of investment has been rigorously defended, it is difficult to see how a pensions industry whose principal aim is to reduce employers' short-term contributions can do other than foster an environment of short-termism in companies dependent on pension fund investment. Equally, when investment managers are assessed by their clients (the trustees) every six months it seems only natural that they will be wary of under-performing other managers for more than two or three years. Since the sort of long-term investment British industry crucially needs would not yield results for perhaps a decade, short-termism is inevitable.

# 4 Longevity and flexibility

By looking at how the pensions industry is organised institutionally, it is already possible to see some of its existing weaknesses and injustices. But when reform is considered it must be remembered that pension law is quite unlike any other responsibility of the legislature.

**F**or not only does it command huge funds whose ownership is an issue of contention, but any changes made now will not have their full consequences until well into the next century. Since this is well outside the time horizons of most MPs, pensions present one of the greatest domestic challenges to political parties.

For this reason, it is imperative that reform is only made within the context of the new demands that will be made of pensions. This section looks at three 'macro-social' changes that are already taking place in Britain, two of which are already widely discussed and one that provokes an embarrassed silence from most players in political debate.

## *Greying Britain*

One of the few certainties planners can rely on is that the British population is getting older. The ever growing number of retired people is a phenomenon familiar to anyone who has ever looked at the country's future prospects since the consequences of this demographic shift are immense. In health administration for example, demands for long-term care will continue to rise well into the middle of the next century. Equally, transport, leisure, town planning and finance will all shift even more to service the needs of the 'greying consumer'.

Behind this process lie two changes. The first, and most widely recognised, is the increasing longevity of Western Europeans. Although a very gradual process that has inched people's life expectancy up for over three hundred years, its acceleration in the post-war period has significantly altered the challenges social provision faces. As the recent debate about the statutory age of retirement has shown, sixty or sixty-five is far better considered as late middle age for the many people who can expect to live to eighty. Furthermore, since individuals in their 'fourth age' are likely to have far greater care

requirements than those younger, the merits of a pension system that makes little distinction between young and old pensioners are questioned.

The second change is in the overall structure of British society's age spread. Falling birth rates and progressive longevity mean the country's population is becoming increasingly top heavy, which has a crucial effect on the dependency ratio (the number of economically active people relative to those who are not). Since all pay-as-you-go models of state pension rely on a generational transfer of wealth from the active to the inactive, a changing dependency ratio can subvert the whole funding structure of social insurance. This is of course one of the reasons why politicians are so eager to temper the burden of the state pension - especially in an era of mass unemployment.

Pensions serve a dual purpose. They are a bulwark against poverty and a means of spreading pay wealth over the life cycle. It is therefore a measure of additional pensions schemes' success that OAPs are becoming more and more affluent, making them better able to plan and enjoy lengthening retirement. This success is equally born out by the very oldest and frailest pensioners, who suffer most because they gain nothing from such schemes. These pensioners are usually forced to depend on nothing more than the Basic State Pension and an Income Support top-up during years when their needs are greatest. As the government admitted earlier this year, the most recent available figures show that 61% of pensioners have an income of less than £5,000 per year and these are clustered among the over 70s. While we must recognise the success of the private sector in providing decent pensions, we must also be aware of the individuals who will one day fill the shoes of today's poorest pensioners if the wealth creation of the pension industry is not extended to those who at present are excluded.

### *The flexible firm and the flexible family*

This brings us onto the second 'macro-social' change that British households will experience in the years to come - occupational flexibility. By this we mean two things. First is the rise of the 'flexible firm' which employs practices aimed at enhancing its ability to adjust production inputs so that fluctuations in the level and type of demand can be better met. Although the concept of the flexible firm has been phrased in futuristic language (with terms like 'Post-Fordism' and 'Just-in-Time-Production') and has been greeted with optimism, the strategies used to attain flexibility usually mean profound disruption for the workforce. The increased use of subcontracting or self-employed workers are means of achieving so-called 'numerical flexibility', while 'pay flexibility' can mean anything from hiring predominantly part-time workers, who do not incur National Insurance costs, to replacing wage hierarchies with performance related bonuses. Such changes are now common to all areas of the economy and it is clear they have been on the whole successful in imposing flexibility upon the workforce.

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This trend is however also linked to a second manifestation of flexibility that derives from individuals' own choices about working patterns. The rising number of dual-earner families for example is inevitably going to continue and will demand ever more complex working arrangements. Childcare in particular will see new forms of provision when society finally adapts to changing family shapes that have emerged over the past twenty years. In a similar vein, individual preferences for home-working (often encouraged by firms wishing to minimise fixed capital costs) have generally meant skills have become more flexible, especially in the professional sector where consultancy and freelancing is now growing exponentially. Over the coming years this will extend across the whole workforce, altering working practices in every industrial sector. Finally, there is also evidence to suggest that the rise in the flexible firm and the flexible family has greatly reduced the amount of time individuals spend working in any one job. The Guardian's 'Why Work' Survey revealed that over the past twenty years, individuals' expectations of moving job in the next year have almost doubled and the number of people who think they will be in the same job in three years' time will soon be in a minority.

The consequences for pensions of a flexibly employed workforce are again numerous. As well as obvious changes such as self-employed workers taking up more personal pensions, there will be far more pressure on existing occupational schemes to improve the position of members who leave for other firms. The issue of transfer values therefore needs much consideration.

When occupational pensions were first set up, managers assumed, not unjustifiably, that workers would stay with their firm for most, if not all, of their working lives. The issue of what happened to the funds that a pension scheme member had built up when he or she changed employer and hence pension scheme was not really considered. Within the climate of company paternalism pensions were considered another benefit supplied on the condition of workforce loyalty. The job-for-life syndrome has of course declined although the pension industry itself has been much slower in recognising the phenomenon of the 'early leaver'. It was not until 1963 that the rights of pension scheme members were protected by statute when the Social Security Act made it mandatory for occupational schemes to "preserve" the pensions of a member who left over the age of 26 with 5 years' service. This meant these workers became deferred pensioners who still had a right to some level of pension when they eventually retired. Unfortunately at this time preserved pensions are not protected against inflation and so quickly lost much of their value. The position was improved in 1975 with inflation proofing but it was not until 1985 that occupational schemes were required to provide actuarially assessed Transfer Values. These are cash sums that are passed onto a new employer's occupational scheme when an employee changes job. Previous to 1985, it was up to individual schemes whether or not they did this.

Although legislation such as the 1986 Social Security Act has done more to

bring pension schemes in line with the demands of their members, there remain problems. In particular leavers who join new schemes often find their transfer value provides much less generous benefits than they were expecting. Much of the problem is that the actuaries who calculate the transfer value from the old schemes use different assumptions from those used in the new scheme. This means pension assets are eaten into every time an employee moves job, with the result that occupational pensions schemes have become a real hindrance to labour market efficiency.

# Issues for socialists

There are a number of issues which arise from this and which are sure to dominate the pensions debate for the remainder of the decade.

## *Universality versus targeting*

The largest single item in the entire government budget, as well as that in the Social Security budget, is the cost of the flat-rate retirement pension. It remains a crucial component of most pensioners' budgets but is only indexed to prices. Fifty years hence, its value will have fallen to around 8% of average earnings. Will Labour let the value of the old age pension wither away? Or is it going to commit itself to re-linking this pension to earnings even though this policy was in part responsible for losing the last election? Or will the party target generous increases in pensions to the poorest pensioners only?

## *Retirement age*

The pension industry, and European Community, is piling pressure on the government to decide when to equalise pension ages. Should the unified retirement age be set at 65, 67 or even 70 as a means of improving the dependency ratio? Or should the retirement age be brought down to 60 so as to 'vacate' jobs for those standing in the dole queue?

## *Poverty and old age*

The aim of SERPS was to break the link once and for all between old age and poverty. A growing number of private schemes no longer offer this as an objective. Should tax concessions be withdrawn from those schemes which do not offer a guarantee in this respect? Or should the standard flat-rate old age pension and SERPS be recast into a new state pension scheme?

## *Ownership of pension funds*

Through our pension funds we already own half of all equities (and thereby firms) quoted on the London stock exchange. How can this ownership be transferred to individuals? Can such a reform be achieved without breaking up the existing occupational pension schemes and the advantages they clearly bring to members? In what ways could a new pattern of pension ownership serve more effectively the long-term financial needs of British industry?

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## Making sense of pensions

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