Risk and Security in the Private Provision of Old Age Pensions

A Review of the Government's Stakeholder Pension Proposals

Deborah Mabbett
Department of Government
Brunel University
Uxbridge UB8 3PH

Email: deborah.mabbett@brunel.ac.uk

11 March 1999
1. Introduction

This paper investigates the issues involved in enhancing the propensity of people of working age to contribute to old age pensions. It asks what types of institutional arrangements serve to promote contributors' security and confidence that they will get something back from their pension savings. Current pension reforms in Britain are particularly concerned with encouraging voluntary pension savings, and this paper examines how initiatives by private providers might promote voluntary provision.

Clearly it is not adequate simply to address the problem of security by assuming that an investor in a private pension scheme is protected by contract, while one contributing to a state scheme is not. Such a position not only ignores the possibility of constitutional safeguards for contracts made with the state, but also neglects the fiduciary issues which have affected private pension arrangements. Furthermore, it is unhelpful simply to polarise political-constitutional security against civil, contractual security. Not only does the private sector offer a range of models of pension scheme governance and control (notably through the involvement of trustees), but also the state itself may contribute to the security of private contracts through the activity of a regulator. Security for pensions cannot, therefore, be a matter of state versus private sector.

These issues are very important to the current British debate over the development of 'stakeholder' pensions. The stakeholder arrangements are being formulated against the background of two quite different forms of private pension: occupational and personal. Contributors' claims are not secured by contract in defined benefit (e.g. final salary) occupational pensions. While the payment of contributions by the employee might be
thought to create a contract with the occupational pension provider, the benefits which would accrue on this basis would not be defined benefits. The security of defined benefits is derived from the trust established by the sponsoring employer, whereby the employer commits to making the necessary contributions to ensure that the pension reaches the pre-specified level.

This admixture of contract and trust creates some problems. Thomas and Dowrick note that "[b]eneficiaries under a pension scheme, unlike those in the family trust, are not mere donees: they earn their benefits from their employment duties and the contributions they make to the scheme" (1995, p.3). It can be argued that all contributions (not just the employee's) are paid pursuant to the contract of employment and constitute part of the remuneration package. This reasoning has led to criticism of the way that employers control pension trusts. One alternative is that occupational pensions should be made more `contractual', with clearer advance specification of employers' obligations to contribute, employees' rights on leaving, and conditions governing the preservation of benefits and uprating of pensions in payment.

However, experience with personal pensions suggests that the contractual model has limitations. While personal pensions are usually established under trust law, there are no independent trustees and the trust deed gives control over the funds to the pension fund manager. The relationship between the contributor and pension provider is basically contractual. Personal pensions have not been an unqualified success in Britain. Problems have arisen not so much from providers breaching contracts as from persuading people to enter unsuitable contracts and exploiting the `small print' of contracts. In such situations, the general principles of trusteeship might be used to modify or override unsatisfactory provisions in contracts.

An alternative to trusteeship is for the state to impose suitable contract terms on the parties. The Green Paper on pension reform (‘Partnership in Pensions’, 1998) includes proposals for the establishment of stakeholder pension schemes which meet minimum standards, some of which would be set by statute and others by a regulator. The proposal involves the
government giving its stamp of approval to a set of contracts which the private sector could then sell, i.e. reliably commit itself to. This 'partnership' between the state's supervision of contracts and the marketing effort and contractual commitment of the private sector would, it is argued, promote pension saving. The 'kitemark' (stamp of approval) is intended to give investors confidence that the product is good value. The minimum standards "will give a minimum level of protection and reassurance to potential scheme members that a stakeholder pension will provide them with a good basic deal" (DSS, 1998, ch 7, para 18).

We can see that, whereas trusteeship imposes standards of behaviour and rules of conduct on providers in order to protect contributors, 'kitemarked' contracts would work by proscribing the decisions of the providers and limiting their discretion. One basic condition for this approach to work is that the contracts should not need to be revised during their term, i.e. they should be resilient to future changes in the economic environment. It is therefore very significant that stakeholder pensions will be money purchase pensions; the government does not envisage guaranteeing good value in defined benefit terms. This is fundamental to the durability of pension contracts. Money purchase schemes are not vulnerable to the systemic crises which affect defined-benefit schemes because the rules allow the value of benefits to change as economic conditions change. In effect, money purchase contracts provide security about the terms on which pensions are provided ('rule security') but leave contributors exposed to risk about the living standard that their contributions will support in retirement.

What issues are involved in evaluating the procedural or governance-oriented safeguards of trusteeship and the rule security provided by contract? This paper examines the issues from several different perspectives. It begins with a brief overview of how contributors might assess procedural and contractual safeguards, and shows that the Department of Social Security (DSS) and the Treasury seem to have taken different views of this issue. It then turns to examine the institutions which are involved in personal pension provision and the nature of the products they offer. This discussion highlights issues around the discretion exercised by providers and how this might be reduced by the development of more transparent contracts. Section 4 turns to the implications for the government of regulating
pension contracts. It is argued that there are substantial problems of regulation inherent in the kitemarking approach. While these can be overcome by eliminating provider discretion, it is then unclear what the point of involving private providers in stakeholder pension provision is. Section 5 discusses some issues in operating the trustee model when a pension scheme does not have a sponsoring employer, while section 6 concludes that some basic issues around contributors' security remain unresolved.

2. Incentives and safeguards for contributors: two views

In undertaking a transition from defined benefit to money purchase pensions, one problem for the government is that the imposition of greater risk upon contributors will, if people are risk averse, reduce their willingness to contribute to pension schemes. Two quite different views can be taken of how to address this dilemma. One view focuses on incentives. Its starting point is the expectation (or hope) that self-interested people will make a rational and informed assessment of all the relevant risks. While there is a risk that pension funds will perform poorly, this has to be set against the virtual certainty of poverty in old age if contributions are not made. Furthermore, the kitemark should remove catastrophic risks (losing everything), as well as what might be called 'commitment risk' where a contributor's circumstances change (kitemarked schemes would allow flexibility to stop and restart contributions). Flexibility in allowing contributors to revisit their decisions, and 'transparency' in the form of ongoing information about the value of their accumulated funds and the pension they might buy, improve contributors' ability to manage the risks inherent in a money purchase scheme. Some of the risks arising from investment in financial markets can be reduced by holding a diversified portfolio of assets, while phased switching into low volatility assets ('lifestage switching'), flexibility in the date of annuity purchase and improvements to the annuity market can all reduce the risk of ending up with a low post-retirement income.

The other view of the problem rests on a different approach to human behaviour in the face of
risk and uncertainty. March and Olsen provide a summary, albeit in a different context. It "is built around ideas of identities and conceptions of appropriate behaviour. It assumes that individual action depends on the answers to three different questions: What kind of person am I? What kind of a situation is this? What does a person such as I do in a situation such as this?" (1995, p.7) This approach sees the task of increasing the propensity to contribute to a pension scheme as involving more than the calibration of appropriate incentives. The institutional structure of pension provision will also be important. Institutions which are seen as trustworthy and reputable may be able to ensure that people take out appropriate pensions. They could also gather and process financial information on investors' behalf, filtering out 'noise' from the financial markets and providing information about long-term trends and prospects rather than short-term developments. On this view, the institutions of pension provision are important in their own right, whereas in the 'incentives' view, they are just intermediaries with the task of ensuring that the individual responds appropriately to signals provided by the market and the state.

A consultation paper on stakeholder pensions put out by DSS in 1997 suggested that stakeholder pension schemes should be 'multi-member' schemes in order to reduce marketing and sales costs and the cost of individual advice (DSS, 1997, para 6). It went on to argue that "the fact that [personal pensions] are individual arrangements increases the difficulty of ensuring the effective protection of members' interests." In other words, it is argued that appropriate institutions are necessary to protect the interests of contributors as a group. These ideas are developed in the Green Paper, specifically in the proposal that stakeholder pensions would have to have an 'approved governance structure'. The structure envisaged in the Green Paper is that schemes would be established under trust law and supervised by a board of trustees. The Green Paper sees the trustees as providing ongoing representation of members' interests. They would be able to press for improvements for members after joining. This contrasts with an individual contractual approach in which as many relevant conditions as possible are determined at the time of joining, and revisions are achieved by negotiating new contracts, possibly with a different provider (thus relying on 'exit' rather than 'voice'). In the trust-based approach, the importance of making the correct decision about joining
would, in effect, be downplayed because the initial contract would be less important than good practice in the ongoing administration of the scheme (DSS, 1998, ch.7, paras 19 and 22).

The Green Paper also contains some interesting propositions about how stakeholder pensions would be sold (and, implicitly, the basis on which people will buy, i.e. contribute). It suggests that schemes would be based on existing membership and representative organisations. These ‘affinity organisations' would provide "a means of recruiting scheme members without the need for expensive advertising or sales-forces. The link with a known organisation can also increase people's confidence in a pension scheme. And the organisation itself provides a source for scheme trustees who can be expected to represent the interests of scheme members." (DSS, 1998, ch.7, para 66) This language clearly lends itself to an identity-based interpretation, such that people will contribute to a pension scheme if they see themselves as ‘that kind of person' in ‘that kind of situation'. Contributing to a pension would then be ‘appropriate behaviour'.

The significance of these nuances was brought sharply into focus in February 1999, when the Treasury released a consultation paper entitled 'Helping to Deliver Stakeholder Pensions'. This consultation paper sets out proposals for individual pension accounts designed to maximise flexibility and transparency. Contributors would build up their own pension funds held in the form of shares or units in unit trusts, investment companies and other collective investment schemes. Contributors would have a choice of funds, and fund managers would aim to maximise the performance of their funds. Performance would be measured (indicated) continuously by the value placed on fund units in the financial markets. A key feature of the Treasury's proposal is that the financial markets can facilitate transparency by yielding highly public information.

The Treasury proposal is to establish a simple product which the purchaser can understand and monitor. One difficulty is that contributors may not have the skills and knowledge to
perform their monitoring function very effectively. Furthermore, the long-term nature of the product may limit scope for consumers to `exit' when they are dissatisfied. To surmount these problems, regulations to allow switching between providers and ensure that transfers are not penalised are advocated. The Treasury proposals address the problem of `front-loading' of charges, which makes switching costly. The Treasury also emphasises the importance of education and improvement in the public's understanding of equity investment (Treasury, 1999, paras 15 and 16).

As government statements have emphasised, stakeholder pension schemes set up under trust could manage their funds by investing in collective investment schemes such as unit trusts, so the Treasury proposals are not incompatible with the Green Paper. However, the Treasury proposals mean that the establishment of schemes with a board of trustees could be redundant. The reason is that the proposal would allow individuals to attract pension contribution tax relief by buying units in collective schemes directly. It would no longer be necessary, as it is now, to channel such contributions via a trust.

The Green Paper and the Treasury consultation paper draw their images of potential stakeholder pension providers from different sources: the DSS from occupational schemes, the Treasury from the unit trust sector. Occupational schemes have several of the features which an institutionalist approach would deem desirable, such as governance by boards of trustees, an `affinity' basis of distribution (via the workplace) and (to a variable extent) an underpinning of security provided by the employer. Occupational schemes are given a warm write-up in the Green Paper, and money purchase occupational schemes will be able to be designated as stakeholder pension schemes (DSS, 1998, ch.7, para 28). However, the government's objective of increasing pension savings and scheme coverage means that new providers of stakeholder pension schemes are needed. The DSS proposal envisages that affinity groups might not necessarily be based on employment and that trustees might be drawn from social organisations, although it is not clear what these might be.
To understand the Treasury position, it is necessary to digress briefly on the different types of financial product under discussion. Collective investment schemes such as unit trusts, open-ended investment companies (OEICS) and investment trusts operate by pooling members' investments. Each scheme member owns units of the pool, which rise and fall in price in line with the underlying value of the assets owned by the scheme. The units are traded and prices are quoted. This means that contributors can buy additional units readily; they can also sell their units, although, since pension investments attract special tax treatment, pension units would not be convertible into cash (except possibly into cash pension funds). Nonetheless, trade in units may be valuable in enabling members to switch their investments at low cost. The Treasury's proposal is that people could build up their own pension funds by buying units in these collective investment schemes.

Under existing personal pension arrangements, contributors may buy units in funds managed by the provider. These arrangements differ from the Treasury proposals in three main ways. First, in existing arrangements, administration of the pension package is usually bundled together with fund management. (The reasons for unbundling these activities are discussed in section 4.) Second, units in the funds are not routinely traded, and the value of members' units is, therefore, not public information. Third, the assignment of returns to investors' accounts is not always done by a transparent process. The Treasury's proposal would change these features of current provider practice.

Existing personal pensions therefore satisfy neither the DSS nor the Treasury. The DSS view, stated in the Green Paper, is that existing personal pension schemes will not be able to describe themselves as stakeholder pensions, because they lack appropriate governance structures. Personal pensions will also not qualify for stakeholder pension designation under the Treasury's proposals. While personal pensions have inadequate governance according to DSS, they are insufficiently transparent to satisfy the Treasury.
3. The lessons from personal pension provision

The previous section showed that the government's proposals contain two views of how people might be persuaded to contribute to stakeholder pensions: an institutional DSS view and an individualistic Treasury view. These two views yield different parameters for and expectations of the providers of stakeholder pensions. For DSS, the important issue is whether there are affinity groups not based on employment which might take on an important role in pension provision. For Treasury, the problem is how to improve the transparency of pension arrangements and reduce the charges levied by providers, which, among other things, muffle the incentive signals coming from the government in the form of tax concessions on contributions to stakeholder pensions.

The two departments have developed their respective images of the ideal pension provider against the backdrop of existing large-scale provision of personal pensions, mainly by insurance companies. The nature of this provision stands as a challenge to the Treasury's proposals. The existing practices of personal pension providers are not highly transparent. Costs and charges remain high even after a decade of competition and innovation.

The differences between the Treasury's proposal and existing practices are most apparent in the case of insurance companies' endowment policies, of which the most important are with-profits funds. While with-profits funds are not the only type of investment that personal pension providers offer, it is useful to focus on them to highlight some issues about transparency and volatility versus 'opacity' and stability.

Endowment policies, which may be with-profits or without, offer a guaranteed value at maturity (e.g. at retirement). They are therefore an insurance product, although the guarantee may be very limited (e.g. that the money value at maturity will not be less than the money amount paid in). With-profits policies supplement this guarantee with annual and terminal bonuses. Whereas, in a unit trust framework, the assignment of investment returns to individual accounts is based on the pricing of the underlying assets in financial markets, an
insurance company declares bonuses on the basis of its judgment of past and prospective investment performance. The institution is accountable for ensuring that it meets `policy-holders' reasonable expectations' (PRE), and actuaries are expected to exercise their professional judgement in assessing PRE. Nonetheless, there are considerable variations between companies in bonus policy. Some aim to distribute most returns in the form of annual bonuses, while others prefer to manage uncertainty by waiting until maturity to declare a large terminal bonus (the difficulty with annual bonuses is that they are `reversionary', i.e. they cannot be retrieved from policy-holders if the value of the fund's assets subsequently falls). There is also discretion in setting transfer values: even if a fund commits to providing a `fair' transfer value (and many impose penalties), there are different ways of determining the value of the contributor's asset share. Whereas the Treasury's proposals would enable contributors to switch their investments between funds readily, with-profits investments are not really designed to be switched.

In recent years, the management of with-profits funds has come under critical scrutiny. In 1998, annual bonuses on with-profits policies were cut, reflecting lower expected yields over the next 5-10 year period, although terminal bonuses rose in 1998 due to growth in equity prices that year. `That sinking feeling in with-profits land' (Daily Telegraph, 9.1.99, B1) led the newspapers to ask questions about the methods used to determine bonuses. Several years earlier, a debate had sprung up in the actuarial profession about how to cope with the implications of the Unfair Terms in Consumer Contracts Regulations (SI 1994/3159). Among other things, these regulations attack contracts which impose fixed commitments on one party while allowing flexibility to the other. As explained by one actuary, "greater transparency and clear, rigid definitions of benefit structures are being demanded increasingly vehemently by the consumerist lobby, the media, and, most recently, Europe in the form of the European Union (Unfair Contract Terms) Directive, now incorporated into UK law. Many view these forces as irresistible, and impossible to accommodate within the current framework of most with-profits policies, which depend so heavily on the application of actuarial discretion." (Heeney, 1995, p.671) One particular problem which provoked debate
in the actuarial profession was the acknowledgement that providers `over-declared' (gave bonuses which were too high) in the early 1990s in order to boost their performance in league tables, i.e. as a marketing strategy (FT Money, Dec 12/13, p.1). Some actuaries felt that this strategy was justifiable, as marketing success would boost profits, and thereby boost with-profits performance. Others took the view that this "reduce[d] the with-profits concept to a form of lottery, which does nothing to enhance the standing of our profession and the life assurance industry" (Wright, 1995, p.685).

A contract-based analysis of with-profit funds leads readily to the conclusion that more transparency is needed, i.e. to support for the Treasury approach. However, it could also be argued that the provision of guarantees and smoothing of returns achieved by with-profits funds is valuable to investors, and that concerns about their administration could be met by more effective governance, for example through supervision by trustees who are independent of management (the DSS approach). In arbitrating between these two views, it is rather important to establish why the insurance companies have been successful in marketing discretionary products. Is it because the legal and regulatory framework has `steered' them in this direction, or does it reflect something about contributors' preferences?

This is a very difficult question to answer. To some extent, it is possible to identify legal rules and tax provisions have favoured insurance companies and limited the growth of unit trust-based pensions. However, the government has also contributed to the popularity of discretionary products in other ways which could be described as `preference-shaping’ and `institution-shaping'. The government has shaped preferences in the following way. The degree of riskiness which contributors feel able to accept depends on other components of their income in retirement, such as the basic state pension. The lower the basic pension, and the more reliant on their funded pension contributors are, the more risk-averse one would expect them to be. Thus the government could be said to have shaped the preferences of contributors towards smoothed and guaranteed products with its policy of reducing the basic pension relative to average income. The government has also affected the shape of the
institutions involved. The risk-management strategies available to pension providers are heavily influenced by the government's participation in the financial markets. For example, 'lifestage switching', which is the main risk-reducing strategy available as an alternative to with-profits investment, involves switching an investor's portfolio from equities to gilts or cash as the retirement date approaches. It therefore depends on an adequate supply of gilts and/or stability in the value of money. The government's monetary policy is 'institution-shaping' because of its effects on the risks investors face and the instruments available to manage those risks.

The responses of financial institutions to the DSS's Consultation Paper on Stakeholder Pensions (DSS, 1997) illustrated both of these processes. (An annex to the Consultation Paper posed 64 questions for respondents. The responses of institutions are noted in the following discussion by their answer number, except where general introductory comments are quoted.) On risk-aversity and the basic state pension, one can contrast the views of Friends Provident and the Midland Bank. Friends Provident argued that with-profits was "an ideal model" to ensure that some guarantee could be offered to investors, given that "equity investments alone will not match the investor's risk profile where he or she is reliant on the Stakeholder Pension as the sole or main source of retirement income" (A.27). The Midland criticised with-profits funds on the grounds that "they are not widely understood by policy-holders", and turned the argument that providers exercise discretion to improve security for contributors on its head, arguing that bonus fixing "leads to uncertainty of future benefits and confusion in the minds of policy-holders" (A.28). However, the Midland also argued for a universal retirement benefit set at a 'social minimum' which would be considerably more generous than the current flat-rate National Insurance Retirement Pension. With pensioners' incomes underpinned in this way, guarantees and risk-reducing investment strategies would not be necessary (A.27).

The role of the government in the financial markets - specifically, its capacity to offer financial instruments which would improve investors' security and reduce volatility without
reliance on the discretionary methods of the insurance companies - was picked up by a
number of providers in their responses to the 1997 consultation exercise. Several providers
considered the possibility that guaranteed products (including annuity products, also an area
affected by volatile returns) might be offered or backed by the government. Allied Dunbar
argued that guarantees would be possible if the government introduced new financial
instruments for providers, to enable them to match their liabilities. Eagle Star and the
Pensions Management Institute saw scope for the Government to provide guaranteed annuity
rates at retirement.

Not all providers were concerned about contributors' risk aversity and the effects of volatility
in the financial markets. The Association of Unit Trusts and Investment Funds (AUTIF)
argued that futures and options can be used to reduce end-date risk, with the benefit of "daily
valuations driven by markets and no discretionary judgments being applied" (AUTIF, p.12).
The submission from Alliance Trust Savings Ltd (ATS) indicates how financial institutions
outside the large insurance companies see themselves as having potential to provide a
transparent product at low cost, and are critical of the way the insurance companies have
performed. ATS argued for maintenance of individual accounts to maximise transferability
and to avoid "obstrification (sic) as has been the history of 'with profits' insurance policies"
(A.28). Volatility in returns could be managed through lifestage switching (moving assets
into safer investments near retirement) rather than with-profits smoothing, the former being
"clearer, fairer and not subject to abuse" (A.29).

The difficulty with accepting the views of the unit trust providers is that these are not major
retail institutions, so their analysis is not necessarily a good guide for the government as it
considers the types of pensions which may attract investors. Many retail providers
responding to the 1997 consultation exercise were aware of market research indicating that
low-income contributors, in particular, were concerned about risk and would seek guarantees.
The problem was considered at length in the Tesco Personal Finance submission. This
submission, prepared with the assistance of London Economics, assumed that regulation was
the key to preventing contributors from entering unsuitable contracts. It favoured transparency in providers' activities, which facilitates regulation by minimising problems of asymmetric information (where the providers conceal information from the regulator). Tesco noted that "[w]ith existing with-profits life policies, the smoothing process is very complex and non-transparent, making comparison and monitoring difficult for consumers and regulators alike" (Tesco, section 2.1.7., p.14). However, any pension product which offered guaranteed returns would introduce problems of comparing differentiated products, would pose regulatory issues and would require financial advice (section 2.1.8., p.16).

The submission did not resolve this dilemma, and it raised a further question about contributors' resistance to transparent but risky pension products. Tesco pointed out the very substantial cost, in reduction in average yield, of holding a guaranteed portfolio. The implication was that contributors should be educated not to seek guaranteed products. The submission argued that 'financially unsophisticated' contributors may not perceive the risks correctly and may therefore be unable to evaluate the risk-return tradeoff accurately (Tesco, p.17).

This analysis suggests another explanation for the popularity of insurance companies' pension schemes. While legal and regulatory factors and contributors' own risk-averse preferences have played their parts, it is also arguable that the institutions themselves have shaped contributors' decisions with their marketing and sales efforts and the nature of their advice. While Tesco suggested that providers should "employ their marketing expertise in promoting Stakeholder Pensions" with the "focus on reducing and simplifying information to aid customer understanding and minimise costs" (p.iv), there is no obvious reason why providers would choose to simplify products. Simplification may not be the best marketing strategy. Providers may find it more profitable to promote sales by engaging in superficial product differentiation (Financial Times, 4.2.99, p.25), leading to more complexity and, potentially, higher levels of administration costs. Guarantees are an important source of complexity and a major aspect of the insurance companies' marketing 'pitch'.
It is apparent that the reasons why the existing pattern of personal pension provision is opaque and costly rather than transparent and cheap are quite profound. While it may be desirable to create the legal opportunity for low-cost providers of transparent products to enter the market, it is far from clear that they will penetrate it substantially. The reasons for the current dominance of insurance companies' products go beyond the legal, regulatory and tax 'favours' they enjoy. They stem from contributors' risk aversity, the ability of the insurance companies to offer products which respond to (and arguably exploit) the desire for security, the lack of basic security from the state pension and the impact of the state itself on volatility and inflation risk in the financial markets.

4. The role of regulation

The discussion in the previous section has suggested that transparent, low-cost products will not necessarily achieve market dominance unaided. One response might be to restrict the availability of more opaque products through regulation. There is, as already noted, an affinity between transparency and regulation, because the regulatory regime must limit the asymmetry of information between regulator and provider to be effective.

Given that the aim of regulation is supposedly to benefit contributors, pension providers responding to the 1997 consultation exercise showed a remarkably strong desire to be regulated. Respondents emphasised that it was the pension product which should be regulated (by awarding a kitemark to pensions with certain features), not the sales process, marketing strategy or any other aspect of the provider's management. Kitemarking was seen as an alternative to an expanded trustee role. A number of respondents associated the trustee model with the administration of defined benefit occupational schemes, and they assumed that trustee functions would not need to be exercised in a money purchase scheme. Scottish Equitable argued that operating a money purchase scheme meant that "there need be no issues of exercising `trustee discretion'", and went on to suggest that "[h]opefully, there will be few areas of concern which cannot be covered by kitemarking" (A.38). Similarly, Pearl
stated that kitemarking of products would provide the necessary security, and added that 
"[t]he nature of Stakeholder Pensions is such that there is no need for trustees because there 
are no decisions which a trustee would need to take" (A.38). More generally, institutions 
indicated that they saw governance issues as being rendered redundant by tighter regulatory 
control. In response to question 38 ("What would be the most appropriate way of establishing 
Stakeholder Pension schemes so as to provide security for members and effective 
mechanisms for ensuring that schemes are run in the interests of members and participating 
employers?"), CIS stated that "[s]ome form of kitemarking or benchmarking of products by 
regulators would be the most appropriate" (A.38). Sun Life of Canada replied "[s]imple and 
easy to understand legislation and regulation" (A.38).

If regulation is the central process whereby contributors' interests are protected, this raises 
problems about whether the regulator will be able to operate effectively to ensure 
compliance. It is inherent in the involvement of private firms in stakeholder pension 
provision that some decisions will be taken and operations conducted out of sight of the 
regulator. If this was not the case (if providers were to be continuously monitored and 
supervised), it might be more efficient to give the task of provision to a state agency. This 
would enable the government to prescribe the incentive structure of the agency in all its 
details, thereby minimising the scope for conflict between the self-interest of the provider and 
the aims of the government. The development of an appropriate regulatory model therefore 
requires some explanation of why the private sector should be involved in stakeholder 
pension provision, why there should be multiple providers, and what the basis of competition 
between the providers (if any) should be.

The primary aim of the government is to maximise the number of people achieving an 
adequate income in retirement without aid from the government. To achieve this aim, the 
government seeks to promote a pattern of contributing to pension funds among the earning 
population, and to maximise the income these contributions bring in retirement. While the 
objective of promoting contributions is shared by providers, there are problems with the costs
of the marketing effort they make, and with how that effort is organised and directed. Providers may also aim to maximise the income they earn from fund management rather than the return on funds accruing to investors, leading to excessive trading. The regulatory challenge is to design structures which utilise private sector effort while minimising the scope for opportunistic behaviour by providers.

While the submissions reported above saw regulation as an alternative to internal governance, it can be noted that an appropriate structure of internal governance could greatly ease the task of the regulator. The governance structure might, for instance, include some internal checks and balances which can substitute for monitoring by the regulator. Furthermore, internal governance would be consistent with the exercise of discretion by the institution, whereas reliance on regulation means that the provider's activities must be as transparent as possible. For example, trustees could prevent fund managers engaging in excessive trading to maximise commissions (internal governance), or the regulator could prevent such activity by requiring passive fund management (transparency).

Few submissions from financial institutions to the stakeholder pension consultation exercise endorsed passive fund management (Tesco was a notable exception) and the Treasury's proposal for unit trust-based delivery endeavours to reconcile active fund management with transparency. It does this by `unbundling' fund management from retail provision (collection of contributions, maintenance of accounts). Unbundling and passive fund management are alternative ways of dealing with the problem that claims made for active fund management may reduce competitive pressure on administration charges. (Contributors might pay high administration charges in the expectation of getting a higher return on their investment.) Unbundling ensures that high retail costs cannot be concealed by investment returns. It might also drive down fund management costs by creating competition between fund managers to attract business from retail providers.

One reason for Treasury to avoid the prescription of passive fund management is that the
elimination of competition between fund managers would be a major step towards rendering competition between providers redundant. However, this remains a logical consequence of stringent kitemarking, as some of the submissions in 1997 recognised. If all the pension products on offer are essentially the same, there is no basis of competition and no role for contributor activism (transfers between providers) once charges are equalised. AXA Sun Life observed that, provided members could stay in their scheme when they changed employer, and given adequate kitemarking, "there should be no need for transfers to be common" (A.34). An even stronger position was taken by The Association of Corporate Trustees (TACT), who argued that "[i]f the system is to be as cheap and simple as possible transfers should be prohibited, whilst recognising that this makes the ongoing monitoring role even more important" (A.35).

The dilemma in establishing the regulatory regime is as follows. Kitemarking will restrict the competitive strategies which firms can adopt by setting many of the parameters of the product being sold. Restrictive kitemarking appears to be necessary because it is easy to envisage ways in which providers' competitive strategies will worsen contributors' well-being ('consumer detriment'). However, the more restrictive the kitemark, the less point there seems to be in the presence of multiple providers.

One implication is that it may be more efficient for the regulator to establish a structured competitive process in order to obtain information about the potential efficiency of the sector. Competition for the benefit of the regulator could be organised by competitive tendering for licenses or franchises to run stakeholder pensions. The Pensions Management Institute (PMI) argued that there should be only a limited number of providers in order to achieve economies of scale, and that they should obtain their licenses by competitive tendering (section 8). The regulator's monitoring function would be eased by not giving too many licenses. PMI suggested that licensed organisations should have to produce an Annual Report for the Regulator and publish their results in national newspapers (section 7). The advantage of this arrangement would be that the regulator could use competition to obtain information, without
that information being muddied by the extraneous responses of consumers. Furthermore, the market would not have to rely on consumer activism (in the form of transfers between providers) to be efficient.

The case for franchising serves to illustrate the unimportance of the providers in the Treasury proposal. One of the features of transparency in this context is that the contributor can see right through the provider to the product which lies behind. Only limited trust in the provider is called for (e.g. to perform standard accounting functions, credit contributions correctly, etc). Transparent products do not require a high level of provider reputation for markets in them to develop. As many aspects as possible about how contributors' money will be managed are determined by rules set out in advance, and, ideally, alternative contracts can be evaluated by contributors without advice (especially advice from the provider).

By contrast, the providers are important in the 'institutional' DSS proposal. The individualistic approach emphasises competition as the rationale for having multiple providers, and is defeated if it can be shown that choice and exit will not ensure that provision takes a form which is responsive to the needs and preferences of contributors. The rationale for having multiple providers in the institutional model is that the different providers cater for different affinity groups. The emphasis is on plurality rather than competition. It is assumed that people participate in different social networks, and the different providers are supposed to connect with these. Reputation has an entirely different role in the institutional approach: the provider is expected to offer and advise on pensions with the backing of its reputation. However, this approach will only work with appropriate internal governance; it is not consistent with relying completely on regulation.

5. Trusteeship
At the time of the 1997 consultation exercise, the then Minister for Welfare Reform, Frank Field, had put forward the idea that stakeholder pension providers should be constituted as mutuals (the reasons are discussed in Mabbett and Bolderson, 1998). It was perhaps with
some relief that the financial institutions saw off this idea and grappled instead with the preference of the Undersecretary of State with responsibility for pensions, John Denham, for a trustee-based approach.

Some submissions from financial institutions commented positively on the potential role of trustees. Colonial UK/ Unity Trust Bank suggested that "the Schemes would be best established as trusts with the board of trustees including representatives of members, such as trade unions, and of employers" (A.38). NPI also referred to the occupational pension model in suggesting that "[m]embers should be given the opportunity to take part in managing their Stakeholder Pension Scheme. This could be achieved by Stakeholder Pensions being set up under trust and having Member Nominated Trustees." (A.38) Organisations which are particularly involved with occupational, rather than personal, pension provision were more likely to contemplate the trustee model favourably. For example, Bacon and Woodrow, actuaries with a strong presence in the occupational scheme market, argued that schemes should be run as trusts with sponsor and member representation on the trustee board.

A crucial issue for the practicality of these proposals is to establish where the trustees might come from. The provisions in the Pensions Act 1995 for member-nominated trustees (MNTs) for occupational pensions would not be easy to apply to non-employer based schemes. For example, employers meet the costs of MNTs in occupational schemes, providing time off work and also arranging training. The existence of established representational structures (unions) facilitates the election of MNTs. For the TUC, there was no question but that stakeholder pensions would be employment-based, and it gave firmly union-oriented answers to questions on governance and affinity, adding for good measure that "an individual life company or retail outlet should not be permitted to provide a stakeholder pension by itself" (A.49).

However, while existing occupational schemes might provide a starting-point for the development of stakeholder pensions, one of the challenges for future pension provision is to
combat the tendency for employer-sponsored scheme coverage to decline. It might be attractive to the government to loosen the links between employment and contribution. A number of responses to the 1997 consultation paper pointed out the possibilities for making pension contributions out of more liquid savings vehicles (such as ISAs) and for family members to make contributions on each other's behalf, rather than always linking contributions to earnings. However, breaking the link between contributions and employment leaves a "governance vacuum". While people may be sufficiently loyal in their shopping habits to be said to belong to a Tesco or Sainsbury "affinity group", there are no representative organisations attached to their membership and no established processes for selecting representatives. It is difficult to envisage what sorts of non-union representative associations might be appropriate for pensions, although local authorities have suggested that they could contribute to the governance of local and regional schemes.

Even if these obstacles could be overcome, effective trustee governance could still face a "free rider" problem. It may be that few people would be willing to invest time and effort in governing a scheme, given that only small benefits would accrue to them as individuals, while many "passive" members would benefit from their efforts. Some submissions were very dampening about the prospect that members would become involved in the running of their schemes. Norwich Union observed that its "experience with the smaller scheme market is that many employers and certainly most potential members given the choice would not want to be involved in the operational governance of their current scheme. Most would prefer to rely on others to make all the choices and decisions for them." (A.38)

For DSS, a discouraging feature of the responses to the consultation paper was that many providers did not attach importance to affinity groups. Direct Line Life (DLL), a relatively innovative recent entrant into the industry, offering a simple pension product, was unimpressed by the concept of affinity groups, stating that "[w]e see Stakeholder Pensions as intrinsically individual plans for consumers" (A.49). However, Tesco did place importance on the development of new marketing and distribution channels, and saw itself as an affinity
group benefitting from a high-trust relationship with potential contributors. It argued that new providers "will already have strong, regular relationships with a range of customers stretching well beyond the traditional clientele of financial institutions. The familiarity and untarnished reputations of such non-traditional pensions providers may help them to attract many customers." (p.33). In some ways, this is a curious argument for Tesco to put forward. It suggests that factors such as affinity and reputation, rather than just low cost, will affect contributors' choice of provider. In identifying a marketing advantage coming from access to loyal customers, Tesco implicitly endorses the DSS view that the importance of multiple providers stems from their ability to connect with different social groups and networks.

6. Conclusion
Both the Treasury and DSS proposals for stakeholder pensions contain implicit critiques of the performance of the private sector in providing personal pensions in the past, but both envisage delivery of pensions in the future by the private sector. Both proposals are therefore dependent on private sector responses for their success. The Treasury's proposals rest on sponsoring the development of new providers (gateways to unit trusts) in place of the discredited insurance companies, while the DSS proposals invite current providers to reform themselves for the new era.

It was argued in the introduction that one reason for privatising pensions is that private providers may have a better reputation than the state for adhering to contracts. This is particularly important, where, as in Britain, the level of compulsory pension contributions is rather low. While private providers receive some compulsory contributions through the contracting-out mechanism, they are also charged with attracting additional pension savings. Privatisation is meant to make pensions more `saleable'.

The Treasury appears to have a very straightforward view of what will make pensions sell. Basically it is that an investor will buy a pension if its discounted expected value exceeds the
present value of the cash in hand. Transparency is needed to evaluate the investment. A transparent financial product is one where the purchaser can see exactly what s/he is getting. This will not be a commitment to provide a fixed pension (a sum certain in money), but the transparent product will set out the basis on which the pension is determined by reference to easily verifiable information from the financial markets. The Treasury view is that this is an attractive product. Provider institutions do not have an important role in this model. One preoccupation of the Treasury is with reducing the fees and commissions levied by financial institutions. These fees capture some of the tax incentives which the government offers to investors, thereby reducing the effectiveness of the incentives. The underlying orientation of the Treasury is statist, in that the central focus is on how the government can encourage saving.

The bundle of concerns wrapped up in the DSS proposals is more difficult to summarise succinctly. There are differences with the Treasury on how to promote contributions and on the social role of the pension providers. Instead of assuming that people will contribute to pensions if it is in their financial interest to do so, the DSS proposals are consistent with the view that people will contribute if it is the norm and expectation that they do so. Thus DSS advocates a requirement on employers to provide access to a stakeholder pension scheme for all employees, and seeks the involvement of affinity organisations in promoting and administering stakeholder pensions.

In the institutional approach taken by DSS, there are elements of trust as well as contract in the relationship between providers and contributors. Not only may the provider offer and advise on choices with the backing of its reputation, but the provider may also invite investors to leave various decisions to it, i.e. to give it discretion. The exercise of discretion acknowledges the inequality between providers and investors, rather than attempting to combat it. Contributors are expected to rely on the skills and knowledge of the providers. Clearly this calls for appropriate internal governance: providers must be subject to a control structure which ensures that contributors' interests are put ahead of providers' self-interest. The existence of such control structures would reduce the burden placed on regulatory
control and compliance.

Competition is the achilles heel of the Treasury proposals. Whereas the internal governance approach relies on effective trustees, the transparency approach relies on the regulator to achieve an effective structure for competition if it is not to degenerate into a system of state control. In effect, competition is what makes it ‘worth bothering’ with multiple providers in the transparency model. However, the operation of competitive processes in pension provision is highly problematic. Contributors lack vital information with which to evaluate providers, creating scope for opportunistic behaviour by providers to achieve a competitive advantage. This makes the kitemark very important, but an important limitation of the kitemarking approach is that the private pension providers may come to be seen as little more than agents delivering a state-sponsored product. (This is particularly apparent in the franchising suggestion.)

The Treasury and DSS proposals present a series of oppositions: between transparency and discretion, contract and trust, regulation and internal governance, competition and plurality. Underlying these oppositions are different views about how people will best bear and respond to the risks of private funded pension provision. The institutional and regulatory regime established by the government could have a strong effect on the propensity to contribute to stakeholder pensions. In particular, it must be acknowledged that the frequency of changes to government policies affecting pensions may itself have a negative influence on the propensity to contribute. It is therefore important to ask whether the policy regime envisaged in the Green Paper is likely to be stable, or whether it will come under further pressure for reform. Focusing specifically on money purchase pensions, the issue is whether private money purchase arrangements are sustainable. At first sight, the answer would appear to be yes. On a formal, contractual level, it does not matter whether the stock market booms or busts, as the scheme promise only the pension the fund will purchase on maturity, rather than promising benefits defined by reference to past earnings or wage-earners’ current living standards.
However, we have seen that, even within a private system, there are different ways of assigning returns to contributors. These have developed partly in response to the volatility of financial markets. Volatility will tend to undermine the claim that private funded pensions give contributors a ‘fair’ return on their contributions, because it generates arbitrary fluctuations in income. It does not take much imagination to envisage the government intervening where the performance of pension funds or the terms offered in annuities markets seem to be leading to outcomes which are ‘unfair’. (The Telegraph's recently-launched campaign to highlight the impact of falling annuity rates is called “Fair Deal for Annuities” (Daily Telegraph, 20.3.99, B1).) A number of submissions to the 1997 consultation exercise suggested that the government should support the development of private funded pensions with appropriate financial instruments. It is doubtful whether the government will really be able to leave pensioners' incomes to be determined by contracts and markets.

In regulation theory, it is argued that long-term investment by the private sector requires precommitment by the government to safeguard an adequate rate of return (Levy and Spiller, 1996). This applies to pension schemes because contributors are called upon to make irreversible investments. There are different ways of achieving precommitment to protect contributors, such as giving independence to the regulator and setting down key principles in legislation. Strong private institutions representing the interests of contributors may also constitute a check and balance in the formulation of policy. One function of these different institutional devices would be to ensure that policies on taxation and state benefit entitlements, as well as monetary and financial policies generally, are operated to protect contributors' interests. It is unlikely that stakeholder pensions will attract a high level of voluntary contributions without more commitment by the government to improve contributors' security in retirement.
Acknowledgements:

My thanks to Gwenllian Williams of the Pensions Review Team at the DSS for her prompt response to my request for copies of submissions to the 1997 consultation exercise. Thanks also to Helen Bolderson, Jim Tomlinson and Barbara Waine for helpful comments.

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