Pooling of DC Pensions

UK occupational pension provision is switching from defined benefit (DB) to defined contribution (DC) and this change needs to be managed carefully. The Green Paper contains some useful proposals, especially on gradual retirement and tax, but has not addressed numerous vital pension issues. For example, have we structured our DC system in the right way? Why do we mainly offer DC pensions individually, or in small groups? The costs of doing it this way are high and DC pensions are not benefiting from the economies of scale that could come from pooling. Are the investment options in DC properly structured? Do members understand what the implications of lower DC contributions really are? There are important challenges to be met in switching away from DB. DC is a very different type of system and is not working optimally in the UK.

In the past, those with occupational schemes (around half the workforce) just did not need to worry about their pension. They knew what the employer would provide and could plan accordingly. But this will now change. Individuals are losing huge potential benefits and have not really appreciated the true cost of providing final salary pensions in the UK. For example, the value of a £10,000 a year public sector final salary pension for a married man aged 60, is around £250,000 (Taxpayers take note, we will all have to pay higher taxes for public sector workers' pensions!) Replicating DB pension promises will be extraordinarily expensive within a DC environment and without some changes, our DC pension system will not provide adequate, good value pensions in the future.

The important elements which will determine the eventual level of DC pensions are:

1. contributions
2. charges
3. investment performance
4. annuities.

As regards contributions, employers have usually used the move from DB to DC as a smokescreen for cutting pension contributions. This is effectively a large pay cut. If less money is being contributed for them, they will end up with lower pensions. Individuals then have various options. Either they should consider extending their working lives, or make up the shortfall themselves by saving more, or lower their expectations of retirement income. This debate is urgent and employees affected by this should be taking independent financial planning advice. They must now take responsibility for their future income, rather than relying on employers' final salary schemes. Better financial education and better access to advice are essential!

Charges deducted from pension plans – investment management, brokerage, administration, commission etc – are high. Government introduction of stakeholder pensions has pushed charges down, but we can learn from other countries, like Australia, which have structured their DC pensions more efficiently. The fact that DC pensions are often managed in small pools, or individually, causes charges to be much higher than under DB. I believe we should encourage pooling of pension plans. This could be on an industry-wide or profession-wide basis, regional, or even age-related. Pooling of assets should lead to significant cost reductions, due to the benefits of economies of scale and better buying power by large groups of consumers.

Investment design of DC pensions in the UK has also not been adequately focussed on. The asset allocation profile has generally been quite primitive. DC plans often have only one default option, but this will not suit everyone. Large pools could provide an array of different default options, suited to particular types of people. For example, funds designed for younger individuals, those nearer retirement, an index-linked option, a high risk option and so on. This may help people feel more comfortable about investing in a pension. At the moment, they often find the task too difficult and operating individually leads to poor value. The Sandler suite of products could perhaps be adapted for these purposes.

Finally, the workings of the annuity market need to be urgently improved. It is disappointing that Government is still just *consulting* on annuities. Action is required. First of all, people are not choosing the right annuity for their circumstances and secondly, they are not getting a good rate. Both these elements could be addressed by ensuring everyone buying an annuity receives independent advice before they buy. Of course, buying annuities in large groups, as part of pooled schemes, should also improve their value.

In summary, we are moving to a DC pensions environment, but the Green Paper has not fully risen to the challenges which this entails. Ensuring people appreciate what contributions levels are needed, improving financial education, improving access to financial planning advice for middle income groups are essential elements, but resources are not being sufficiently devoted to this. Encouraging pooling of pension assets in DC – perhaps by industry, profession, union, age or even region – should improve consumer buying power and lower costs. We are trying to run our system too much on 'individual' lines, but the costs of this are prohibitive.. Mis-selling, overcharging and exit penalties have severely damaged confidence and it would be much more sensible to manage pensions collectively, rather than individually. This should reduce charges, improve consumer buying power and deliver better pensions.