

The Growing Importance of Personal Pensions in the U.K. Pension System

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1. Introduction

Loss of income due to aging, death, injury and illness is a constant risk throughout the human life cycle. People generally prepare for this contingency on their own, supplemented with the safety net provided by the social security system.

The United Kingdom – a nation considered a leader on social security issues – is attempting to meet the economic demand due to aging and other factors by reducing the role of social security (public pensions) and encouraging greater private sector activity to fulfill people's needs in this area.

Due partly to the public's strong interest in the pension system's role as the primary guaranteed form of income for the aging population, both the government and private sector have implemented major institutional changes in the past few decades. Many interesting issues have been raised in the process.

The operation of a pension system that emphasizes private sector activity is of particular interest to Japan, where the population is aging at an accelerating rate. This paper examines the public and private pension situation in the U.K. to glean possible lessons for Japan.

2. Outline of the U.K. Pension System

The U.K.'s rather complicated pension system consists of the following three categories.

- (1) *Public pension* – This category consists of the basic pension, which is available to everybody, and the State Earnings Related Pension Scheme (SERPS), which covers employed persons. Both schemes are operated on a pay-as-you-go basis.
- (2) *Occupational pension* – Offered by private and public sector employers to employees, this category consists of defined benefit, defined contribution and hybrid type schemes. Most

large companies offer defined benefit pensions.

(3) *Personal pension* – This type of pension is available to self-employed persons and persons who do not participate in an occupational pension. In general, this pension type is a defined contribution plan that complies with the Income and Corporation Taxes Act of 1988 (ICTA 88).

Members are allowed to contract-out or replace the SERPS portion of their pension with an occupational or personal pension scheme. There are 7.5 million participants in the earnings related scheme, 9.3 million participants in contracted-out occupational pensions, and 5.5 million participants in contracted-out personal pensions.

The U.K. Pension System

Voluntary personal pension				
Earnings related voluntary contribution				
	Occupational pension	Contracted-out occupational pension	Contracted-out personal pension	Personal pension
Earnings related pension (SERPS)				
Basic pension				
Employed persons (incl. public employees)				Self-employed persons

The basic and earnings related pensions are public schemes; the rest are private schemes.

Source: Pension Fund Association, *Corporate Pension Systems Abroad* (1996).

(1) Public Pensions

In the U.K. public pension system, the basic pension scheme was established by the 1946 National Insurance Act (implemented in 1948), and the earnings related pension scheme by the 1975 Social Security Act (implemented in 1978). Since both are forms of social security, all persons with income above a certain level are required to participate by paying contributions.

In principle, funding for public pensions comes from the contributions of members. Employees and employers each pay a separate contribution proportional to the employee's income, while self-employed persons pay a fixed contribution. For example, the employee's contribu-

tion rate is 2% of their weekly income for the first 64 pounds (approximately ¥12,800), and 10% for the rest. The employer pays a sliding contribution rate of 3% to 10% based on the employee's income.

As for pension benefits, the basic pension provides fixed national minimum benefits to self-employed and employed persons alike (starting at age 65 for men and age 60 for women). The maximum benefit is approximately 65 pounds (¥13,000) per week.

For the earnings related pension, benefits are proportional to the length of participation and average income, and benefit payments begin at the same time as the basic pension. Specifically, the calculation is as follows.

Pension value = Average income exceeding minimum level (after reevaluation) x Benefit rate
(20%) x Sliding rate

During participation in the scheme, income is reevaluated according to a sliding wage scale, and benefits are adjusted according to a sliding inflation scale.

As aging progresses, concerns about the financial future of the pay-as-you-go public pension system have prompted the government to aggressively promote the contracting-out of SERPS to the private sector.

The contracting-out system has existed ever since SERPS was introduced in 1978. It allows superior occupational pensions that provide larger guaranteed benefits than SERPS (and meet other conditions) to be used in place of SERPS, and waives payment of corresponding contributions. Private sector pension management received a big push when the contracting-out system was expanded in 1988 under the Thatcher government, reducing contributions of employers (with contracted-out rebates) for individuals who have contracted out.

The promotion of privatization through the contracting-out system, along with the containment of public pension benefits (by shifting from a sliding wage scale to a sliding inflation scale in the 1980s, and reducing the payout ratio of SERPS from 25% to 20%), are expected to keep contribution rates in the U.K. lower over the long term than in Japan and other industrialized countries.

(2) Occupational Pensions

Because occupational pensions enjoy tax relief for contributions and reserves, they must satisfy statutory requirements (contribution maximums for employers and employees, pensionable

age, etc.) and receive regulatory approval. Occupational pensions consist of the following categories.

1. *Defined benefit plans* – Benefits are linked to length of service and income (for example, each year of service is equivalent to 1/60 of the final income). To guarantee benefits, the plan assumes investment and other operating risks.
2. *Defined contribution plans* – Employees contribute a fixed portion of their income to the plan, and receive pension benefits based on what the fund has earned at the time of retirement. Thus members assume investment risks while they are in the plan.
3. *Hybrid plans* – This type of plan combines features of the defined benefit and defined contribution plans. For example, in some plans, benefits are based on the higher of final salary or accumulated contributions, while others provide benefits for both final salary and accumulated contributions.

As of 1997, defined benefit plans were most common, comprising 80% of the total, followed by defined contribution plans at 14%, and hybrid plans at 6%.

However, the defined contribution pension market has been growing due to factors such as the rising operating costs of defined benefit plans since the 1980s due to inflation, expansion of the contracting-out system to include defined contribution plans, and stricter regulation of defined benefit plans in the 1995 Pensions Act (including stronger protection of benefit rights by stipulating minimum reserve requirements).

Under these circumstances, occupational pensions are being supported by two types of schemes: (1) self administered schemes, in which assets are invested by trustees and (2) insured schemes, whose investment medium is insurance policy.

Generally, the self administered scheme is used by large companies, and the insured scheme by smaller companies. In recent years, life insurers have been aggressively undertaking self administered schemes by establishing managed funds (an investment contract by which an insurance company offers participation in pooled funds) through their asset management subsidiaries.

(3) Personal Pension Schemes

Introduced in 1988 by the Conservative government, personal pension schemes are a defined contribution plan (available to self-employed persons and some employees) that allow individ-

uals to make pension provision.

Public interest in personal pension schemes grew when the contracting-out system was expanded in 1988, allowing the contracting-out to personal pension schemes. Employees who are members of occupational pension schemes could also voluntarily contract out to a personal pension scheme.

Tax-free contribution to personal pension schemes are allowed within limits (17.5% of income at age 35, and 25% of income at age 50), and investment earnings are tax deferred during the accumulation period.

Appropriate personal pension schemes, which are those that can be used by members for contracting out, are managed using national insurance rebates (received for contracting out) and additional contributions (by employees, and also possible by employers). Specifically, members of appropriate personal pension schemes can manage investments until retirement by allocating national insurance rebates to a protected rights fund, and additional contributions to a personal fund.

Savings products are offered by: (1) life insurance companies, (2) fraternal societies, (3) unit trusts, (4) building societies, and (5) banks. More specifically, life insurers primarily offer dividend-paying or unit link annuities combined with term life insurance, while unit trusts offer investment trusts, and building societies offer deposit management plans (guaranteed minimum variable interest rate deposit accounts). In the diverse and competitive market for personal pension schemes, life insurers have a lead due to their early start selling annuities to self-employed persons prior to the introduction of personal pension schemes.

With respect to pension funding at retirement, the requirement to purchase life or other annuities from life insurers (or fraternal societies) gives life insurers an overwhelming edge at the payout period.

3. Sales of Personal Pensions and Related Issues

The conservative government's deregulation of the pension system in the late 1980s gave employed persons flexibility to choose from among SERPS, occupational pension, and personal pension schemes.

Since the introduction of personal pension schemes in 1988, the government has aggressively promoted the contracting-out system (particularly a shift to personal pensions), while life

insurers have also campaigned to increase sales. As a result, personal pension sales grew rapidly, reaching five million policies by 1993 (the initial estimate of the potential market was 21 million persons).

However, problems arose regarding the appropriateness of selling personal pensions to potential and current members of occupational pension schemes. Life insurers were criticized for misleading people to buy personal pensions even when occupational pensions were more appropriate and collecting lucrative sales commissions.

The situation deteriorated to the point that the regulatory authority, the Securities and Investments Board, was prompted to call on the industry (including brokers) to acknowledge these detrimental policies and provide compensation.

However, the determination of whether an occupational pension or personal pension is better for any particular individual is not a simple matter.

For example, a defined benefit occupational pension scheme offers guaranteed benefits as well as any employer contributions. However, disadvantages include limited benefits (two-thirds of final income, and unfavorable benefits for early retirement), possible failure of the plan, and inability of members to become involved in investment decisions.

Advantages of personal pensions include portability and flexibility to adapt to changing environments, no maximum contribution (if investment performance is good), ability to make investment decisions, and preferential government policies (2% government subsidy for a limited time). On the negative side, benefits are not guaranteed (members assume the investment risk), and voluntary employer contributions are rarely encountered.

Thus in deciding which plan best meets their needs, individuals must first consider their particular situation (age, employment stance, investment stance, company's prospects, etc.). Whether the decision arrived at is best ultimately is determined at retirement time.

Despite the complexity of the problem, the industry began acknowledging damages and providing compensation on a priority basis (starting with phase 1 for retirees and older employees). Progress was slow at first due to the intricacy of the problem and difficulties such as collecting customer data. But the pace picked up as Prudential and other companies tackled the problem standing on the consumer's side, and phase 1 of the operation was completed in 1998. Phase 2 then began for cases with the next highest priority level (younger persons, etc.), and is still in progress.

Government estimates put the total compensation costs at around 8.4 to 11.1 billion pounds (approximately ¥1.6 to 2.2 trillion). However, the industry insists that costs can be covered with the internal reserves (contribution of lapsed policies) of life insurers, and that the rational expectations of present policyholders for dividends will not be compromised.

However, the fact remains that the personal pension problem has caused damage to the life insurance industry, and the industry's aggressive stance to resolve the compensation issue appears to be paying off in regaining the public's confidence.

4. New Movements Toward Pension System Reform

The U.K.'s privatization policy for the pension system has basically produced the desired results of stabilizing public pension finances and expanding the private pension market.

In 1997, after coming to power for the first time in 18 years, the new Labor government compiled its long-standing plans for pension and social security reform in a green paper entitled *A New Contract for Welfare: Partnership in Pensions* (December 1998).

The green paper's basic position is that the present pension system is inadequate because: (1) it does not cover socially underprivileged persons (persons needing long-term care, unable to work, earning low income, etc.), and (2) it is also not optimal to present workers. The labor party spelled out its policies to provide coverage for underprivileged persons, while encouraging the middle class to become more self-reliant.

More specifically, the Labor party raises the following points:

1. Low-income persons earning less than 3,300 pounds a year (¥660,000) do not pay national insurance premiums, and cannot receive the basic pension or SERPS (but instead receive other public assistance). Pension funds are also not being provided for persons engaged in long-term care and those unable to work.

2. The present pension system is also disadvantageous to present workers due to the following circumstances:

Changes in the pension system – Maturation of the occupational pension scheme (due to the decline in public sector employees, etc.), and the shift from defined benefit to defined contribution plans.

Greater labor market mobility – Increases in persons with three or more job changes, self-employed persons and part-time workers, and small businesses who have difficulty providing occupational pensions.

Personal pension plan problems – High front-end charges limit use by low-income earners and persons who cannot pay contributions on a continuing basis.

Against this backdrop, the green paper proposes the following measures to assist persons who otherwise would not have retirement income, and provide present workers with more savings alternatives.

- (1) Abolish the earnings related public pension, and introduce a New State Second Pension that assures a minimum retirement income for low-income earners.
- (2) Introduce low-cost stakeholder pension schemes to encourage persons capable of saving to do so.

In the green paper, the timeline for reform calls for introducing the stakeholder pension scheme by April 2001, and the New State Second Pension by April 2002. Five years after the stakeholder scheme has been introduced and becomes established, the second pension is to be shifted to uniform benefits.

The life insurance industry will be impacted by the introduction of the stakeholder scheme. Life insurers will come under pressure to improve management efficiency because: (1) the stakeholder pension has a low cost of operation (fee restrictions will be added to the qualifications, promoting competition among participating institutions), and (2) the stakeholder pension is a defined contribution plan with high portability and flexibility (penalty-free transfer of savings, unrestricted ability to stop and resume contributions). More specifically, since the stakeholder pension is a low-cost product aimed at low and middle income persons, companies traditionally strong in this area such as Prudential will need to improve the efficiency of their sales force to withstand cost competition in the sales channel.

These changes in the pension system may conceivably prompt companies to seek alliances that help expand their business in the pension market (or at least survive). One notable recent development was the acquisition announcement by Lloyds TSB, one of the top four banks, of the U.K.'s seventh largest life insurer, Scottish Widows. This move within the Bank Assurance group appears to be aimed at improving the competitiveness of both companies in the pension market.

5. Conclusion

Aside from slight modifications concerning underprivileged persons, Labor's pension reform proposals are basically consistent with the privatization policy pursued by the previous Con-

servative government: introduction of the stakeholder pension scheme would promote the goals of self reliance and competition among private financial institutions.

For users, the emergence of an inexpensive and flexible alternative will expand the available choices. Life insurers and other financial institutions will in effect be handed the task of exercising their ingenuity to develop more efficient and diverse products.

Labor's reform proposals may undergo changes before coming to fruition. But one thing is clear: the pension business itself is entering a new stage. Attention will continue to be focused on developments in the government and among financial institutions.