

# UKSA

UK SHAREHOLDERS' ASSOCIATION

The independent voice of the private shareholder

## **UKSA's Response**

**To**

**the DSS consultation document**

**A New Contract for Welfare:**  
**Partnership in Pensions**

**30 March 1999**

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## **A. SUMMARY**

### **1. Introduction**

The UK Shareholders' Association is the only democratic and independent body representing private shareholders across the UK.

We are strongly supportive of the reforms proposed in the consultation.

### **2. Reforming Annuity Rules**

We should like to see further liberalisation of the rules for annuity provision, for all forms of private pension savings:

- Savers should only be obliged to buy an annuity sufficient to provide an adequate retirement income and should be free, if they wish, to keep the remaining assets invested and to withdraw funds when required, taxed as income.
- Savers who wish to continue working should be allowed to defer part or all of their annuity purchases at least until the age of 80, or even indefinitely.

### **3. Stakeholder Pensions: Low Costs and Charging Standards**

The proposed charging limits on stakeholder pensions should specifically include the 'total expense ratio' for underlying investment funds, rather than just the funds' 'management fees'.

Stakeholder scheme trustees should not be allowed to accept commission payments on behalf of the sponsor, in return for directing the business of fund management, scheme administration, insurance provision or annuity sales to a particular provider.

### **4. Stakeholder Pensions: Insurance Benefits**

All Stakeholder Pensions should be based around pure investment vehicles. Any elements of insurance should be optional extras, for members who chose to subscribe to them, or paid for by the employer as an additional and separate employee benefit. They should be kept completely separate from the investment funds.

### **5. Occupational Schemes: Compulsory Membership**

We oppose measures that might pressure employees into joining occupational schemes.

However, savers should be encouraged to take advantage of suitable schemes, and not to reject the scheme benefits without considering the consequences. We agree with the proposal that any employee wishing to opt out of an employer's occupational scheme

- 'will be given a clear statement of the rights he or she is giving up and has to confirm explicitly his or her wish to opt out of the employer's scheme';
- 'has to certify that he or she has adequate alternative provision' (ch.8,para.13)

### **6. Education and Trust: Better Information about Annuity Options**

All money-purchase schemes should be required to ensure that their members are aware of their right to choose an alternative annuity provider.

## **B. DETAILED RESPONSE**

### **1. INTRODUCTION**

The UK Shareholders' Association is the only democratic and independent body representing private shareholders across the UK.

The Association does not claim to represent savers in insurance funds and collective funds, with the exception of investment trusts. Some of our response (sections 2 and 5) is concerned with allowing savers greater control over their own savings, and is therefore of direct relevance to our membership; we are responding on other issues because we believe our role, as a body representing savers, allows us to combine focused investment knowledge with a consumer perspective.

We are strongly supportive of the reforms envisaged by the consultation. There are clearly major problems with Personal Pensions, which have decimated the savings of a large proportion of their contributors. The consultation addresses some of those problems (though not all), while the Stakeholder Pension proposals should provide a low-cost and flexible alternative for many people whose needs are not met by the pensions industry today.

In particular, we support the following characteristics of the Stakeholder Pension proposal, which should not be diluted:

- the two-tier structure, in which trustees are responsible for putting the interests of the membership ahead of the interests of fund managers and have total freedom to invest those funds in the most competitive and appropriate funds available;
- the low-cost regulatory environment;
- the restrictions on levels of charges, and also on complex and obscure charges;
- the total absence of penalties for savers who vary contributions, suspend contributions or transfer to other schemes;
- freedom for employees to make their own savings arrangements if they do not wish to join an employer's scheme.

## **2. REFORMING ANNUITY RULES**

Chapter 11 of the consultation acknowledges that 'many people want to retire when it suits them', and states that, from the year 2010, people will be allowed to defer taking their state pension for as long as they wish (ch.11, paras.35-36). We assume there are funding implications that prevent this measure from being introduced at an earlier stage.

Chapter 8 considers the options for people in Occupational Pensions who want to phase in their retirement between the ages of 50 and 75.

However, the consultation does not address another issue which is of urgent concern to many savers approaching retirement, and which currently discourages many younger savers from making adequate private pension provision: the existing obligation to transfer most of their pension savings into annuities by the age of 75.

Annuities ensure that the saver's income will not fall or cease during retirement. However, a high price is paid for that certainty:

- annuities generally provide a far lower level of total return than is available from stockmarket investments, resulting in a much lower level of retirement income;
- there is also nothing left in the fund to cover the extra cost of long-term care, should it become necessary.

**We should like to see further liberalisation of the rules for annuity provision, for all forms of private pension savings.**

**Our view is that savers should only be obliged to buy an annuity sufficient to provide an adequate retirement income<sup>1</sup>, and should be free, if they wish, to use any remaining sum as they see fit, for example:**

- to provide a higher level of annuity provision;
- to buy health insurance, long-term care insurance &c.;
- to keep those assets invested in the scheme and to withdraw funds when required, taxed as income.

**On the death of the saver, we would expect any remaining sum to become part of a spouse's pension assets or to be subject to tax as an inheritance.**

**We also believe that savers who wish to continue working should be allowed to defer part or all of their annuity purchases at least until the age of 80, or even indefinitely.**

This would be consistent with the reforms allowing people to defer taking their state pensions indefinitely, but could be introduced much earlier because it would not require state funding.

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<sup>1</sup> We have not attempted to define an appropriate level for an 'adequate retirement income', although it might reasonably be related to the retirement income available from a Second State Pension.

**3. STAKEHOLDER PENSIONS: LOW COSTS AND CHARGING STANDARDS**  
**(Chapter 7, paragraph 33)**

**(a) Including 'total expense ratios' in the percentage charge limits**

We welcome the basic proposition that simple charging structures, and limits on the permitted levels of charges, should be imposed for Stakeholder Pensions.

We note that the limit on charges 'will cover all normal operating costs of the scheme' (ch.7, para.32).

**We ask that this limit should specifically include the 'total expense ratio' for the underlying investment funds, rather than just their 'management fees'.**

It has recently become evident that the percentage management fees quoted by collective fund managers significantly understate the true costs to investors, because they do not normally include the costs of administration, fees for legal, audit and trust work and (in the case of investment trusts) directors' remuneration.

Recent research<sup>2</sup> has shown that savers in unit trusts pay an average of 15% more than the quoted annual fee, once the full costs are taken into account. However, the total cost for some funds was found to be more than **double** the stated annual management fee<sup>3</sup>.

Clearly, any regulatory limits on charging structures will provide little protection to pension scheme members if the figures on which they rely can understate true costs to such an extent.

The concept of 'total expense ratio', which includes these costs as well as the basic management fee, is rapidly becoming more widely understood in the UK.

We note that collective funds in the USA are required by law to disclose their total expense ratios. In the UK, by contrast, there is no such requirement and the only expense acknowledged in most fund marketing literature is the annual management fee.

It is, of course, impossible to predict a fund's total annual expenses in advance with absolute certainty. However, where the total expense ratio of an underlying fund caused a Stakeholder scheme to exceed the permitted level of charges it would be reasonable to require that the excess be reimbursed.

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<sup>2</sup> UK Fund Charges, published October 1998, Fitzrovia International Ltd., 4 Brook St, London W1Y 1AA

<sup>3</sup> Examples quoted are:

	Annual Management Fee	Total Expense Ratio
Homeowners Investment Growth	1.5%	3.67%
Five Arrows Asian Opportunities	1.5%	4.69%
Jupiter Far Eastern	1.5%	3.49%

**(b) Ensuring that decisions affecting the membership are not driven by commissions**

The consultation 'would welcome views on whether standards should be set in any other areas and on the specification of the standards discussed here' (ch. 7, para.33).

One major issue that is not addressed by the Stakeholder Pension standards is commissions, paid to scheme sponsors in return for directing the business of fund management, scheme administration, insurance provision or annuity sales to a particular provider.

The impact of commissions on investment management charges and scheme administration charges is clearly limited by the proposed charging limits. However, the consultation document does not mention any similar safeguards to protect scheme members when their scheme savings are converted into annuities - another area where high commissions are rife; and the long-term impact on members could be very considerable if an investment manager is chosen on the basis of commissions to the sponsor, rather than on the basis of investment performance.

Of course, schemes that are genuinely being run in the interests of members will not accept commissions from fund managers or administrators, or from annuity providers. However, it is naïve to believe that the trustees will always disregard the interests of their sponsors (usually an employer). The various legal battles over pension fund surpluses have demonstrated that some employers are keenly interested in profiting from their pension schemes, or in recouping their costs - especially after hostile take-overs - and that some trustees will allow them to do so.

An obvious way for employers to benefit from their pension schemes is to accept commission from finance houses in return for providing them with the business of scheme administration, fund management or annuity sales.

**In order to ensure that trustees supervise the schemes solely for the interests of the members, and that they seek out the best value for their members, we ask that stakeholder scheme trustees should not be allowed to accept commission payments on behalf of the sponsor, in return for directing the business of fund management, scheme administration, insurance provision or annuity sales to a particular provider.**

Since many life assurance funds, collective funds and annuity providers have commission costs built into their charging structures, it might be necessary to allow commissions on annuities, provided that they were reimbursed direct to the members concerned, and to allow other commissions provided that they were transferred directly into scheme funds and not offset against costs or paid out to the sponsor.

#### **4. STAKEHOLDER PENSIONS: INSURANCE BENEFITS** **(Chapter 7, paragraphs 74 to 80)**

The consultation document states that Stakeholder schemes will be based around 'money purchase' rather than 'final salary', but that 'it is also consistent with schemes which choose an insurance arrangement to offer some elements of guaranteed benefits, or for pensions to be paid by the scheme itself, subject to meeting any charging limits' (ch.7, para.74). This indicates that schemes could be based around insurance products.

We recognise that there is considerable concern about the lack of certainty associated with pure investment money-purchase schemes, where the final benefit is largely dependent upon investment performance.

However, schemes that are mainly based around guaranteed benefits create major difficulties which are fundamentally incompatible with some of the basic Stakeholder Pension principles, in particular:

**A simple charging structure:** products that combine investment and insurance are notoriously opaque, and it is difficult to see how they can be reconciled with the clear and simple charging structure that is proposed elsewhere: for individual members, actuarial calculations can have as great an impact on the actual benefits as the declared charges.

**Comparability with other schemes:** schemes that are based around guaranteed benefits cannot readily be compared with pure investment schemes, or (unless they offer identical benefits) with one another.

**Portability:** almost all insurance-based schemes penalise savers who do not remain with the scheme for the full term. Much of the penalty arises out of commission and sales costs, which should be minimised within stakeholder schemes, but it is an unavoidable, inherent characteristic of insurance schemes that the guaranteed benefits only come into play if a policy is held to term. Employees who move frequently between employers with such schemes, and who transfer their pension savings from scheme to scheme as they go, will see their savings progressively savaged - just as employees moving frequently between final-salary occupational schemes find their savings savaged today.

Life insurance cover is a very important benefit, which employers and other scheme sponsors should be encouraged to offer, along with other insurance benefits. However, such benefits should never be integrated with stakeholder pension investment funds.

**We ask that all Stakeholder Pensions be based around pure investment vehicles. Any elements of insurance should be optional extras, for members who chose to subscribe to them, or paid for by employers as an extra employee benefit. They should be kept completely separate from the investment funds, so that there can be no confusion between the investment charges and the insurance costs, and so that there is no risk of the guaranteed benefit element being paid for out of investment fund returns.**

**5. OCCUPATIONAL SCHEMES: COMPULSORY MEMBERSHIP**  
**(Chapter 8, paragraphs 8 to 14)**

We support the decision not to force savers to increase their contributions to pension savings, once basic pension needs have been provided for. Our own members value highly their existing freedom to invest their own savings as they see fit, through their homes, their businesses, life assurance, collective investments and direct shareholdings.

We oppose measures that would pressure employees into joining occupational schemes, since this may prevent savers from choosing to invest their own funds as they see fit, and since there are many circumstances in which a saver may be better off rejecting a poor-quality employer's final-salary scheme in favour of more flexible low-cost alternatives.

Many savers have no need for the expensive services of a financial adviser; they should not be pressured either to accept their employer's scheme or to waste their valuable time and savings on unwanted financial advice.

**An employee should not be required**

- **'to show that he or she has taken advice about his or her pension arrangements',**  
**or**
- **'to show that his or her advice confirms that his or her alternative provision is adequate or equivalent' (ch.8,para.13)**  
**before being allowed to opt out.**

However, we recognise that many savers fail to take advantage of generous and suitable occupational pension schemes, because they have been badly advised or because they fail to recognise the importance of saving for retirement.

**Savers should be encouraged to take advantage of suitable schemes, and not to reject the scheme benefits without considering the consequences. We agree with the proposal that any employee wishing to opt out of an employer's occupational scheme**

- **'will be given a clear statement of the rights he or she is giving up and has to confirm explicitly his or her wish to opt out of the employer's scheme';**
- **'has to certify that he or she has adequate alternative provision' (ch.8,para.13)**

We note that 'adequate alternative provision' will not always take the form of pension savings.

## **6. EDUCATION AND TRUST: BETTER INFORMATION ABOUT ANNUITY OPTIONS**

**(Chapter 10, paragraphs 19 to 26)**

The consultation rightly considers the need for savers to understand their pension options, and to be offered 'trustworthy, clear and impartial information'. (ch.10,para.2).

Proposals are made for 'Improving information given by private pension providers' (ch. 10, paras.19-24), and for using a 'Good Practice Workplace Code for Pensions' (paras.25-26) to ensure good-quality pension information for employees. This is also touched upon under the 'Quality in Pensions' heading (ch.8).

However, none of these sections specifically mention the need for savers to be aware of their options when pension savings are converted into annuities.

At present, many retiring savers suffer from an effective absence of competition when buying annuities - because those savers are simply unaware that they can choose an annuity other than the one to which they are directed by their pension scheme provider.

Providers can profit from directing their scheme members to uncompetitive annuity products, knowing that a significant proportion of those members will simply accept what they are offered; meanwhile, those members can suffer a significantly lower retirement income, because they are not aware that they can shop around.

Clearly, different regimes and codes of practice will apply to personal pensions, occupational pensions and stakeholder pensions.

**However, we ask that, under the various regimes and codes, all money-purchase schemes be required to ensure that their members are aware of their right to choose an alternative annuity provider.**