A New Solution for Private Pensions

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A Perspective for UK Investors

John Nugée , Head, Official Institutions Group

One of the most striking features of the election campaign earlier this year was that there was almost no discussion of many of the really big issues facing the country. But that does not mean that the issues went away or ceased to be important. Now that the election is past, it is not only "safe" again for politicians to talk about them, but it is becoming pressing that the dialogue recommences.

Among the foremost of these is the issue of pension provision. Future historians will look in amazement at the 2005 campaign. This was the first election after the rapid and almost total collapse of the system of private sector defined benefit ("DB") pension schemes that had served Britain so well for so long, yet hardly a word was said about the issue by either of the main parties. This is not because the problem was not noticed or is not understood, but simply because no politician has an answer which is deemed palatable enough to put before the electorate.

The problems that DB schemes face are well known and do not need restating. Suffice it to say that private sector pension plan sponsors in droves have decided that they can no longer afford the risks and costs of DB schemes, and have replaced them by defined contribution ("DC") schemes that in nearly every case have been less generous and will provide less adequate pensions for their workforce.

It is important at this point to recognise that a DC scheme does not automatically guarantee a worse pension than a DB scheme. A properly funded DC scheme, coupled with a thriving and fairly priced annuity market, can deliver just as large and adequate a pension as a traditional final salary DB scheme. Many of the problems faced by newly established DC schemes, and much of the anger of those who have been moved to them, often against their will, have arisen simply because contributions, from either employer or employee, have not been large enough. But even if the contributions have been of adequate size, there is one difference that can never be overcome or eliminated: the transfer of risk from the employer to the employee.

Volatile equity markets can make this risk very considerable indeed. It can be illustrated by considering two people with identical working experiences, salary histories and pension funds, but with slightly different retirement dates, say 2000 and 2002. The man retiring in 2000 cashes in his pension fund at the height of the equity market, and finds that gilt yields are quite high and his ample funds buy a very adequate annuity. His colleague is less lucky and, when he comes to cash in his pension fund, the equity market has fallen to roughly half the value it had 2 years earlier. And then to add insult to injury, both nominal and real yields have plummeted and he finds annuities are very expensive. The result is that his pension will be considerably less than half his slightly older colleague's, despite identical contributions histories. And this difference, of course, stays with him for the rest of his life.

Of course in practice this risk is often mitigated by progressive reallocation of pension investments to fixed income as one approaches retirement, and many "life-style" funds will do this for one automatically. But there remain a large number of people who, whether through inertia or ignorance, reach retirement still heavily exposed to equity markets and these "point-of-encashment" risks. This is an extreme amount of volatility in future welfare to place on the shoulders of the individual. Now as children we were all taught that "life isn't fair", but this degree of random unfairness is surely intolerable and demands redress.

The root cause of this excessive volatility is the fact that DC pension funds are usually cashed in at one fixed point in time. The individual has a small amount of freedom in choosing when to buy an annuity, but for those who have no other income in retirement, there is really very little alternative to buying the annuity almost as soon as they retire, to replace their salary income stream. As a result, a disproportionate amount of an individual's welfare in retirement is determined by the conjunction of equity markets and gilt yields at one single point in time. They cannot really know, and certainly cannot reliably depend on, any level of income until that point.

This lack of certainty about one's future level of income is in direct contrast with the member of a DB scheme, who can see his benefit accruing and building up during his working life. Although the size of their pension is not known precisely, because it depends on the final salary before retirement, all members of DB schemes know that they accrue pension benefits at a

A Perspective for UK Investors *(continued)*

predetermined rate, and by using their current salary as the worst case multiplier, this gives them the assurance of at least a minimum they can look forward to.

I believe that it is this uncertainty, more than anything else, that gives DC schemes their bad name, and which therefore needs to be redressed with urgency if faith in pensions is to be restored.

What is needed is a method for those in DC schemes to build up during their working life some guaranteed level of pension for when they retire. Those in employment need to know that upon retirement their pension will be at least a certain amount, based on financial provisions they have already made. The lottery of depending entirely on where the markets happen to stand on the day they retire needs to be replaced by a gradual accumulation of pension entitlement, in exactly the way that those in DB schemes can see their entitlements building up.

"... The solution is a 'deferred annuity' ..."

How can this be achieved?

The solution is a "deferred annuity"; that is, the ability to buy now a guaranteed life annuity which will start in the future. For example, a 35-year-old should be able to buy an annuity to start paying out in 30 years time, when he or she is 65. This guarantees an amount of income in retirement, independent of market fluctuations between now and when the 35-year-old retires. In short, it begins to replicate for the DC scheme member the certainty that the DB scheme member enjoys.

If such annuities were readily available, it would be entirely logical for an employee to set aside some money each year to buy additional annuities, thus building up his or her retirement income bit by bit, slice by slice, year by year. And the scheme would have the great flexibility that one could buy more or less as circumstances, and one's view of how much pension income one will need, change.

Who should offer such annuities?

Here it must be recognised that there is a fair degree of time-based credit risk in a deferred annuity. A 20-year-old buying an annuity today which will start paying out on their retirement is buying an income stream which will not start until the year 2050 and may easily continue to the year 2075 or beyond. Few people can say for certain which private sector institutions will be able to honour an obligation 70 years or even 45 years into the future, and this therefore becomes a natural arena for the state.

I suggest that the Treasury should offer deferred annuities, preferably index-linked to inflation and perhaps through National Savings and Investments. Such annuities would be hugely welcomed by those facing the uncertainty of DC scheme annuity levels, and would almost certainly spawn an active market in financial products and strategies utilising this new instrument. And finally, deferred annuities would have the unique advantage for the Treasury that for many years there would be no debt servicing costs at all - neither coupons nor maturity payments. As well as meeting a significant need, and providing a solution to the unjustness of the DC retirement lottery, deferred annuities would thus be a welcome relief for the Exchequer in the next few years when borrowing and borrowing costs are both set to rise.

What is the Government waiting for?

For more information: State Street Global Advisors Limited, 21 St James's Square, London SW1Y 4SS.

Telephone: 020 7698 6000 ▪ Facsimile: 020 7698 6340 ▪ Web: ssga.co.uk

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