Occupational Pension Provision in the United Kingdom

Christopher D. Daykin

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Securing Employer-Based Pensions

An International Perspective

Edited by Zvi Bodie, Olivia S. Mitchell, and John A. Turner

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and

University of Pennsylvania Press
Philadelphia
I
Pensions in Developed Nations
This chapter examines the variety of occupational pension provision within the United Kingdom, including the interaction of the pension system with the social security system.¹

In the United Kingdom all employed and self-employed workers earning more than a low threshold income pay contributions to the social security system to earn entitlement to a basic pension. The amount of the basic pension depends on the individual's contribution record but not on the level of earnings. A second tier of provision is available to all employees through State Earnings Related Pension Plans (SERPs). However, it is possible to contract out of this part of the social security system through membership in a suitable occupational pension plan or by means of an appropriate personal pension.

Occupational pension plans usually provide additional benefits over and above those required for contracting out of SERPs. Some plans only provide such additional benefits, and their members remain contracted in to SERPs. Employers are free to set up an occupational pension plan (or not), and, even where the employer has set up a plan, employees can choose whether or not to join. Employees who do not join a contracted-out occupational pension plan, or who do not own a personal pension designed for the purposes of contracting out, will automatically be covered by SERPs.

All members of occupational pension plans are free to make additional personal pension provision, as are those who are covered by SERPs, although upper limits are imposed by the tax authorities on contributions to tax-efficient personal pension contracts.

About 50 percent of employees are members of an occupational pension plan. Some 90 percent of these are contracted out of SERPs.
25 percent of employees are contracted out of SERPs by means of an appropriate personal pension.

**Social Security in the United Kingdom**

**Basic Pension (First Tier)**

All employed and self-employed workers in the United Kingdom earning more than a low threshold income—about 18 percent of national average earnings—are required to pay National Insurance Contributions to gain entitlement to the basic social security pension.

The social security system provides a flat rate basic pension (i.e., not dependent on earnings) from state pension age (currently 65 for males and 60 for females, although the female pension age will be increased to 65 between the years 2010 and 2020, with the intention of achieving equal retirement ages for males and females). The maximum amount is payable only if contributions have been paid (or credited) for 90 percent of the working lifetime, from age 16 to state pension age, but proportionately reduced pensions are payable to those with incomplete contribution records, provided that contributions have been paid or credited for 25 percent of the working lifetime.

The maximum flat rate pension for a single person in 1994/95 is equivalent to some US$ 86 a week. A married couple can qualify for a maximum pension of about US$ 138 a week on the basis of the husband’s contribution record. Pensions are revalued in April of each year at least in line with the movement of the Retail Price Index (the United Kingdom’s consumer price index) over a specified previous 12-month period. Social security pensions are not reduced if the pensioner has other earnings or income.

**Additional Pension (Second Tier)**

In addition to the flat rate pension, earnings-related pensions are payable from state pension age to those who have contributed as employed persons. The main benefit is an additional pension that is based on earnings between the lower and the upper earnings limits, revalued to the level appropriate at the time of retirement. It was planned to build up over the first 20 years of the scheme to 25 percent of the individual’s average earnings between the limits (i.e., excluding earnings below the lower earnings limit). Once the scheme had been in place for more than 20 years, the average was to have been taken over the best 20 (revalued) years of the individual’s career. Additional pension does not accrue in respect of periods of self-employment.
The lower earnings limit corresponds fairly closely to the amount of the basic pension (about 18 percent of national average earnings). The upper earnings limit is \( \frac{7}{2} \) times the lower earnings limit (currently 135 percent of national average earnings). Following changes made in 1988, the proportion of revalued earnings that will be paid to those who retire will fall for new awards after 1998, until a long-term figure of 20 percent of average revalued total career earnings is achieved (the best 20 years provision has also been dropped). Revaluation of relevant career earnings is in line with the general movement of earnings over the period. The upper and lower earnings limits are revalued in line with the basic state pension, that is, usually in line with the retail price index.

**Contracting Out of the Second Tier**

Employers are permitted to contract out (from the additional earnings-related pension) employees who are members of an adequate defined benefit occupational pension plan. The plan must undertake to provide members and their surviving spouses with guaranteed minimum pensions that are broadly equivalent, although not identical, to the earnings-related additional pension to which they would have been entitled if they had not been contracted out.

Those who are contracted out are entitled to a rebate in their National Insurance Contributions in respect of earnings between the lower and the upper earnings limits. This is set for each five-year period on the basis of a recommendation from the Government Actuary regarding the cost to the average occupational plan of funding the accruing liability for guaranteed minimum pensions. The rebate was set at 4.8 percent of earnings for the period commencing in April 1993.

The effect of this form of contracting out is to substitute earnings-related benefits provided by occupational pension plans, on a fully funded basis, for the earnings-related benefits that would otherwise have been payable through the social security system on a pay-as-you-go basis. Almost half the workforce is contracted out through membership in such defined benefit occupational pension plans.

In 1987 the possibility of contracting out was extended to those with an appropriate personal pension. The minimum contribution, which was initially set as equal to the rebate for contracted-out defined benefit occupational pension plans, is paid directly into the personal pension arrangement by the Department of Social Security. There are certain restrictions on the form in which the benefit may be paid, so that appropriate personal pensions always have to be distinguished from other types of personal pension contract.

Since the minimum contribution is the same for all, regardless of age
and sex, but the cost of providing a given level of benefit increases with age, contracting out by means of an appropriate personal pension is particularly attractive to younger employed persons. About a quarter of the employed workforce (nearly 5 million people) is now contracted out on the basis of appropriate personal pensions.

Contracting out is now also possible for employers with money purchase (defined contribution) plans (COMPs). The employer's obligation extends only to paying the minimum contribution into the plan and no guarantees have to be given concerning the minimum level of pension. Additional contributions may be made by the employer and by the employees. About 300,000 employees are now thought to be members of COMPs.

An individual who has been contracted out may still receive an earnings-related additional pension from the social security system. The amounts of any guaranteed minimum pensions payable from occupational pension plans are simply deducted from the total entitlement to additional pension that would have existed if the individual had not been contracted out; the balance is payable from social security.

In 1994/95 contributions to social security will fall by about US$ 11 billion, or some 17 percent of gross contribution income, as a result of contracting out. Gross earnings-related additional pension from the social security system would have been around US$ 6 billion in 1994/95, but the net amount payable, once account is taken of contracting out, is at about half this level. The proportionate reduction will increase further as the scheme matures, so that in 2035/36 the net payments are expected to be US$ 18 billion (in terms of 1994/95 levels of benefit) as compared to potential gross expenditure of around US$ 45 billion.

Major changes to the contracting out arrangements were introduced through a pensions bill in the 1994/95 session of Parliament, which involve the abolition of the guaranteed minimum pension concept from April 1997. Instead, contracted out defined benefit plans will have to satisfy certain overall benefit requirements. Those who are contracted out will in future be totally contracted out and will not be entitled to any additional pension from the social security system in respect of that period. The contracted out contribution reduction will reflect the full value of earnings-related social security benefit forgone.

The minimum contribution for appropriate personal pensions (and for COMPs) will be made age-related (although the same for men and women at any particular age) and designed to cover the cost of replicating the earnings-related social security benefit forgone through an individual pensions contract. Greater flexibility will be introduced in the way in which appropriate personal pension benefits can be taken, including flexibility regarding retirement age.
Private Pension Plans

Private pension plans play a vitally important role in the overall structure of provision for retirement in the United Kingdom. Until 1987 private pension plans were mainly sponsored by individual employers, although a few plans existed on an industry-wide basis. Personal pensions were considered suitable for the self-employed and for some senior executives with individually tailored pension arrangements. The introduction in 1987 of appropriate personal pensions as a vehicle for contracting out of the State Earnings Related Pension led to a rapid growth in personal pension coverage, mainly among the 50 percent or so of employed workers who were not previously members of any occupational pension plan.

Concern in the 1970s and 1980s about some of the apparent inequities of many private sector occupational pension plans, particularly in regard to the treatment of early leavers and the absence of full indexation of pension benefits, led to a proliferation of legislative requirements for pension plans. The effect of these, together with the complexities of contracting out, has been to dampen enthusiasm, at least among employers, for defined benefit occupational pension plans. Nevertheless, there is little evidence so far of employers discontinuing defined benefit plans or of any significant switch to group money purchase plans, although some employers setting up new schemes may be attracted to the defined contribution route.

Small employers are more likely to operate an insured plan. There has been a reduction in the number of insurance companies willing to operate such plans on a defined benefit basis, largely because of the administrative burden involved. It is thought that a number of smaller employers have switched from defined benefits to money purchase arrangements.

Money purchase, whether on a group basis or in the form of personal pensions, has come back into fashion, having been badly discredited in the 1950s and 1960s because of inadequate payouts. Results for individual pensioners are bound to be variable. Investment performance will have to be very good to overcome the inherent cost disadvantages of individual pension policies, as compared to the relatively efficient cost structure of occupational pension plans and the very low administrative costs of the social security system.

Money purchase plans may have the effect of stimulating more widespread interest in the value of the pension promise and the importance of one's accumulated pension rights as a major personal asset. The effect of the emphasis on personal pensions in recent years has certainly been to goad occupational pension plans (and employers) into much more
occupational pension provision in the united kingdom

Table 1: Members of Pension Plans as Percentage of Number of Employees, by Sector and by Sex, United Kingdom, 1975-1991

<table>
<thead>
<tr>
<th>Year</th>
<th>Private Sector</th>
<th>Public Sector</th>
<th>Both Sectors</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Men</td>
<td>Women</td>
<td>Men</td>
</tr>
<tr>
<td>1975</td>
<td>52</td>
<td>17</td>
<td>86</td>
</tr>
<tr>
<td>1979</td>
<td>48</td>
<td>24</td>
<td>88</td>
</tr>
<tr>
<td>1983</td>
<td>52</td>
<td>24</td>
<td>94</td>
</tr>
<tr>
<td>1987</td>
<td>49</td>
<td>22</td>
<td>90</td>
</tr>
<tr>
<td>1991</td>
<td>48</td>
<td>27</td>
<td>85</td>
</tr>
</tbody>
</table>

Source: Government Actuary (1994a), Tables 2.1 and 2.4, and earlier surveys.

Note: Excludes employees who have some pension rights but are not accruing benefits in respect of current employment.

Table 2: Occupational Pension Plan Coverage, United Kingdom, 1991 (millions)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Men</th>
<th>Women</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Employees</td>
<td>Members</td>
<td>Employees</td>
</tr>
<tr>
<td>Civil Employment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private Sector</td>
<td>9.3</td>
<td>4.5</td>
<td>7.4</td>
</tr>
<tr>
<td>Public Sector</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Public Corporations</td>
<td>0.5</td>
<td>0.45</td>
<td>0.2</td>
</tr>
<tr>
<td>Central Government</td>
<td>0.6</td>
<td>0.6</td>
<td>1.25</td>
</tr>
<tr>
<td>Local Authorities</td>
<td>1.3</td>
<td>0.95</td>
<td>1.65</td>
</tr>
<tr>
<td>Total Public Sector</td>
<td>2.4</td>
<td>2.0</td>
<td>3.1</td>
</tr>
<tr>
<td>Total Civilians</td>
<td>11.7</td>
<td>6.5</td>
<td>10.5</td>
</tr>
<tr>
<td>Armed Forces,</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Central Government</td>
<td>0.3</td>
<td>0.3</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>12.0</td>
<td>6.8</td>
<td>10.5</td>
</tr>
</tbody>
</table>

Source: Government Actuary (1991), Table 2.4.

Note: Employees are single-counted, i.e., those with two jobs are counted once only.

active marketing to employees of the benefits of the pension plan, and hence to a heightened awareness of what pensions are all about.

Coverage

Table 1 shows the development of membership of occupational pension plans in the public and private sectors in the United Kingdom since 1975, based on regular surveys carried out by the Government Actuary. Table 2 shows in more detail the coverage in different types of employment, while Table 3 shows the coverage by size of membership for private sector
TABLE 3  Self-Administered and Insured Private Sector Pension Plans by Membership Size, United Kingdom, 1991

<table>
<thead>
<tr>
<th>Number of Active Members</th>
<th>Self-Administered</th>
<th>Insured</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Plans (thousands)</td>
<td>Plans (thousands)</td>
<td>Plans (thousands)</td>
</tr>
<tr>
<td>1 to 11</td>
<td>18,000</td>
<td>77,500</td>
<td>95,500</td>
</tr>
<tr>
<td>12 to 99</td>
<td>11,820</td>
<td>14,930</td>
<td>26,750</td>
</tr>
<tr>
<td>100 to 999</td>
<td>4,390</td>
<td>560</td>
<td>4,950</td>
</tr>
<tr>
<td>1,000 to 4,999</td>
<td>610</td>
<td>9</td>
<td>619</td>
</tr>
<tr>
<td>5,000 to 9,999</td>
<td>95</td>
<td>660</td>
<td>95</td>
</tr>
<tr>
<td>10,000 &amp; over</td>
<td>85</td>
<td>1</td>
<td>86</td>
</tr>
<tr>
<td>Totals</td>
<td>35,000</td>
<td>93,000</td>
<td>128,000</td>
</tr>
</tbody>
</table>


Note: 1 Plans with no members accruing benefits in respect of current service are excluded from the table.

2 The number of plans with 11 or fewer members is subject to a wide margin of uncertainty because of the limitations of the sampling method used.

plans. Further data from the Government Actuary's Ninth Survey of Occupational Pension Schemes are given in Tables 4, 5, 8, 9, and 10.

In the private sector, coverage is generally very high among large organizations and relatively low among small firms. These figures do not, however, include personal pensions, which can be expected to be more common among employees of small organizations. Of the 10.7 million members of occupational pension plans in 1991, 9.7 million were contracted out of the SERPs. All of the one million members of schemes not contracted out were in the private sector, so that 100 percent of public sector pension plan members and 78 percent of private sector pension plan members were contracted out.

**Framework for Occupational Pension Plans**

There is no general legislative framework for occupational pension plans in the United Kingdom. The main constraint on the form of such schemes is the need to obtain approval from the Inland Revenue (the taxation authority) in order to qualify for beneficial taxation treatment. This tax treatment is not available for plan membership for earnings above about US$ 115,000 per year.

In order to qualify for tax privileges, a plan must be established under an irrevocable trust, with the administration and financial management of the plan in the hands of trustees. The trust fund has to be maintained quite separately from the assets of the sponsoring employer, and money
TABLE 4 Members of Pension Plans Paying Contributions of Various Types, United Kingdom, 1991 (thousands)

<table>
<thead>
<tr>
<th>Percentage of Salary</th>
<th>Private Sector</th>
<th>Public Sector</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Contracted Out</td>
<td>Not Contracted Out</td>
</tr>
<tr>
<td><strong>Defined Benefit Plans</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Under 2%</td>
<td>20</td>
<td>5</td>
</tr>
<tr>
<td>2% and under 3%</td>
<td>150</td>
<td>25</td>
</tr>
<tr>
<td>3% and under 4%</td>
<td>275</td>
<td>105</td>
</tr>
<tr>
<td>4% and under 5%</td>
<td>730</td>
<td>30</td>
</tr>
<tr>
<td>5% and under 6%</td>
<td>1,690</td>
<td>85</td>
</tr>
<tr>
<td>6% and under 7%</td>
<td>1,125</td>
<td>70</td>
</tr>
<tr>
<td>7% and over</td>
<td>105</td>
<td>35</td>
</tr>
<tr>
<td><strong>Total Paving Percentages</strong></td>
<td>4,095</td>
<td>355</td>
</tr>
<tr>
<td><strong>Non-Contributory or Other Basis</strong></td>
<td>945</td>
<td>205</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>5,040</td>
<td>560</td>
</tr>
</tbody>
</table>

| **Money Purchase Plans** |               |               |     |       |
| Under 2%               | —             | 25            | —   | 25    |
| 2% and under 3%        | 65            | 60            | —   | 125   |
| 3% and under 4%        | 45            | 65            | —   | 110   |
| 4% and under 5%        | 40            | 45            | —   | 85    |
| 5% and under 6%        | 50            | 60            | —   | 110   |
| 6% and under 7%        | 10            | 10            | —   | 20    |
| 7% and over            | 20            | 10            | —   | 30    |
| **Employee's Share of National Insurance** |               |               |     |       |
| Contracted-Out Rebate  | 170           | —             | —   | 170   |
| **Total Paving Percentages** | 400           | 275           | —   | 675   |
| **Non-Contributory or Other Basis** | 30            | 195           | —   | 225   |
| **Totals**             | 430           | 470           | —   | 900   |

| **Combined Totals**    | 5,470         | 1,030         | 4,200| 10,700 |

Source: Government Actuary (1991), Table 6.5.
Note: 1Includes members whose contributions are purely voluntary.

can only be lawfully returned to the employer in special circumstances. This applies to plans in both the private and public sectors, apart from a few public service plans that are established under their own legislation and do not require separate Inland Revenue approval (e.g., the civil service, the armed forces, teachers, and health service workers). With the exception of the scheme for local authority workers, these statutory public service plans are not funded.

Pension plans are usually established by individual firms or companies
**TABLE 5**  Number of Active Members of Final Salary Plans by Pension Accrual Fraction (thousands)

<table>
<thead>
<tr>
<th>Pension Accrual Fraction</th>
<th>Contracted Out</th>
<th>Not Contracted Out</th>
<th>Public Sector</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plans giving benefit on retirement of pension only, possibly part commutable to a lump sum</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Better than 60ths (if service less than 40 years)</td>
<td>755</td>
<td>120</td>
<td>190</td>
<td>1,065</td>
</tr>
<tr>
<td>60ths</td>
<td>3,405</td>
<td>245</td>
<td>170</td>
<td>3,820</td>
</tr>
<tr>
<td>Between 60ths and 80ths</td>
<td>95</td>
<td>25</td>
<td>-</td>
<td>120</td>
</tr>
<tr>
<td>80ths</td>
<td>120</td>
<td>45</td>
<td>-</td>
<td>165</td>
</tr>
<tr>
<td>Less than 80ths</td>
<td>5</td>
<td>25</td>
<td>-</td>
<td>30</td>
</tr>
<tr>
<td>Totals</td>
<td>4,380</td>
<td>460</td>
<td>360</td>
<td>5,200</td>
</tr>
</tbody>
</table>

| Plans giving benefit on retirement expressed as pension and separate lump sum |                |                    |               |       |
| Better than 60ths (if service less than 40 years) | 20             | -                  | 5             | 25    |
| 60ths                    | 45             | -                  | 130           | 175   |
| Between 60ths and 80ths  | 10             | 10                 | 285           | 305   |
| 80ths                    | 585            | 70                 | 3,405         | 4,060 |
| Less than 80ths          | -              | -                  | 15            | 15    |
| Totals                   | 660            | 80                 | 3,840         | 4,580 |

Source: Government Actuary (1991), Table 7.8.

for their employees (or for certain categories of employees). A single pension plan may be established in respect of the employees of a group of related companies. There are also a few industry-wide pension plans established for all the employees in a particular industry. The employer must contribute to the plan for it to be approved for tax purposes (or must contribute to another plan of which the employee is also a member).

**Trustees**

Pension plans operate as trusts under the general provisions of trust law, which lays the responsibility for good conduct of the trust on the trustees. There are no legal requirements regarding the composition of the trustees. In practice about 60 percent of members of private sector plans are in plans where at least some of the trustees are elected or nominated as representatives of the members. The employer usually has the power to appoint the trustees.
TABLE 6 Percentage Distribution of Investments of Self-Administered Pension Funds, United Kingdom, as of December 31, 1992

**United Kingdom Investments**
- Cash, Deposits and Other Short Term Assets (Net of Short Term Liabilities and Borrowing) 3.3
- Government Fixed Interest Securities 3.8
- Company Fixed Interest Securities (Including Convertibles) 1.6
- Loans and Mortgages 0.1
  - All Fixed Interest 8.7
- Government Index-Linked Securities 2.8
- Ordinary Shares 52.9
- Unit Trust Units 2.2
  - All Equity Shares 55.2
- Land, Property and Ground Rents 5.2
- Property Unit Trust Units 0.5
  - All Real Estate 5.7

**Investments Outside the United Kingdom**
- Cash, Deposits and Other Short-Term Assets 0.3
- Government Securities 2.8
- Ordinary Shares 16.5
- Other 0.5
  - Total Investments Outside the United Kingdom 20.1
  - Total Investments 100.0

**Source:** Government Actuary (1994b).

TABLE 7 Average Percentage Distribution of Income of Pensioner Units by Source, United Kingdom, 1980–88

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>State Pension</td>
<td>61</td>
<td>61</td>
<td>51</td>
</tr>
<tr>
<td>Occupational Pension</td>
<td>16</td>
<td>18</td>
<td>23</td>
</tr>
<tr>
<td>Savings Income</td>
<td>11</td>
<td>13</td>
<td>17</td>
</tr>
<tr>
<td>Earnings</td>
<td>11</td>
<td>8</td>
<td>8</td>
</tr>
<tr>
<td>Total Gross Income</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Total Net Income</td>
<td>93</td>
<td>92</td>
<td>90</td>
</tr>
</tbody>
</table>

**Source:** Family Expenditure Survey (1980, 1984, 1988).

With one exception, there are no formal requirements for consultation with members or employers. The exception is the obligation to consult relevant trade unions on the decision whether to contract out of the social security second tier. In practice pension plan issues will often form part of negotiations between the employer and employee associations (or trade unions) on remuneration and conditions of service. Changes to the pension plan rules, including benefit improvements, are normally a
### Table 8: Number of Pensions in Payment from Defined Benefit Plans According to Increases Promised by Plan Rules, United Kingdom, 1991 (thousands)

<table>
<thead>
<tr>
<th>Amount of Promised Increase</th>
<th>Private Sector</th>
<th>Public Sector</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed Increase of:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5.00% or greater</td>
<td>100</td>
<td>-</td>
<td>100</td>
</tr>
<tr>
<td>4.00 to 4.99%</td>
<td>70</td>
<td>-</td>
<td>70</td>
</tr>
<tr>
<td>3.00 to 3.99%</td>
<td>440</td>
<td>-</td>
<td>440</td>
</tr>
<tr>
<td>Less than 3.00%</td>
<td>90</td>
<td>-</td>
<td>90</td>
</tr>
<tr>
<td>Percentage of RPI</td>
<td>30</td>
<td>-</td>
<td>30</td>
</tr>
<tr>
<td>Full RPI Linking</td>
<td>460</td>
<td>2,830</td>
<td>3,290</td>
</tr>
<tr>
<td>Index-Linking with RPI to a maximum of 5%</td>
<td>1,220</td>
<td>100</td>
<td>1,320</td>
</tr>
<tr>
<td>Other</td>
<td>390</td>
<td>270</td>
<td>660</td>
</tr>
<tr>
<td>None</td>
<td>600</td>
<td>-</td>
<td>600</td>
</tr>
<tr>
<td>Totals</td>
<td>9,400</td>
<td>3,200</td>
<td>6,600</td>
</tr>
</tbody>
</table>

Source: Government Actuary (1991), Table 9.5.
Note: RPI is the official Retail Price Index (Consumer Price Index).

### Table 9: Numbers of Plans and of Members in Plans in the Private Sector by Type of Plan, United Kingdom, 1991

<table>
<thead>
<tr>
<th></th>
<th>Contracted Out</th>
<th>Not Contracted Out</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Plans (thousands)</td>
<td>Plans (thousands)</td>
<td>Plans (thousands)</td>
</tr>
<tr>
<td><strong>Private Sector</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(by Number of Members in Plan)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Defined Benefit</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1-11</td>
<td>9,600</td>
<td>10,200</td>
<td>19,800</td>
</tr>
<tr>
<td>12-99</td>
<td>8,900</td>
<td>3,600</td>
<td>12,500</td>
</tr>
<tr>
<td>100-999</td>
<td>3,660</td>
<td>570</td>
<td>4,230</td>
</tr>
<tr>
<td>1,000-4,999</td>
<td>530</td>
<td>50</td>
<td>580</td>
</tr>
<tr>
<td>5,000-9,999</td>
<td>90</td>
<td>1</td>
<td>91</td>
</tr>
<tr>
<td>10,000+</td>
<td>80</td>
<td>4</td>
<td>84</td>
</tr>
<tr>
<td>Totals</td>
<td>22,860</td>
<td>14,425</td>
<td>37,285</td>
</tr>
</tbody>
</table>

Defined Contribution

|                      |                |                    |                  |
|                      | Plans (thousands) | Plans (thousands) | Plans (thousands) |
| 1-11                 | 10,300         | 65,700             | 76,000           |
| 12-99                | 6,800          | 7,200              | 14,000           |
| 100-999              | 400            | 270                | 670             |
| 1,000-4,999          | 30             | 7                  | 37              |
| 5,000-9,999          | 5              | 1                  | 6               |
| 10,000+              | 1              | 1                  | 2               |
| Totals               | 17,536         | 73,179             | 90,715          |

Totals, Both Types

|                      |                |                    |                  |
|                      | Plans (thousands) | Plans (thousands) | Plans (thousands) |
|                      | 40,396         | 87,604             | 128,000          |

Source: Government Actuary (1991), Table 5.2.
Note: 1The number of plans with 11 or fewer members is subject to a wide margin of uncertainty because of the limitations of the sampling method.
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Table 10 Self-Administered Private Sector Pension Plans by Market Value of Assets, 1991

<table>
<thead>
<tr>
<th>Market Value of Assets (US$ million)</th>
<th>Plans</th>
<th>Members (thousands)</th>
<th>Total Value of Assets (US$ billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under 1.5</td>
<td>24,300</td>
<td>340</td>
<td>12</td>
</tr>
<tr>
<td>1.5-10</td>
<td>8,000</td>
<td>830</td>
<td>35</td>
</tr>
<tr>
<td>15-75</td>
<td>2,080</td>
<td>1,020</td>
<td>73</td>
</tr>
<tr>
<td>75-150</td>
<td>260</td>
<td>390</td>
<td>27</td>
</tr>
<tr>
<td>150-375</td>
<td>185</td>
<td>610</td>
<td>45</td>
</tr>
<tr>
<td>375-750</td>
<td>90</td>
<td>660</td>
<td>45</td>
</tr>
<tr>
<td>750-1,500</td>
<td>50</td>
<td>590</td>
<td>51</td>
</tr>
<tr>
<td>1,500+</td>
<td>35</td>
<td>1,360</td>
<td>162</td>
</tr>
<tr>
<td>Totals</td>
<td>35,000</td>
<td>5,800</td>
<td>450</td>
</tr>
</tbody>
</table>

Source: Government Actuary (1991), Table 4.3.

matter for the employer. Even if the trustees do not have the power to change the rules, their consent is usually required. These provisions are set down in the trust deed that establishes the plan. Unless the deed contains a power of alteration, the law does not permit changes except where approved by the Occupational Pensions Board.

Once trustees have been appointed, they are not expected to behave as representatives of any particular sectional interest. It is their responsibility to administer the trust deed in accordance with the rules of the plan. The responsibilities of trustees are laid down in general trust law, which is of ancient origin and does not provide specifically for pension aspects. The trustees have a personal and fiduciary responsibility to invest the scheme moneys in a prudent way, in compliance with the trust deed and rules. The trustees can delegate the tasks of administration and investment to employed staff or to external experts, but they retain ultimate responsibility for the sound management of the affairs of the pension plan.

Contributions

As mentioned above, the employer must contribute to the plan. The plan may indeed be financed entirely by contributions from the employer. However, it is common for the rules to specify an employee contribution rate, usually defined as a percentage of salary. Table 4 summarizes the distribution of different employee contribution percentages for both public and private sector plans.

The employer's rate of contribution is occasionally specified in the rules of the plan, with appropriate provision for dealing with emerging
surpluses or deficits. However, the most common arrangement is for the employer to meet the balance of cost. The employer contribution rate from time to time is then agreed upon in the light of regular actuarial valuations, taking into account the adequacy of the assets already held by the fund in relation to the value of accrued rights, the expected cost of providing the benefits that will be accruing in the future, and the estimated value of future contributions by employees.

Benefit Design

By far the majority of members of occupational pension plans in the United Kingdom belong to defined benefit schemes. Most of these provide benefits based on salary at or near to retirement. The commonest arrangement is for pension to build up as a fraction of final salary, with a pension of 1/60th payable per year of service. However, other fractions are also sometimes used (see Table 5). Final pensionable salary is defined in the rules of the plan and may be the earnings in the last year before retirement or an average over several years. Where an average is used, the earlier years may be revalued to the level at retirement using an index, usually the Retail Price Index.

In order to qualify for tax approval it is also necessary to comply with certain rules regarding maximum benefits. The maximum permissible pension at normal retirement age is two-thirds of final salary, subject to a limit on pensionable earnings for persons who have changed jobs or entered new pension arrangements since 1989. Although this maximum pension would usually only be attained by those with 40 or more years of service, some plans offer accelerated accrual of benefits for late entrants. The maximum two-thirds pension may be paid provided that there has been at least 20 years' service.

Part of the pension can be commuted (converted) into a lump sum on retirement, subject to limits laid down by the tax authorities. This lump sum is payable free of all taxes, whereas pensions are taxable as earned income.

Many public sector plans provide a pension of 1/60th of final pensionable salary for each year of service, together with a lump sum equivalent to three years of pension. These are shown in the second half of Table 5 as a pension of 1/60th of final pensionable salary for each year of service. With pension increases in line with the Retail Price Index, as is the case in the public sector, and corresponding survivors' benefits, a 1/60th pension is more valuable than a 1/60th pension and 1/60th lump sum. The table shows how many members of final salary plans, in the public and private sectors, have various different pension fractions.

Normal retirement age is defined for each plan within the plan rules.
Until recently it was common for plans to follow the state pension ages, although some adopted a different approach, such as age 60 for both males and females, or age 65 for both. The European Court of Justice on May 17, 1990, in the case of Barber v. Guardian Royal Exchange, stipulated that it was unlawful, on the basis of Article 119 of the Treaty of Rome, to have inequalities in pension plans between men and women. In the light of this, most plans have now equalized the pension age for men and women, at least for service from the date of the judgment, in spite of the fact that state pension ages in the United Kingdom will not be fully equalized until 2020.

Most defined benefit pension plans also provide pension benefits on ill-health retirement and lump sum benefits on death in service, as well as pensions to surviving widows, widowers, and children. Ill-health retirement benefits are usually based on final pensionable salary, but they often take into account a longer period of service than that actually worked, for example by adding a fixed number of years or by, say, doubling the actual period of service. Many plans now provide a pension on ill-health retirement based on the total potential service that could have been completed up to normal retirement age. Part of the ill-health pension may be taken in lump sum form, as for retirement pension. Ill-health awards are usually subject to a fairly strict definition of inability to continue working because of ill health or incapacity. Most plans can provide early retirement pensions without enhancement where ill-health retirement criteria are met.

Widows' and widowers' benefits are also normally related to final pensionable salary, defined as at the date of death of the member, or at the date of retirement if death occurs after the normal pension has come into payment. Widows' and widowers' pensions are usually at the level of one-half (or occasionally two-thirds) the equivalent member's pension. When the spouse's benefit arises from death in service, it is common for the full potential service to normal retirement age to be taken into account. Many plans increase the payment to the widow or widower if there are dependent children and pay orphans' pensions if there is no surviving spouse. A lump sum benefit is also usually payable on death in service, regardless of family status and whether or not there are surviving family members. This can be up to four years' salary, but two years' salary is the commonest formula.

Vesting and Early Leavers

Anyone who leaves employment (or the pension plan) before normal retirement age, with two or more years' pensionable service, must be granted entitlement to the accrued benefit, although the benefit is not
usually payable until retirement age (or prior death). The accrued benefit is defined according to the usual pension formula, treating the date of leaving as the date of retirement. Accrued rights deferred to normal retirement age in this way are required by law to be revalued at 5 percent a year, or in line with the Retail Price Index if this increases at less than 5 percent a year over the period of deferment. A different formula applies to accrued rights to guaranteed minimum pension under the contracting-out arrangements. In this case revaluation is in line with an earnings index, but pension plans can limit their liability to a fixed rate of increase, which is currently set at 7 percent a year. Early leavers with less than two years’ service can be given a simple refund of their own contributions. As an alternative to retaining accrued rights in the pension plan that they are leaving, those with more than two years’ service may have the cash equivalent of their accrued rights (i.e., a transfer value) paid to another occupational pension plan or into a personal pension arrangement. Where a transfer value is paid to another occupational plan, it will be used to provide credited years of pensionable service to be added to the years of actual future membership in the new plan, or credits on a money purchase (defined contribution) basis.

The rules of the occupational plan usually provide for the amount of any transfer value payment to be determined by the plan actuary, and similarly any credit given to a member in respect of an incoming transfer value. In calculating the transfer value payment, or the credit to be awarded in the receiving plan, the actuary is required to comply with the mandatory guidance note “GN11: Retirement Benefit Schemes—Transfer Values” issued by the Institute of Actuaries and the Faculty of Actuaries.

GN11 requires the transfer value to be a fair representation of the actuarial value of the benefits otherwise available on withdrawal, having regard to market rates of interest. Consistent methods and assumptions must be used for outgoing and incoming transfers (to discourage bias in the assumptions). The actuary is required to advise the trustees of a reduced transfer value if the assets of the plan are not sufficient to cover the accrued liabilities.

Increases of Pensions in Payment

The pension (and other) benefits are defined in the rules of the plan. The rules often provide for pensions in payment to be increased by a fixed percentage each year (say 3 percent or 5 percent), but with discretion to the trustees to award additional increments as the finances of the pension fund permit, with a view to maintaining more nearly the real value of the pension at the time of award. Most public sector pension
plans currently provide automatic or near-automatic indexation of pensions in line with movements in the Retail Price Index.

Member Protection

The main protection for pension plan members is provided by the trust fund and the role of the trustees. In principle the assets of the trust fund should be maintained at a level sufficient to ensure that accrued liabilities—that is, liabilities in respect of past service (and salary to date, although allowing for any provisions in the rules or in the law for increases of benefits in deferment or in payment)—can be met.

If the assets should at any time be shown by an actuarial valuation to be insufficient to meet the accrued liabilities, it is the responsibility of the trustees to seek to rectify the situation, usually by means of additional contributions from the employer over a future period. Employee contributions may also be increased in some cases. If the employer is unable or unwilling to increase contributions, it may be necessary for the trustees to wind up the scheme (or apply to the Court for directions) and secure benefits for past service.

In the event of insolvency of the employer, or a decision by the employer to cease contributing to the plan, it is the responsibility of the trustees to ensure that the assets of the trust fund are applied to meet the accrued liabilities, insofar as is possible, in accordance with the rules of the plan. The assets of the plan cannot be called upon by the liquidator of the employer’s business. The trustees will usually seek to purchase annuities and deferred annuities for individual members from an insurance company to correspond to the accrued liabilities under the plan.

If there is a deficiency in the assets of the plan when they are applied to meet the discontinuance liabilities, as described in the previous paragraph, the balance is treated as a debt on the employer. In the case of insolvency of the employer, this debt will rank with other creditors in the liquidation (it does not have any priority as a debt, although creditors automatically rank above the interests of equity shareholders). If the debt is not paid, the trustees must reduce the benefits payable. This will be done in accordance with the priorities laid down in the trust deed and rules.

There is no requirement for insurance of pension plan liabilities against the risk of employer insolvency, since the separation of the assets in the trust fund is deemed to provide adequate protection. Protection against the risk that the trust fund might be inadequate to meet the accrued liabilities is provided by the role of the actuary and the disclosure to members of the current funding level.

Limited protection is offered in respect of the guaranteed minimum
pensions (GMPs) for contracted-out defined benefit plans. In the event of discontinuance, such plans can buy back the liabilities for GMPs into the State Earnings Related Pension scheme. The GMP rights will be restored in full in the social security system, even if the assets available are inadequate to meet the stipulated buy-back terms. Over the 16 years since this system was introduced, around 750 pension plans have had recourse to the "deemed buy-back" arrangements as a result of winding up with inadequate funds to fulfill promises to members. For all these plans the total buy-back premiums received amount to some US$ 4.5 million, and approximately US$ 150 million was treated as having been paid. Some US$ 145 million of this related to Maxwell companies in 1992/93 and 1993/94. The total amount represents some 0.05 percent of the current assets of funded pension plans.

Insurance companies are subject to an intensive regulatory regime, which covers both financial strength and the marketing of products. In the light of this, insurance company insolvency is regarded as a fairly remote contingency. However, insured pension plans can be inadequately funded relative to the benefits promised, for example because contributions have not been set high enough, or because money has not been passed over to the insurer.

Self-administered plans are not subject to any formal solvency requirement or supervision. However, the investments must be managed by an investment manager with an appropriate authorization under the Financial Services Act 1986, and will as a result be subject to supervision by one of the regulatory bodies, for example the Investment Managers Regulatory Organization (IMRO).

A surplus can only be removed from a continuing plan with the approval of the Inland Revenue and, in the case of some plans, the Occupational Pensions Board, and will be subject to a 40 percent self-standing tax charge on any repayment to the employer. Surpluses can, however, be used to relieve future contributions that the employer might otherwise have expected to pay.

Although the regulatory regime is not comprehensive, there appear to have been relatively few problems and the controls provided by the trust fund structure have been quite robust. However, in the well-known Maxwell case it appears that, without the knowledge of most of the trustees, and in defiance of trust law, a determined employer may have diverted the pension plan assets to purposes unconnected with the pension plan, through a complex web of transactions between connected companies. This appears to have been facilitated because Maxwell also controlled the principal investment manager. As a result, a serious position of underfunding has arisen in some of the plans, although guaranteed minimum pensions in contracted-out plans are protected by the SERPs deemed
buy-back arrangements. Some of the lost moneys have been recovered, some voluntary contributions have been made by London firms, and in some plans the deficiency may be rectified in due course by the continuing employer.

In the wake of these problems, the government established the Pension Law Review Committee (1993), under the chairmanship of Professor Roy Goode, to report on the security of pension scheme rights and to recommend any changes to the law that might be desirable to improve such security.

In September 1993 the Report of the Pension Law Review Committee was presented to the Secretary of State for Social Security. The report contained 218 recommendations, covering a broad range of aspects of occupational pension provision in the United Kingdom, having particular regard to the importance of strengthening the security of the rights of members of pension plans. The Report recommended the creation of a post of Pensions Regulator with adequate staffing to supervise the operation of occupational pension plans and with powers to intervene in their affairs in order to safeguard the interests of members. It was further proposed that the trustees of each plan should have an “appointed scheme actuary” with responsibility for monitoring the financial affairs of the plan, for reporting annually on the solvency status of the plan, and for advising the trustees on the level of funding necessary to ensure a satisfactory continuing financial condition.

Pension plans would be required to meet a minimum solvency requirement based on 100 percent of the present value of benefits promised active members and former vested members, together with 100 percent of the cost of purchasing annuities to buy out retirees receiving benefits (and contingent pensions payable to the dependents of such pensioners). Cash equivalents are already used in the context of transfers between pension plans and represent the present value of the vested accrued rights to which an early leaver would be entitled.

Pension plans falling below the minimum solvency standard of 100 percent of cash equivalents would be required to present a proposal to demonstrate how the solvency position was to be restored. Should solvency fall below a “base level” of 90 percent of cash equivalents, the Pensions Regulator would require an immediate injection of cash into the plan or, failing that, consider whether to wind up the plan and invoke the “debt on the employer” provisions.

The Committee recommended that a compensation arrangement should be established to handle the problem of shortfalls in pension plan assets, restricted, however, to shortfalls arising from fraud, theft, and misappropriation. The compensation arrangement would be funded by
means of a post-event levy on all occupational pension plans that might be covered by the compensation arrangements.

No fundamental change was proposed in the basic legal structure of pension funds, relying as it does on the precepts of trust law. However, the Committee did propose that there be a consolidated Pensions Act and that the Pensions Regulator should be responsible for administering it.

Some tightening up was proposed in the requirements relating to trustees. For earnings-related plans the active members should be entitled to appoint from among their number at least one-third of the trustees, whereas at present it is left entirely to individual pension plans (and more particularly to the employer) to determine the composition of the trustees. Pensioner trustees should also be encouraged, since the interests of active members, pensioners, and deferred pensioners may often be different and sometimes in conflict. The Pensions Regulator would have the power to disqualify individuals from acting as pension plan trustees.

Employers should retain the right to wind up a pension plan, with or without the consent of members, or to change the benefits of the plan in respect of future service accruals. In the event of a plan winding up, active members should be entitled to 100 percent of the cash equivalents of their early leaver rights. Any shortfall in scheme assets relative to this standard should be made good by the employer. The amount of any such shortfall should be a debt on the assets of the employer, ranking with other creditors in the event of the employer's bankruptcy.

Trustees should be required to satisfy a "prudent man" investment standard. Detailed investment decisions should continue to be made only by individuals authorized under the Financial Services Act 1986 in their conduct of investment business. Self-investment should not exceed 5 percent of the assets of the scheme, as is currently the case for contracted-out plans, and any self-investment above this level should be disregarded in determining compliance with the minimum solvency requirement. Pension plans should not, however, be required to place the assets with an independent custodian. The provision of information for members should be improved, both in content and in clarity and presentation.

Other recommendations related to the importance of taking the value of pension rights into account on divorce, the simplification of Inland Revenue requirements for tax approval of pension funds, the simplification of the contracting-out regime, the use of plan surpluses, and the structure of future pension plan regulation.

These recommendations were accepted by the government almost in their entirety, in a June 1994 White Paper. Follow-on bills introduced
in the 1994/95 session of Parliament will implement the proposals, including a minimum solvency standard based on cash equivalents, a compensation fund limited to cases of fraud, theft, and misappropriation of assets, a compulsory requirement for one-third of trustees to be appointed by members and pensioners, whistle-blowing roles for actuaries and auditors, and a Pensions Regulator with fairly wide-ranging powers. The issue of pension rights in divorce settlements is not, however, to be resolved at this stage.

The minimum solvency requirement will apply to all defined benefit plans, apart from those that are not approved for tax purposes because they offer benefits above Inland Revenue limits and those that are backed by a guarantee that offers protection at least as good as that provided by the minimum solvency requirement (for example, unfunded public service plans).

The cash equivalent concept, which is to form the basis for the minimum solvency requirement, is the same as that already used for transferability of pension rights (and for defining any debt on the employer when a scheme is wound up). It represents the present value of the vested accrued early leaver rights or the present value of the pension in payment or deferred pension rights already granted. For the purposes of the solvency test it may be extended to equivalent notional early leaver rights in respect of those with less than two years’ service whose benefits have not yet vested.

Cash equivalents will be required to comply with minimum requirements laid down in mandatory professional guidance by the Institute of Actuaries and the Faculty of Actuaries. Discussions are continuing on this but the intention is that pensions in payment should be valued assuming matched investment in government bonds or index-linked bonds. However, deferred pension rights in respect of early leavers or active members will be assumed, at the younger ages, to be invested in equities, with some blending at ages in between.

The solvency position will be reported every three years in the actuarial valuation, but actuaries may be required to disclose material changes to the solvency position on an annual basis. The Pensions Regulator will be responsible for ensuring that action is taken by the trustees of plans that do not meet 100 percent of the minimum solvency requirement. Plans reporting under 90 percent solvency will be expected to take immediate action by means of a cash injection of some other measure of equivalent value. This might be by means of a guarantee from a recognized bank, or possibly by providing some form of cash reserve, if the trustees are satisfied that the reserve is adequately ring-fenced in the event of employer insolvency.

The new legislation will override existing priority rules in pension plan
trust deeds so that, in the event of the plan winding up, each member will in principle be entitled to the value of the cash equivalent of his or her accrued rights.

Pension rights accruing after April 1997, whether in respect of defined benefit plans or contracted-out money purchase plans (including appropriate personal pensions), will be required to be revalued in line with price movements up to 5 percent a year (with the limit applied on an annual basis) once they come into payment. Deferred pension rights in respect of early leavers from defined benefit plans will be revalued in line with prices, with an overall cap of 5 percent a year throughout the full period of deferment. This corresponds to the existing arrangements for deferred pension rights in excess of any guaranteed minimum pension.

Disclosure to Plan Members

Trustees are required to make regular disclosure to plan members of certain prescribed documented information. It is sufficient for some to be made available on request, for example the trust deed and rules, but members must receive written notification that the annual report and accounts are available. A large volume of basic information about the plan must be supplied to members. This obligation can be met by issuing a plan booklet, together with an update in the annual report. The information includes the following: tax approval and contracted-out status; eligibility and conditions for membership; how contributions are calculated; whether contributions have been paid in accordance with the rules and the recommendations of the actuary; benefit information; rights of early leavers; treatment of discretionary benefits; awards of pension increases; names of trustees; names of actuary, auditors, solicitors, banks, investment managers, and other advisers; investment policy; investment performance review; extent of any employer-related investments; review of financial development of the scheme.

A statement by the actuary must be included in the annual report, referring to the latest valuation and the recommended rates of contribution. A full copy of the actuary’s valuation report must be made available to any member on request.

Actuarial Control

A full actuarial valuation must be carried out at least every three and a half years (to be reduced to three years from 1997). The actuary must comment on the funding position in relation to accrued rights had the plan been wound up on the valuation date, and must also advise on the contributions necessary in the future to support the benefits.
There are several alternative approaches to funding, but the most common in current usage is the projected unit method. Under this method a standard contribution rate is assessed to cover, over the period to the next valuation (or some other control period), the cost of the additional pension rights that may be expected to accrue. The existing assets are then compared with the liabilities in respect of pension rights already accrued up to the valuation date, allowing for expected increases in salaries up to retirement age. Any surplus (or deficit) is dealt with by reducing (or increasing) the standard contribution rate, usually for a fixed period of years. Other funding methods in use include the attained age method, the entry age method and the aggregate funding method.

In the past, there have been no specific funding requirements laid down in regulations, other than an obligation that contracted-out plans demonstrate that they have the resources to meet guaranteed minimum pensions. This is changing with new pension legislation implementing the recommendations of the Pension Law Review Committee.

At present the actuary is required by mandatory professional guidance on actuarial valuations ("GN9: Retirement Benefit Schemes—Actuarial Reports") to report on the "current funding level," which represents the ratio of assets to the value of accrued rights. However, although this is disclosed in the actuarial valuation report, which is made available to members on request, at the moment plans are not obligated to remedy a current funding level of less than 100 percent. This will also change under the new legislative requirements.

**Defined Contribution Plans**

In recent years some employers have become concerned about the apparently open-ended cost of defined benefit plans and alarmed about the increasing complexity of regulations affecting the running of such plans. An alternative arrangement, which has the merit of simplicity, as well as effectively limiting the employer's liability, is to establish a defined contribution plan. Some employees also appreciate this approach, since it enables them to see more clearly how their "investment" — their own share of the fund — is growing.

The contributions of employees and employer can be invested with an insurance company, either in individual policies or in a managed fund, or can be invested in an autonomous pension fund under the control of the trustees, with suitable investment managers. The interests of individual members will be represented by the value of the insurance policies under the individual approach, or in other cases by the value of units in the fund that have been attributed to them. The main risk, from the point of view of employees, is that the resulting benefit will not bear any reasonable
relationship to their final salary level at retirement, particularly after a period of high inflation. This problem can be to some extent alleviated by targeted defined contribution plans, where the contributions can be adjusted in order to target the benefit on a particular level relative to final salary.

Personal Pensions

Employees cannot be forced to join a pension plan operated by their employer. Self-employed persons or employees who are not members of a pension plan can set up their own personal pension arrangement with an authorized pension provider, such as an insurance company, a building society, or a bank. On reaching retirement age, the proceeds of the pension investment must be used to purchase an annuity from an insurance company, although one-quarter may usually be taken in lump sum form. Dependents' benefits can also be purchased. There are limits on the amount of earnings that can be invested in a personal pension, ranging from 17 1/2 percent of earnings at most ages to more than double that level at ages close to normal retirement.

As mentioned earlier, personal pensions can now also be used as a vehicle for contracting out of the state earnings-related additional pension. The contracted-out contribution rebate (referred to in this context as the minimum contribution) is paid by the Department of Social Security directly to the personal pension provider chosen by the individual. The amount is a flat percentage of earnings in the relevant band, regardless of the age or sex of the individual. This is attractive only to younger employees, in particular those who are likely to change jobs frequently. As individuals get older they will be best advised to contract back in to the state additional pension, although they may continue to make contributions to a top-up personal pension.

Appropriate personal pensions for contracting-out purposes (i.e., purchased with minimum contributions) must be taken in pension form, with 3 percent a year pension increases, and a benefit to a surviving spouse of half the member’s pension, but additional contributions can be applied for other chosen benefits.

Supervision and Regulation

Pension plans in the United Kingdom are subject to a great deal of regulation, including requirements of the Inland Revenue, rules for contracting out, and provisions for the protection of members. Requirements are laid down regarding authorized investment managers, actuarial valuations, and the disclosure of information to members, but the
enforcement of these and other provisions relies upon the integrity of trustees and the legal rights of members in the Courts (or before the Ombudsman). There is no general system of supervision of pension plans and no single pensions regulator.

Plans that are contracted out of the state earnings-related additional pension are monitored by the Occupational Pensions Board, an independent statutory body, to ensure that they have, and are likely to continue to have, adequate resources to meet accrued liabilities in respect of guaranteed minimum pensions. The actuary has to provide a regular certificate to this effect and the supervision relies heavily on this certification process. However, no specific funding standards have been laid down up to now.

**Tax Advantages**

Tax privileges are given to occupational pension plans to encourage employers to set them up and to maintain them. The four main benefits for a tax-approved occupational pension plan are (1) that employers’ contributions are an allowable expense against profits; (2) that employees’ contributions are tax-deductible (i.e., tax is assessed only on the net income after the deduction of pension plan contributions); (3) that employers’ contributions to the plan are not treated as taxable remuneration in the hands of the employee; and (4) that no tax is payable on investment income or capital gains within the pension fund.

In order to qualify for tax approval, the plan must be established under an irrevocable trust and the employer must contribute. Employee contributions must be limited to a maximum of 15 percent of earnings and the plan must comply with certain maximum benefit requirements. These include a maximum pension (after 20 or more years service) of two-thirds final remuneration (defined in one of several approved ways) and a variety of constraints on other benefits, including invalidity pensions, survivors’ pensions, and lump sums.

A lump sum of up to four years’ salary may be paid on death in service. This is free of tax provided it does not pass automatically to the member’s estate. In practice the trustees generally have complete discretion concerning the choice of recipient. A lump sum of up to one and one-half years’ salary may be paid to the member on retirement, subject to 20 or more years service and a corresponding reduction in the members’ pension benefit. This is also free of tax. All other benefits are taxable as earned income in the hands of the recipient.

The tax privileges of belonging to a tax-approved occupational pension plan are not available in respect of earnings in excess of about four and a half times national average earnings, except for those individuals
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who remain in the pension scheme of which they were a member prior to June 1989.

The tax authorities have defined a maximum funding level that qualifies for tax-free treatment of the investments of the fund. The total amount of assets that may be held tax-free is 105 percent of the value of the accrued liabilities on the projected unit method of funding, with prescribed principal assumptions. For the purposes of this comparison the assets are valued on a discounted cash flow basis using prescribed assumptions. If the fund is above the prescribed level at an actuarial valuation, action must be taken, by increasing benefits or reducing contributions, to enable the fund to comply. Otherwise tax is levied on the excess assets. Assets may be returned to the employer to bring the funding level down, subject to Inland Revenue requirements and there being power in the trust deed. If there is no power in the trust deed, the Occupational Pensions Board can be asked to issue a modification order to amend the deed. Any refund to the employer is subject to a self-standing tax charge of 40 percent.

All contributions by the sponsoring employer are tax-deductible, including both regular contributions and contributions to fund a deficiency, provided the plan complies with the rules for tax approval. Although the investment income and capital gains of the investments of approved pension plans are in principle free of all taxes, some Advanced Corporation Tax payable by companies cannot be recovered against dividend payments to pension scheme shareholders.

Contributions to personal pension arrangements approved by the Inland Revenue may be made out of gross income by employed individuals who are not members of occupational pension plans and out of profits by the self-employed. Individuals who are members of an occupational pension plan may make additional contributions to a free-standing additional voluntary contribution (FSAVC) scheme. However, for employees in an occupational plan the overall limitation on contributions of 15 percent of earnings applies. Rather higher limits are applied where the provision is solely through a personal pension, ranging from 17½ percent of earnings at younger ages (35 and under), up to 40 percent of earnings at age 61 and above.

**Investment of Funds**

The trustees are responsible for investing the assets of the pension fund. Some of the largest schemes employ their own investment managers. Medium to large schemes mostly use the services of stockbrokers or merchant banks for the management of investments, sometimes apportioning the fund between two or more such managers. Investment managers
must be authorized under the Financial Services Act of 1986 to carry on investment business. Insurance companies may also offer investment management services of this type.

Smaller schemes often hand over the funds to an insurance company to manage. This can be through the purchase of policies on the lives of individual scheme members, but is now more usually a straight investment contract. This may be unit-linked, where the results depend directly on the behavior of the underlying assets, or deposit administration, where the capital that has been invested is guaranteed and a variable amount of interest is added each year at the discretion of the insurer. The distinguishing feature of an insured arrangement, as compared to a self-administered one, is that the underlying assets are owned by the insurance company. The asset of the pension plan is the insurance contract. However, it is possible (and not uncommon) for plans to be partly insured and partly self-administered.

The investments of self-administered pension funds were estimated at the end of 1990 to account for some US$ 450 billion, equivalent to 55 percent of the gross domestic product in 1990, and a little in excess of the total net assets of all United Kingdom insurance companies (including life insurance, property/casualty insurance, and pensions business) of US$ 415 billion million at the same date.

Since the major part of the liabilities of most pension funds depends on future earnings inflation during the period up to retirement and on future price inflation for pensions in payment, fixed interest assets such as bonds and mortgages are not in general thought to be suitable investments. The emphasis in recent years has been on investment in real assets, such as equities, property, and index-linked government securities. It is not common practice to match price-linked liabilities with index-linked government securities, except in some plans that no longer have any active members and are running off their liabilities. Some 70 percent of the assets of self-administered funds are now invested in equity shares, with about a quarter of these equity holdings in shares quoted on exchanges outside the United Kingdom, in particular in the United States, Japan, various countries of the European Community, and some countries of the Pacific rim. About 6 percent is invested in real estate. Table 6 shows the 1992 estimated distribution of assets into major categories. Self-administered pension funds own just over 30 percent of United Kingdom equities quoted on the London Stock Exchange.

Pension fund trustees are required under trust law to invest the assets of the fund in the best interests of the members. This is usually regarded as precluding investment in the employing company, or in related organizations, unless the terms are fully competitive with those available in the market. Any significant equity investment in the employing company
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is regarded as unsound, since it reduces the security of members' pension rights. Insolvency of the employer would affect not only their jobs but the value of their accrued pension rights. Regulations have been introduced to restrict self-investment of this type, for contracted-out defined benefit plans, generally to a maximum of 5 percent of total assets. Contracted-out money purchase plans are required to invest in a prescribed list of assets (including insurance policies), some within certain limits, but these requirements are not unduly restrictive and are mainly for the purpose of ensuring appropriateness of investment and adequate diversification. Apart from this there are no regulations or laws constraining the investment policy of pension funds or affecting the value that may be placed on the assets for funding or solvency purposes.

Trustees often use portfolio performance measurement services to monitor the investment performance achieved by the managers. Some of these services compare the fund's performance with that of other funds, so that conclusions can be drawn as to whether the fund's performance is above the median, in the upper quartile, and so on. Other services compare performance sector by sector with a suitable index and overall against a benchmark asset distribution set by the trustees.

Some pension funds are managed on a fully discretionary basis. In other cases the trustees establish a benchmark distribution, for example 60 percent United Kingdom equities, 20 percent overseas equities, and 20 percent index-linked government securities. The investment manager is then monitored against the performance of such a portfolio. They can deviate from the benchmark to achieve improved returns, but will need to be able to justify to the trustees the more "risky" profile adopted.

Over the ten years 1982 to 1991 the median return of all pension funds participating in a major performance measurement service was just over 16 percent a year. This may be compared with average price increases of 5.6 percent a year over the same period and earnings increases of 8.2 percent a year.

**Replacement Rates**

The basic social security pension aims to provide 100 percent replacement of income up to the lower earnings limits. This represents some 18 percent of national average earnings. Since the benefit is flat-rate, the replacement ratio clearly falls as earnings increase above this level. Replacement ratios may also be less for those with an incomplete contribution record.

The earnings-related additional pension is still not mature. Those reaching state pension age in 1998-1994 can receive an additional pension of around 18 percent of revalued career average earnings in the band
between the lower and upper earnings limits. This proportion rises to 25 percent for those reaching state pension age in 1998, before falling gradually to 20 percent for those reaching state pension age in 2001 and later.

**Retirement Income**

Table 7 shows the average distribution of retirement income by source at a recent date for all those over retirement age, together with corresponding information for selected earlier years. This shows the growth of the role of occupational pension provision, which can be expected to play an even greater role in the future with increased maturity of occupational pension arrangements and with improvements in the facilities for transferring pension rights on change of employment and for preserving up to retirement age accrued pension rights in respect of early leavers.

**Public Policy**

Government policy for more than a decade has been to restrict the growth of public provision for retirement and to encourage the growth of private provision. The basic pension is intended to provide a low level of guaranteed retirement income for the majority of members of the population, financed according to ability to pay by earnings-related contributions from employees, employers, and the self-employed.

The second tier of retirement income should ideally be provided by occupational pensions or personal pensions. In recognition of the fact that the coverage of such arrangements is not universal and is unlikely to become so in the foreseeable future, an additional earnings-related pension facility is provided by the social security system. This is clearly envisaged as a back-up, or safety net, and every encouragement is provided to employers and to individuals to replace this additional level of social security by occupational or personal pension provision.

Social security for retirement is operated on a contributory basis and is clearly redistributive, with the major part of the benefit expenditure being flat rate, but contributions earnings-related, albeit with an upper earnings limit for employees' contributions. The system incorporates incentives to encourage private provision, particularly by means of appropriate personal pensions. Tax incentives are given to encourage both occupational and personal pensions. The main value of these consists of the deferment of tax, tax-free lump sums, and the possibility of restricting the tax payments to a lower percentage of income since total income is likely to be lower in retirement than at the working ages.

The self-employed are covered by the basic pension and are encouraged to make further provision through tax-efficient personal pensions.
Private pension plans play an important role, covering about 50 percent of employees as active members and another 20 percent of employees with vested accrued rights to a pension at retirement age. About 60 percent of those over the age of 60 are in receipt of an occupational pension, but the proportion is higher for those newly attaining retirement age. The average occupational pension in payment is over US$ 90 a week and for those retiring now it is around US$ 120 a week.

Personal pensions have grown in popularity since they became available as a vehicle for contracting out of the State Earnings Related Pension. The financial incentives in the contracting-out arrangements have meant that most appropriate personal pensions have been taken out by people under the age of 40, with older people remaining fully in the state scheme.

An investigation by the National Audit Office in 1990 estimated that the gross cost of the contracted-out contribution rebate and incentive for personal pension optants might be around US$ 14 billion in the six years from April 1988 to March 1994. The estimated present value of savings in future costs of earnings-related pensions was US$ 5 billion.

Although public policy is to encourage employers to provide occupational pension plans and employees to have private pension provision, it is thought right that individuals should have freedom of choice and not be required to join their employer's plan. Anyone who wishes to can opt instead for a personal pension, or remain in the state earnings-related pension scheme.

In the absence of centralized supervision of occupational pension schemes, disclosure requirements have been developed. These are now quite elaborate and add significantly to the burden on scheme administrators. It is not known how useful this disclosure is to members in general, although in principle it should act as a deterrent to bad practice on the part of employers and scheme administrators. The deterrent effect may be rather weak in the absence of a supervisory body and strong sanctions.

Legislation following the Report of the Pension Law Review Committee is likely to lead to significant changes in the regulatory framework, to a pensions supervisory authority, minimum funding standards, and strengthened roles for scheme administrators, actuaries, auditors and investment managers.

It is unlikely that there will be any change in the basic policy of encouraging complementary pension plan provision or, in the next few years at least, any attempt to build up the role of state provision. If anything, the process of privatization of pensions might be expected to go further. There will be moves to simplify the contracting-out arrangements, as part of the process of equalizing state pension age for men and women.
There will be age-related rebates for contracting out by means of money purchase plans. This should make personal pensions and COMPs attractive for contracting out at all ages, and thereby lead to a further growth of complementary provision and a further diminution of the role of the state in providing retirement income.

Personal pensions at the minimum level for contracting out are unlikely to provide a very adequate income in retirement. A major challenge for education (and marketing) is, therefore, to persuade people that they must make additional voluntary contributions and that the responsibility for ensuring an adequate retirement is theirs. The state will not provide more than the basic flat-rate pension to those who have been contracted out. Of course, there will still be the possibility of means-tested income support, but the whole thrust of encouraging private provision for pensions is to lessen the dependence on state benefits.

Views differ as to the likely success of these objectives. Trade unions and staff associations in general remain very suspicious of personal pensions, which they see as putting too much of the risk (particularly of investment performance relative to inflation) on the individual and too much money (commission, profit, etc.) into the hands of financial intermediaries, insurance companies, and other financial institutions. The preferred option of organized labor is the final salary occupational pension plan, if possible with full price indexation of pensions, both in payment and in deferment.

Most large employers remain satisfied with their existing defined benefit occupational pension plan arrangements, although many complain bitterly about the complexity of the many different requirements and threaten to discontinue the plan if any more regulations are introduced. A new employer might, however, be more inclined to set up a money purchase plan.

There are problems associated with the selling of personal pensions. It is a difficult choice for individuals to make to leave the state earnings-related pension scheme for an appropriate personal pension, or to forgo membership of a final salary occupational pension plan for a personal pension. The choice is far from straightforward, because the nature of the benefits is very different. The individual needs to understand that certain types of guarantees are being given up, relating to the level of pension and the extent of indexation. In return there is greater personal control over pension assets and the possibility of good results if the investment policy is successful.

The selling of financial products in the United Kingdom is governed by the Financial Services Act 1986 (FSA), administered by the Securities and Investment Board (SIB), and the various self-regulatory (i.e., industry-led rather than government) bodies. The FSA requires the fi-
financial intermediary to “know the customer” and to offer “best advice.” There are also requirements regarding documentation of the advice, projections of future benefits, disclosure of commission, and so on.

Of course, there are many reasons why an individual might take out a personal pension. The public policy concern is whether many (or some) such individuals have been badly advised, or even misled, by eager salespersons and have not properly understood the nature of the choice being made.

Since membership of an occupational pension plan is voluntary, it is always possible for an individual to opt out, either just for future service or also by taking a transfer value in respect of past service pension rights to a personal pension. The determination of the transfer value is in the hands of the pension scheme actuary, operating under the requirements of professional Guidance Note 11 (GN11), as for ordinary plan transfers. There is some concern that this gives too great a level of discretion to the actuary and that, as a result, transfer values, although defined as the cash equivalent of the vested accrued rights forgone, may vary too much from plan to plan.

These concerns about transfers, opting out, and personal pensions are of more widespread significance than the higher profile issues of the shortfalls in the Maxwell pension plans. Pensions in payment have so far continued to be paid from the plans and the future prognosis is not looking too bad, since money is being recovered from various sources and guaranteed minimum pensions for the contracted-out plans are in any case underwritten by social security.

However, the publicity surrounding the affair has created concern in the minds of a lot of pension plan members, and many trustees have taken steps to improve controls in order to reduce any risk there might be to pension fund assets. Recent legislation may address this problem with a variety of provisions, including minimum solvency standards, an appointed scheme actuary requirement, member representation on the trustees, an effective pensions regulatory system, and a limited compensation scheme.

**Equal Treatment of Men and Women**

In 1986 the European Community Directive on equal treatment of men and women in occupational social security schemes was approved. Although requiring equality of treatment, there was a temporary exemption for retirement age and for benefits to surviving spouses, pending equalization of retirement age in social security systems.

Actuarial factors that differed by sex could still be used for individual calculations, such as converting pension to lump sum, and for defined
contribution plans. Some of these exemptions have been challenged in the courts, and a very important landmark judgment was given in the European Court of Justice on May 17, 1990 in the case of Barber v. Guardian Royal Exchange. The Court took the view in this case that the principle of equal pay for men and women, which is enshrined in Article 119 of the Treaty of Rome establishing the European Community, applied also to equal pensions for men and women (and to other benefits). It followed that the age at which there was entitlement to a pension had to be the same for men and women, and should have been so from 1957 onward.

In the judgment on the Barber case the Court sought to limit the retrospective impact on pension plans, but considerable uncertainty remained about the interpretation of these provisions. It was clear, however, that, at the least, pension rights accruing in respect of periods of pension plan membership after May 17, 1990 should comply fully with the principle of equal treatment. Very many United Kingdom plans took action to implement equal pension ages for benefits accruing from that date, but most sought to avoid making the changes in respect of any past service.

There was also uncertainty about whether it was permissible under European Community law to implement equal pension ages by raising women's retirement age. Was it necessary to level up benefits when implementing equal treatment? Did an increase in retirement age constitute a worsening?

Further problems arose in the United Kingdom with regard to bridging pensions (higher pensions paid to men between 60 and 65 to compensate for the fact that the state pension age for men is still 65, while that for women is 60, with the aim of providing an equal pension in total). There was also a continuing debate over whether some types of actuarial calculation should be based on unisex tables.

In December 1991 the government issued a consultation paper on equalization of the state pension age for men and women. Following a period of consultation the government announced a decision to equalize at 65 from 2020, with a phasing in of the higher pension age for women from 2010 to 2020. The system of contracting out of the earnings-related additional pension is also to be equalized from 1997.

**Pension Funds Directive**

In 1992 the European Commission proposed a pension fund directive that was intended to provide freedom of cross-border investment for pension funds and freedom to choose an investment manager from another European Community country. These proposals were in general
welcomed in the United Kingdom. However, a measure intended to liberalize the investment scene for pension funds was modified in the negotiations and might have imposed restrictions that do not exist at present for United Kingdom pension funds.

The original intention of the directive was that relaxing investment constraints throughout the European Community would allow large companies with several subsidiaries in different member states to achieve real savings. These would be available from the potential improvement of investment yields (due to greater investment choice between countries and among asset categories) and the reduction of costs arising from consolidation. There would also be greater competition between asset managers as the market for new business increased.

The proposed directive has now been dropped, as unresolved disagreements arose on matters such as the extent of control on currency matching of assets and liabilities.

**Cross-Border Membership**

The original intention of the European Commission (1992) had been to include in the pension funds directive some provisions to facilitate cross-border membership of pension plans within the European Community. However, this proved to be too difficult.

Current impediments to the free movement of workers within the European Community include differing social security regimes, differing levels of benefits provided in different countries, different tax regulations applicable to employer and employee contributions to complementary plans, unwillingness to permit transfer values to other countries, and lack of consensus on minimum vesting requirements, ranging from one-year vesting in the Netherlands to no minimum vesting requirements in several member states.

Although social security systems differ substantially, both in structure and in matters such as pension age, some progress was made in 1971 toward reducing obstacles to cross-border movement through a regulation that requires periods of contribution to different social security systems to be aggregated in determining entitlement. Occupational pension plans are not, however, covered by these arrangements.

Probably the biggest obstacle to an effective solution is posed by the rules and regulations relating to tax approval of pension plans. In order to prevent abuse of the tax advantages available to occupational pension plans, transfer payments other than to another approved pension plan in that country may be restricted.

When a member leaves a United Kingdom occupational pension plan
after more than two years' membership, he or she has the right to vested accrued benefits, payable in due course at retirement age. This applies whether the member is changing employment within the United Kingdom or moving to another country. Possible loss of pension rights cannot, therefore, be considered to be an obstacle to such moves from the United Kingdom to other countries. When someone changes employment within the United Kingdom, a cash equivalent transfer value to another approved scheme (or to a personal pension) is available as an alternative to the deferred vested benefits. There are some restrictions on such transfers being made outside the United Kingdom. Transfers cannot be made to pay-as-you-go social security systems such as the French “régimes complémentaires” or to internal book reserve schemes such as occur in Germany and to a lesser extent elsewhere. Subject to certain conditions imposed by the Inland Revenue, transfers may be made to independent pension funds (including insured plans) in other member states of the European Community and elsewhere. The relevant conditions are: (1) the move to the other country must be permanent; (2) the member must have requested the transfer or given written consent; and (3) the receiving scheme must be a tax-approved bona fide arrangement. Guaranteed minimum pension (GMP) benefits are not usually transferable, but must be left as an entitlement from the United Kingdom ceding scheme.

Notwithstanding the possibility of making transfers as above, the relevant receiving fund in another country may not be willing to accept a transfer of funds with immediate vesting of accrued rights. Transfer payments from pension schemes in other countries can be accepted by a United Kingdom approved fund with the agreement of the Inland Revenue. The resulting benefit rights to the member, when combined with subsequent entitlements, would, however, be subject to the usual overall benefit limits. Benefits accrued in an occupational pension plan in another country (but not transferred by means of a transfer value) are usually ignored in relation to maximum benefit entitlement in the United Kingdom. An expatriate worker coming to the United Kingdom may have the choice of remaining covered by a home country pension arrangement, joining a United Kingdom plan, or participating in an offshore arrangement.

Because of the two-year vesting requirement and the availability of partially inflation-protected vested accrued benefits, occupational pension plans do not present as great an obstacle to cross-border movement to and from the United Kingdom as in many other countries. There are still obstacles, however, to remaining a member of a plan in one country while working, on a relatively temporary basis, in another. An increased level of mutual recognition of tax-approved pension arrangements would
be welcome as a means of lessening these obstacles. Discussions continue within the European Community to see if this problem can be alleviated.

Conclusion

Apart from these direct effects of European Union legislation and Commission initiatives, the development of further economic integration could have an impact on the investment opportunities for pension funds in the United Kingdom. There is already an increasing interest in investing in other European Union markets. There does not seem to be any immediate (or even presently foreseeable) intention of seeking convergence of the form or structure of complementary pension arrangements (or national social security), so we can expect continuation of the current wide variety of arrangements in different countries.

Attention will continue to focus on improving the possibilities for cross-border membership of pension funds, to permit companies operating in several countries of the European Union to offer a common pension arrangement and to overcome obstacles to mobility of labor, such as penal vesting of entitlements.

From a purely United Kingdom perspective there is likely to be continuing debate about contracting out, indexation, and personal pensions. A number of important changes are expected as a result of the recent legislation, but it is unlikely that this will be the end of a continuous process of evolution and change.

Notes

1 This chapter draws heavily on Government Actuary (1994a, b).

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Comments by Anthony M. Santomero

Christopher Daykin has offered the reader a cogent review of the pension system in the United Kingdom and its evolution during the past couple of decades. The author should be praised for a picture that permits an outsider a clear understanding of the structure, financial position, and public policy issues facing the British pension system.

His review is sufficiently lucid to make any recapitulation redundant. Accordingly, my comments here will focus on three points that Mr. Daykin discusses but that warrant further attention. These are: (1) the stability of the government system in light of the “opt out” option to the private system; (2) the overwhelming dependence of the system on the defined benefits structure; and (3) EEC transferability. In each of these cases the author’s description of the current state makes this reader somewhat less comfortable with the status quo than the writer. Allow me to discuss each point in turn.

System Stability

As the author would readily admit, pension programs are types of special-purpose financial institutions. The health and stability of these plans depend upon the balancing of income and expenses, in short, maintaining a non-negative present value. Changes in their environment, caused by shocks in the external economy or public policy perspective, will improve the health of these institutions only if they do not adversely affect the balance between the present value of both income and expenses.

Over the last decade, however, the changes affecting public sector pension plans have not all been stabilizing. As Daykin notes, since 1987 individuals could contract out of the state’s earnings-related pension plan in favor of one of the private sector alternatives. Indeed, there is an overwhelming movement in the United Kingdom away from the state-run system, toward private sector alternatives.

Extreme care must be taken during this transition, as the residual
system could become vulnerable as individual members “opt out” only when it is advantageous to do so. We see this opportunistic behavior in the United Kingdom today. As the author notes, the contract-out rebate is a flat percentage of earnings and is unrelated to the actuarial liability associated with it. Accordingly, younger employees find it attractive to contract out, only to enter the system in older age. Obviously, such behavior is not sustainable unless the benefits are adjusted downward to offset the lost revenue from wage earners reducing their contributions to the program in early years. In this case, the system will exploit the uninformed or low-income earners who have not contracted out of the system. Alternatively, if all become informed players, the system becomes a specialized old-age pension plan viable for elderly workers only.

The resolution to the problem is mentioned by Daykin himself. Contract-out rebates must be made age dependent. Then, the system upon which a large number of workers depends will not possess this adverse selection feature. While it is laudable that this feature is being discussed, it is necessary that such a measure be passed to prevent the movement to private pensions from becoming a long-term public drain.

The Defined Benefit Structure

As the author notes, the United Kingdom pension system is predominantly a defined benefit structure. The public sector system clearly is a defined benefit scheme, and the occupational pension plans are mostly of this type as well. In this respect, the United Kingdom is behind the trend that has been prevalent elsewhere for some time, namely the move toward defined contribution plans. It is obvious that unions prefer defined benefit plans and a greater say in pension fund decisions. Equally obvious is the fact that the employers are increasingly unwilling to absorb the risk of defined (virtually indexed) benefits. Accordingly, firms have been pushing toward limits on both contributions and recourse to firm resources by pension plan trustees.

There is significant evidence of a trend in the United Kingdom toward defined contribution plans as well, although Daykin understates it. He notes that there is little evidence of conversions thus far in the United Kingdom from defined benefits plans to defined contributions plans. However, he goes on to say that newly established schemes have moved toward the defined contribution model. This should be expected. While large firms and/or large unions are reluctant to demand “give-backs” if only because of the employee morale issues, new plans will adapt to the new economic realities that have led others to defined contribution plans. As the international economy becomes more competitive, firms have tried to limit their exposure to long-term, open-ended labor con-
tracts in favor of short-term ones. Multi-year commitments to employment have long given way to layoffs and cyclical employment contracts. It should come as no surprise that management will seek the same short-term focus on pension contributions and commitments.

Of course, labor will object and protest. This is natural as the firm sector sheds its role as insurer of real income in retirement. However, global competition will make this trend as inevitable in the United Kingdom as it has been in the United States and as it is becoming in Japan.

But all is not lost. As the author mentions, a shift toward defined contribution plans increases the employee's involvement in his or her savings decisions and in the capital markets themselves. There is a silver lining to every cloud.

EEC Transferability

The European economy is no longer a set of distinct economic markets. Increasingly, it is an interconnected entity with firms and products crossing borders at will. Labor, of course, has been the slowest commodity to migrate. Even here, however, over time the labor market of Europe will become transnational. In this context, the portability of pensions becomes a serious issue. Yet until recently it has been underdeveloped as an area of harmonization.

Recent policy directives appear to be changing this situation. However, substantial barriers remain. As the author notes, current impediments in the pension area include: (1) differing benefits; (2) different social security regimes; (3) differing tax schemes; and (4) differing vesting rules. While subsequent directives and enabling legislation at the national level will erode away these differences, the status quo is simply not acceptable. Tax differences may be the most difficult politically, but they are the least important. Differential regulation, government guarantees, and public funding of the social system retard cross-border labor movement. They adversely affect both workers and the social objectives of government policy.

If the Second Banking Directorate is any indication, these differences will be worked out, with some combination of cross-border membership and reciprocity. Over time, national origin may well define pension rights, and standardization may well replace the patchwork of systems currently in place. But differences remain in some other areas of financial harmonization because of the sheer complexity of the issues involved. The problems should not be underestimated.

There is, however, a way out. Most problems of pension rights and responsibilities flow from public systems and defined benefits programs. Defined contributions programs more easily lend themselves to financial
harmonization, with some exceptions. The trend toward private sector programs and defined contributions programs indicated above, therefore, enhances Europe's ability to offer its workers portability. It does so without the need to reconcile tax legislation, funding differentials, and national origin issues that arise from the public defined benefit systems that are being replaced.

In essence, the forces of change are enhancing workers' rights, while they are transforming the pension fund system in the United Kingdom, as well as elsewhere in the EEC. As a major participant in the United Kingdom system, Daykin will oversee this transformation on behalf of the British workers he represents. Based upon his grasp of the issues relevant to the current British system, and his significant contributions to that system during his stellar career, they are in good hands.