

**Working Paper for the National Consumers Council**

**RISK, TRUST AND REGULATION:  
THE CASE OF PENSIONS**

**Dr Julia Black**

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London School of Economics and Political Science  
Houghton Street  
London WC2A 2AE  
Tel + 44 7955 7684  
Fax +44 7955 7366  
Email [j.black@lse.ac.uk](mailto:j.black@lse.ac.uk)

## **SUMMARY**

This paper discusses four issues: the principal ways in which individuals can attempt to ensure that they have sufficient income in their retirement, the risks for the individual associated with each of the different options available to them, how, if at all those risks are addressed, and what reforms could be made.

The paper identifies twelve different types and sources of both risk and uncertainty for consumers and analyses how these are presently managed. These are:

- Public policy risk
- Demographic risk
- Earnings and employment risk
- Inflation risk
- Interest rate risk
- Mortality risk
- Market risk
- Funding / solvency risk
- Governance risk
- Investment management risk
- Advice risk
- Complexity / suitability risk

The analysis suggests that two features of risk management of pension provision are particularly striking. The first is the fragmented nature of decision-making on risk. There is no single risk management process in which risks are assessed, managed and communicated. There is rather a multitude of processes, some simultaneous, others sequential, some overlapping, others quite discrete, carried out by a wide variety of players. The second is that whilst mitigation of most risks to the consumer is possible, reduction of one type of risk often increases exposure to another; further mitigation of one type risk to one actor often increases another's exposure to that same risk. Risk trade-off and risk distribution rather than overall risk reduction are thus often the key issues in contention.

## **INTRODUCTION**

There is widespread concern in policy circles that levels of income for future generations of pensioners will be low if not inadequate due to a number of factors. These include demographic changes, reductions in mortality rates, an unwillingness on the part of the state to increase unfunded pension provision, and inadequate personal savings by individuals for their retirement. However whilst most consumers recognise that the state will not provide them with an adequate pension on retirement, few show any awareness of the levels of savings that they will have to make to ensure that they are sufficiently provided for when they cease work. Moreover, many have little understanding of the options available, and the relative risks involved in each.

This paper outlines first what the principal policy issues are relating to the need to ensure consumers have adequate income in retirement, and who the main actors are. The second section outlines the current system of pension provision. The third section identifies the risks faced by the consumer with respect to the different types of pension. The fourth section discusses with respect to each type of risk how it is assessed and managed in the context of each type of pension. The fifth section considers the issue of risk communication. The sixth section concludes with some proposals for reform.

## SECTION 1: ISSUES AND ACTORS

### What is the issue?

The central issue from a consumer perspective, and indeed from a wider societal perspective, is whether individuals will have sufficient income during their retirement. Current levels of average pensioner income are low relative to that of earners.<sup>1</sup> In 1999-2000 the average net income for single pensioners was £149 per week and for couples £281 per week, though these figures hide wide disparities between men and women and between older and younger pensioners.<sup>2</sup> Unfortunately there is also considerable evidence of widespread confusion and ignorance amongst consumers about pensions and a lack of understanding of the options available and risks entailed.

### Who are the players?

In addressing the central issue of how to ensure a sufficient level of income in retirement there is a wide range of players involved. Indeed one of the striking aspects of the issue is not just the wide variety of sources of risk and uncertainty that an individual faces in trying to ensure adequate provision for old age, but the wide variety of actors involved in both creating and managing those risks. Addressing the central risk of inadequate income is not a centralised activity focused on one or two state actors; it is fragmented between numerous actors, including several different government departments and agencies, professional advisors, professional bodies, providers of financial products, and consumers themselves.

The main players involved directly or indirectly in addressing the risks facing consumers in trying to provide for adequate income in retirement are the following:

- the EU (eg directives regulating financial product providers)
- the Government as provider of pensions and related benefits
- Government departments: principally the Government Actuaries Department (GAD), Department for Work and Pensions (DWP), HM Treasury (HMT), Inland Revenue (IR)

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<sup>1</sup> Department for Work and Pensions, *Pensioners Income Series 99/00* (2000); R. Disney, C. Emmerson and S. Smith, *Pension Reform and Economic Performance in Britain in the 1980s and 1990s* (Institute of Fiscal Studies, undated), available at [www.ifs.org.uk/pensions/policy.html](http://www.ifs.org.uk/pensions/policy.html).

<sup>2</sup> Department for Work and Pensions, *Pensioners Income Series 99/00* (2000). See also DWP, *Retirement Pensions Summary of Statistics: First Release* (September 2001); FSA, *Women and Personal Finance: The Reality of the Gender Gap*, Consumer Research Paper 7 (April 2001).

- Government regulatory bodies: Occupational Pensions Regulatory Agency (OPRA), Financial Services Authority (FSA) and associated Ombudsmen
- Professional bodies, notably the Faculty of Actuaries and Institute of Actuaries (collectively referred to as FIA); the Association of Insurance Brokers (ABI); Accounting Standards Board
- Professional advisors with statutory / regulatory responsibilities: pension fund trustees, appointed actuaries, auditors
- Financial product and service providers: life companies, fund managers including pooled investment trust managers, financial advisors including investment advisors and consultants to pension fund trustees and providers of retail financial advice
- Individual consumers

## SECTION 2: WHERE ARE WE NOW?

### Pension provision for employed people in the UK

Pension provision for *employed* people in the UK consists of three tiers. Tier 1 is the basic minimum level of income guaranteed to retired persons by the state. Tier 2 is the mandatory level of pension provision by individuals required by the state, though there is a considerable range of options available within that tier. Tier 3 is the voluntary provision of pensions and other forms of retirement income and protection by individuals for themselves.<sup>3</sup>

Within those tiers, pensions may be funded or unfunded, and be either defined benefit (DB) schemes or defined contribution (DC) schemes. An unfunded scheme is one in which the contributions of today's earners pay for the retirement pensions of current retirees; there is in effect an intergenerational agreement in which current earners expect in turn to be supported by future earners in the former's own retirement. Income is paid out as it is paid in, and there is little or no accumulation of income or capital.<sup>4</sup> A funded scheme is one in which contributions in respect of current earners are accumulated to pay for those earners' income and capital on retirement. A defined benefit scheme is one in which the benefits are defined at the outset, and contribution rates to achieve those benefits are varied to ensure the benefits are met. A defined contribution scheme is one in which the benefits vary depending on the level of contributions made and the investment performance of the fund. Pensions may also be public (provided by the state) or private (provided by non-state bodies: employers, individual consumers).

There are three principal forms of pension provision in the UK, distributed between the different tiers. These are

- unfunded state schemes
  - Basic State Pension (BSP),
  - State Earnings Related Second Pension / State Second Pension (SERPS / SSP)
  - some public sector occupational pension schemes (OPSSs)
- private funded DB schemes (occupational DB schemes)
- funded DC schemes

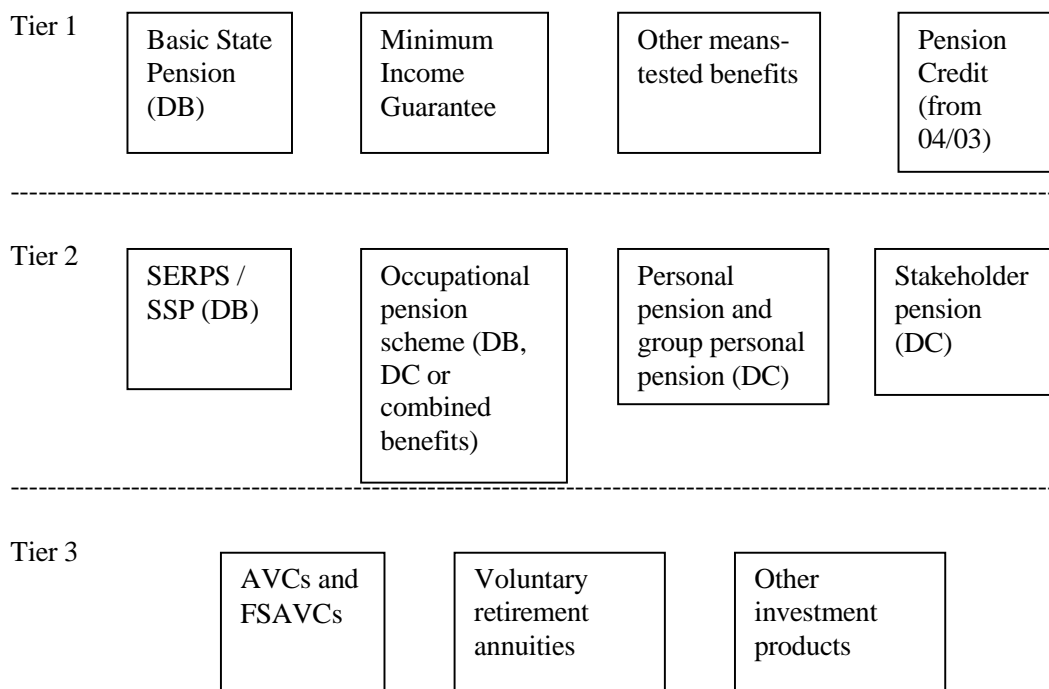
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<sup>3</sup> For details see eg D. Blake, *The United Kingdom Pension System: Key Features* (Discussion Paper PI-0107, The Pensions Institute, 2001).

- o occupational DC schemes
- o group personal pensions
- o personal pensions and stakeholder pensions
- o money purchase additional voluntary contributions (AVCs) to occupational schemes
- o free standing AVCs (FSAVCs).

Each form of pension poses slightly different risks for the consumer.

**Figure 1: Pension provision in the UK for employed persons**

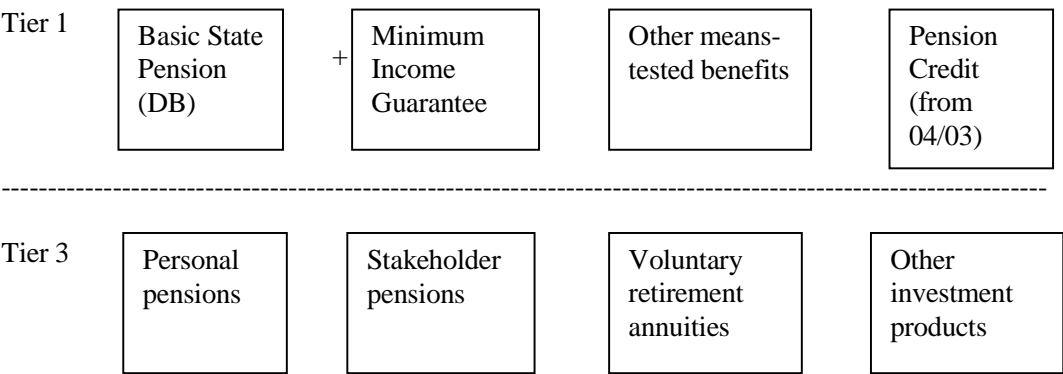


### Pension provision for the self employed in the UK

<sup>4</sup> See further Faculty and Institute of Actuaries, Pension Provision Taskforce, *Unfunded Pension Schemes in*

Employed and self employed people have different options open to them for pension provision, although there is in fact considerable fluidity between the two groups, with most employed people spending at least part of their working lives as self employed and vice versa.<sup>5</sup> For those who are self employed, or more accurately for individuals during periods of self-employment, pension provision consists of the Tier 1 basic minimum provision and voluntary provision (tier 3). There is no mandatory requirement to contribute to SERPS / SSP, nor may a self-employed person opt to contract in to those schemes by paying higher NI contributions. Tier 3 provision consists since 1988 of personal pensions (previously retirement annuity contracts), stakeholder pensions, voluntary retirement annuities and other investments. The lack of mandatory provision for self employed persons and their exclusion from SERPS / SSP has been criticised as based on inaccurate assumptions as to the profile and income of the self-employed as high earning professionals and / or those who will be able to rely on considerable levels of business capital when they retire. In practice the self-employed as a group are more reliant on Tier 1 support than the employed.<sup>6</sup>

**Figure 2: Pension provision in the UK for self employed persons**




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*the EU and the UK Public Sector, Actuarial Position Paper* (2001).  
<sup>5</sup> Pension Provision Group, *Pension Provision and Self Employment* (DWP, 2001).  
<sup>6</sup> Ibid.



### **SECTION 3: WHAT ARE THE RISKS TO CONSUMERS?<sup>7</sup>**

As indicated above, the paper is concerned with the risks to consumers associated with the different options open to them for ensuring that they have adequate income in their retirement. This section briefly outlines the nature of those risks.

#### ***Public policy risk***

All types of pension have the risk that the spending, tax, regulatory policies to which they are subject will be changed both in the course of a current earner's working life and during retirement. State pensions are dependent on the commitment of successive governments to funding people in their retirement, and both state and private pensions are surrounded by a myriad of tax and other regulatory rules. Changes in public policy relating to any of these issues may have a substantial effect on the nature and level of pension entitlements for all types of scheme.

#### ***Demographic risk***

The risk is that the current trends for increasing longevity and declining fertility rates will mean that the population will continue to age, and an ever-declining working population will be thus be supporting an increasing retirement population.<sup>8</sup> This risk faces consumers directly in unfunded schemes as tax rates will probably rise, and in DC schemes as annuity rates will be affected.

#### ***Earnings and employment risk***

The risk is that in the course of a person's working life they will have periods of low or non-earnings, will change employment, may have periods when they are not employed, and that they will be forced into early retirement. This risk faces consumers in all schemes, but is higher for those in occupational DB schemes given the relationship between benefit levels, number of years employed and final salary.

#### ***Inflation risk***

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<sup>7</sup> See FSA, *Financial Risk Outlook 2002* (FSA, 2002), p.41-42.

<sup>8</sup> See Institute / Faculty of Actuaries, Pension Provision Taskforce, *Age of Retirement and Longevity* (date\*\*).

Inflation risk arises in funded DB and DC schemes during the accumulation phase, and for all schemes during the distribution phase of the pension. During the accumulation phase it is faced directly by members of DC schemes and the risk is that inflation will erode the value of the return on investments. During the distribution phase the risk is that inflation levels will be such that they will erode the value of benefits being paid. The latter risk faces pensioners in all schemes, although may be reduced in ways addressed below.

### ***Interest rate risk***

Interest rate risk arises during the accumulation phase for funded DB and DC schemes as it affects the return on certain types investment, in particular gilts and long term bonds which are used to meet liabilities. The yield of those investments is linked to interest rates; the lower interest rates, the lower the yield, and thus the lower the value of the fund. It affects members of DC schemes directly.

Interest rate risk also arises on the distribution phase of DC pensions as it directly affects the levels of annuities that a particular fund will be able to purchase.

### ***Mortality risk***

This risk takes two forms: an aggregate form and an individualised form. In aggregate, the risk is that mortality rates will be continuously revised to anticipate increasing longevity. Mortality rates impact on the level of pension provided in that they expand the predicted period for which a person is expected to live, thus making it more expensive to provide them with income during retirement. The funding of schemes is then affected, and annuity rates are lowered. This affects members of DC schemes directly.

In individualised terms, the risk to an individual is that they will in fact die early in retirement, before they have used up their accumulated fund and whilst they may still have dependents who need providing for. This risk faces members of all funded schemes.

### ***Market risk***

Market risk is the risk that value of the funds investments will decline due to a drop in the market for those investments generally. Market risk is a key source of risk for funds themselves, and is linked to solvency / funding risk. Market risk can also relate to the risk that there will be changes in the supply and demand of particular investments which will affect the investment return or yield: an example is the current shortage of good quality long term assets such as gilts, which are used to back the long term liabilities of pension funds. This risk faces members of DC pensions directly.

### ***Funding / solvency risk***

The risk is that there will be insufficient funds to meet the expected levels of benefits on retirement due to inadequate funding or to the insolvency of the pension provider. It is a risk faced only indirectly by consumers in the case of unfunded schemes (that it might cause benefits to be reduced and /or taxes or NI contributions raised). It is faced directly by members of funded schemes.

### ***Governance risk***

Governance risk is related to funding / solvency risk, as poor governance can result in inadequate funding or insolvency. It can take a number of forms. These include inadequate management, failure to meet future pensioners' reasonable expectations, changes in policy as to the level and availability of benefits on retirement, excessive and opaque charges, and at the extreme, misappropriation of assets (fraud). It arises in all types of pension, though may have different consequences in each.

### ***Investment management risk***

This is associated with governance risk, but due to the frequent delegation of the investment function it is preferable to see it as a separate form of risk. Investment management risk is that the funds will be poorly invested such that fund is insufficient to meet its liabilities. Investment management is separate from market risk; it is that the investment managers will underperform the market conditions, will invest in assets that are unsuitable given the nature of the liabilities of the fund, or will charge fees that are in excess of what is recouped in enhanced investment performance. It is faced directly by members of DC schemes.

### ***Advice risk***

Advice risk is that the consumer will make a sub-optimal decision because of poor advice on suitable retirement options or advice that is given in bad faith. Advice risk is particularly acute in pension provision, as indeed with other complex investment products, as the quality of such products only becomes evident several years after they were taken out: in economic parlance they are 'credence goods'. Few people shop around for investment products, and the advice they receive together with the reputation of the firm providing the product, are the basis on which the majority of investment decisions are made.<sup>9</sup> Advice risk is faced by consumers with respect to all pensions in tiers 2 and 3.

### ***Complexity / unsuitability risk***

The risk is that consumers opt for a form of pension provision that they do not understand and which is not suitable for their needs and circumstances. The risk is considerable. There is extensive evidence that consumers have a poor understanding of pension products in general and of the rights and liabilities that arise under the particular pension policies that they have.<sup>10</sup> Significantly for this discussion many have only a very vague understanding of risk. For example although they are aware that the value of equity based investments may go down, most thought the statement was a disclaimer rather than a warning and had no expectation that their own policy would decline in value.<sup>11</sup> In addition, a significant number interpreted the lowest conjectured projection of benefits contained in the documentation given to them as the guaranteed minimum amount that they would receive.<sup>12</sup> The risk is faced by consumers with regards to all schemes.

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<sup>9</sup> FSA, *Informed Decisions?* (CR 5, November 2000).

<sup>10</sup> Ibid; FSA, *With Profits Review Issues Paper 3: Disclosure to Consumers* (January 2002); *Informing Consumers* (DP 4, November 2000); *Treating Customers Fairly after the Point of Sale* (DP 7, June 2001); *Consumer Panel Annual Report* (FSA, 2000); *Polarisation: Consumer Research* (FSA, January 2002).

<sup>11</sup> FSA, *Informed Decisions*, paras 3.33- 3.37

<sup>12</sup> *ibid.*

**Table 1: Risks to consumers of different pension products**

<b>Type of pension product</b> <b>Type of risk</b>	<b>Unfunded DB schemes</b> (BSP, SERPS / SSP, some public sector OPSs)	<b>Funded DB schemes</b> (occupational DB schemes)	<b>Funded DC schemes</b> (occupational DC schemes, group PPs, PPs, SHPs, AVCs and FSAVCs)
Public policy risk	Yes	Yes	Yes
Demographic risk	Yes	Indirectly	Yes
Earnings and employment risk	Yes	Yes	Yes
Inflation risk	Yes (distribution)	Yes (distribution)*	Yes (accumulation and distribution)*
Interest rate risk	No	Indirectly	Yes
Mortality risk	Indirectly	Indirectly	Yes
Market risk	No	Indirectly	Yes
Funding / solvency risk	Yes	Yes	Yes
Governance risk	Yes	Yes	Yes
Investment management risk	No	Indirectly	Yes
Advice risk	Yes	Yes	Yes
Complexity / suitability risk	Yes	Yes	Yes

\* Though occupational schemes are required to provide limited price indexation.

## **SECTION 4: ASSESSMENT AND MANAGEMENT OF RISKS**

This section considers the processes in place for assessing and managing each of the risks identified above. Many of these risks are addressed through regulatory rules which are often complex in their requirements. Only a brief outline of the main principles of relevant regulation is given.

### ***Public policy risk***

There is in practice little assessment of the public policy risk. There is also little done by governments, who are the source of the risk, to mitigate it other than by having long transitional periods for some changes, eg the equalisation of pension ages will only start to take effect in 2015, when women born in 1955 who would otherwise have reached state pension age of 60 will be subject to the new age of 65. There is very little that a consumer can do themselves to ward against public policy risk.

### ***Demographic risk***

Demographic risk is managed by the state for unfunded DB schemes by raising contribution levels and / or cutting benefits. Both strategies have been used extensively in the UK. It is managed in occupational DB schemes by actuaries' adjustments to calculations of the level of contributions necessary to maintain the defined benefits; as it is the employer that usually tops up the contribution level, the consumer is not at risk. In DC schemes, the risk is managed by adjustments in annuity rates, and in addition those rates include margins which allow for changes in demographic profiles and mortality tables.<sup>13</sup> These are passed on directly to the consumer.

### ***Earnings and employment risk***

In very broad terms earnings and employment risk is addressed through the government's macro-economic policies. At the individual level, earnings and employment risk can potentially be addressed in a number of ways. Personal pensions can be used to address employment risk, for example by those with high job mobility.<sup>14</sup> However, even though on average people change

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<sup>13</sup> Institute / Faculty of Actuaries, Pension Provision Taskforce, *Conversion of Pension Fund Monies into Post Retirement Income* (2001).

<sup>14</sup> There is some evidence that those with higher job mobility do have personal rather than occupational pensions, and those with OPSs tend to stay with the same employer for longer. What the causal relationship

employer six times in their working life<sup>15</sup> it is by no means the case that a PP is more suitable for a person than an OPS, often the reverse is true. So from the consumer's perspective, if they are seeking to address the risk of frequent changes in employment, they need recognise that this is a very complex decision on which they should take advice: they thus are exposed to advice risk and to complexity / unsuitability risk, as the personal pensions mis-selling episode demonstrated.

As regards earnings risk, this can be addressed in part by joining an OPS to which the employer is also contributing. This will not protect completely against earnings risk as those contributions will also be linked to earnings but the extra level of contributions will at least increase the size of the person's pension fund so covering some of the risk. However this is not a straightforward strategy as the earnings risk in occupational DB schemes increases the closer a person is to retirement because of the link between the level of benefit and final salary. Other changes could be made, for example on the rules on calculating preserved benefits and extending entitlements for benefits built up in schemes to be preserved for early leavers.<sup>16</sup>

For those who do not have the option of an OPS, earnings risk can be managed in two ways. Firstly, by the consumer being aware of the risk and acting accordingly by agreeing to a level of premiums that they could maintain even assuming a decline in financial circumstances, and choosing a policy that allows changes in contribution rates over the course of the policy and has provision for contribution holidays. Secondly, and necessary for the success of the first, is for products that have the flexibility to allow consumers to manage these risks to be widely available. The stakeholder pension will allow this risk to be met, but it has other limitations not least the low level of maximum contributions. To ensure all consumers can manage this risk flexible pension products need to be available across the market.

### ***Inflation risk***

In broad terms, the rate of inflation is managed by the Bank of England as part of the government's monetary policy. At the micro-level, as noted above, the consumer is potentially exposed to inflation risk in DC schemes in both the accumulation and distribution phases of the pension, and in DB schemes in the distribution phase. In state DB schemes the risk is met by guaranteeing that the

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is, if any, between the two is far from clear however. See Disney, Emmerson and Smith, *Pension Reform and Economic Performance in Britain*, op.cit.

<sup>15</sup> Ibid.

<sup>16</sup> See Pension Provision Group, *Pensions and the Labour Market* (DWP, December 2001).

pension paid will rise in line with inflation. This does not however guarantee a good relative level of income.

In occupational DB and DC schemes the risk is managed in part through regulation: OPSs are required to provide limited indexation of benefits up to 5% or RPI, whichever is the lower.<sup>17</sup> This extends to annuity contracts taken out in DC schemes, but not to pensions attributable to AVC or FSAVC contributions. Members of occupational schemes therefore only bear the risk of inflation rising above 5% during their retirement.

In non-occupational DC schemes, the consumer faces inflation risk during both the accumulation and distribution phases. During the accumulation phase it can be addressed by investing in assets the return on which is higher than inflation. During distribution, it can be addressed by buying an indexed annuity. However at present these represent only 20% of the annuity market.<sup>18</sup> One of the reasons for the low take up is that such annuities pay an initial rate of income which is lower than that of a flat rate annuity, and it will take several years before the consumer ends up in a better position than if he or she had taken out a flat rate annuity.<sup>19</sup>

### ***Interest rate risk***

This risk is managed in DB schemes by the fund trustees, advisers and investment managers, and it affects consumers only indirectly. In DC schemes consumers face this risk directly during the accumulation phase. They can manage it to an extent by opting for an investment strategy in which the funds are invested in assets such as equities which are less closely linked to interest rates than, for example, gilts and long term bonds, and rely in turn on adequate management of the risk by those to whom they have in effect delegated this task. This strategy will increase their exposure to market risk, however, and is suitable only when a person is still several years from retirement.

During the distribution phase, this risk is significant and is faced by all those who are required to buy annuities as the annuity rate is closely linked to interest rates. Despite their extreme exposure to this risk, there is little consumers can do to manage it. They could opt to postpone the purchase of annuity if interest rates are currently unfavourable, but only if they postpone retirement, or opt for income-drawdown if they have a pension fund of sufficient size. In all cases this postponement

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<sup>17</sup> Pensions Act 1995.

<sup>18</sup> DWP, *Modernising Annuities: A Consultation Paper* (February 2002).



can only be temporary however as an annuity has to be taken out by age 75; moreover postponement exposes consumers to the risk of ‘mortality drag’ (see below).

When they do purchase an annuity, consumers can attempt to manage interest rate risk by taking out annuity products that give them some equity exposure, such as unit-linked or with-profits annuities. These will however expose them to market risk, investment management risk and, particularly for with-profits annuities, governance risk.

### ***Mortality risk***

Mortality rates are assessed by the Government Actuaries Department and mortality risk is managed principally through life companies’ adjustment of annuity rates and pension fund actuaries’ assessments of contribution levels necessary to meet extended liabilities in occupational DB schemes. In DB schemes members are thus shielded from the risk. In DC schemes the risk is borne directly by the life company. However, to cover themselves against the risk that mortality rates will be revised during the course of the payment of an annuity, life companies build in significant margins into the annuity rate, thus passing the risk onto the consumer. The consumer’s options for managing this risk are limited, but they could at the least shop around between annuity providers to look for better rates. There is little evidence that many do, however, and most simply opt for the annuity taken out by their provider.

As regards individual mortality risk in the sense of dying too soon, the ability to protect against this risk is limited due to the rules prohibiting bequest of the pension fund. Consumers can address this in part by seeking products that will provide for widows and dependents benefits. These are usually provided as part of an OPS DB scheme. In other cases, the consumer can opt for an annuity contract that provides for such benefits, though it will pay out less income as a result. Alternatively they could opt for a guaranteed period annuity that will pay a guaranteed level of income for a stipulated period of time, and if the person dies during that period the income is paid to their beneficiaries. Or, if a person has an unusually low life expectancy they can take out an impaired life annuity which pays a higher rate of income. Finally, a person could opt for an income-drawdown scheme as this allows the fund to be bequeathed if a person dies before taking out an annuity. However this exposes the person to the risk that they will erode the fund too quickly and not have sufficient to purchase an adequate annuity later on. This is exacerbated by mortality rates

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<sup>19</sup> Ibid, and *Report of the Retirement Income Working Party* (Pensions Institute, 2000).

which tend to increase the older a person is (sometimes termed ‘mortality drag’<sup>20</sup>). In any event a person must take out an annuity by age 75, so as with interest rate risk this risk management strategy can only be temporary.

### ***Market risk***

Market risk during the accumulation phase is addressed principally by those who are managing the fund: trustees and fund managers in the case of OPSs and life companies and fund managers in the case of other DC schemes. Occupational pension funds and life companies are in addition subject to prudential regulation directed at their solvency, and that has some bearing on how those actors manage their market risk (see below). The principal techniques are through investment strategies that are meant to ensure that market risks are hedged (ie that losses in one sector will be matched or outweighed by gains in another). Whether or not they achieve that aim is disputed.<sup>21</sup>

A consumer can attempt to minimise their exposure to market risk by the pension product that they take out. For example, exposure is greatest in DC schemes (including stakeholder pensions), and least in DB schemes; it exists in investment-linked annuities but not in flat rate annuities. One strategy is to take out a self-invested personal pension (SIPP) in which the consumer manages the fund themselves, but these incur high charges in advice and are suitable only for those with large funds. Alternatively, a person could opt for different management strategies in different successive personal pensions to diversify risk (both strategies also diversify investment management risk, below), assuming a choice is offered. In both, exposure to advice risk is retained if not increased. Finally, some shelter from market risk is provided by with-profits policies as these policies adopt ‘smoothing’ strategies which mean that the returns given on the investment through bonuses do not fully reflect either market falls or market rises on a year by year basis. However, in taking out such policies the investor does retain some market risk, and also increases their exposure to governance risk.

At the distribution stage, holders of DC schemes (including voluntary contributions to occupational DB schemes), are highly exposed to the annuity markets, and as noted above in the context of interest rate risk, their options for managing that risk are limited.

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<sup>20</sup> DWP, *Modernising Annuities*.

### ***Funding / solvency risk***

The assessment and management of funding and solvency risk is subject to a high degree of regulation, most of which has been the subject of criticism and most of which is currently under review or in the process of change.

For unfunded DB schemes the risk is managed by the government through two main strategies: increasing funding through taxes or NI contributions and cutting benefits. The latter strategy in particular has been used extensively.

For funded occupational DB schemes, assessment and management of funding and solvency risk lies with the fund trustees. The principal strategy relied on at present is the minimum funding requirement (MFR) introduced in 1997 by the Pensions Act 1995, compliance with which is monitored by OPRA. This requires schemes to ensure that ‘the value of the assets of the scheme are not less than the amount of the liabilities of the scheme’.<sup>22</sup> The MFR has been subject to a number of criticisms,<sup>23</sup> and the government has now proposed its abolition. It will be replaced by the introduction of a long-term, scheme-specific funding standard combined with a regulatory regime based on transparency and disclosure.<sup>24</sup>

The management of solvency and funding risk for remaining pension schemes is addressed through the prudential regulation of the life companies that provide these products. The objective is to protect consumers from the risk that companies will not be able to pay valid claims, which includes meeting policyholders reasonable expectations (PRE). The current regulation is contained in the rules issued by the Financial Services Authority (FSA) under the Financial Services and Markets Act 2000 (FSMA).<sup>25</sup> Those rules are however derived in some considerable part from EU directives. The substance of those rules was heavily criticised in the wake of the experience of

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<sup>21</sup> See eg P. Myners, *Institutional Investment in the United Kingdom: A Review* (March 2001) (Myners Report), ch 6.

<sup>22</sup> Procedures for valuation set out in Occupational Pension Schemes (Minimum Funding Requirement and Actuarial Valuations) Regulations 1996 (SI 1996/1536) and Faculty and Institute of Actuaries, Guidance Note 27.

<sup>23</sup> See eg Faculty and Institute of Actuaries, *Review of the MFR* (2000) and Myners Report, ch 8.

<sup>24</sup> DSS/HMT, *Security for Occupational Pensions: The Government's Proposals* (March 2001); DSS/ HMT, *Minimum Funding Requirement: the Next Stage of Reform* (Sept 2001), *Minimum Funding Requirement: The Next Stage of Reform, Summary of Responses to Consultation on Draft Regulations* (February 2002), and Occupational Pension Schemes (Minimum Funding Requirement and Miscellaneous Amendments) Regulations 2002 (SI 2002/380) which come into force 19<sup>th</sup> March 2002

<sup>25</sup> FSA Handbook, Interim Prudential Sourcebook for Insurance Companies.

Equitable Life, as was the regulatory approach to prudential regulation that had been historically adopted by the successive regulators who had been responsible for it.<sup>26</sup> As a result, and as part of its wider review of its approach to its regulatory responsibilities, the FSA has instituted a wide-ranging review of the prudential regulation of insurance companies in which it proposes to make much clearer the link between market risk and funding / solvency risk.<sup>27</sup>

These proposals are currently out to consultation. Whilst the FSA has the autonomy to act in some areas, for example to define the appointed actuary's role as it chooses, its room for manoeuvre in setting prudential requirements is constrained by two other actors involved in this aspect of risk management: the EU and accounting standard setting bodies. Decision-making on the overall policy framework for risk management is thus fragmented between these players. In addition, in ensuring that the processes work as they should considerable reliance is placed on two other sets of actors: the appointed actuary and senior management.

From the consumer's point of view, there is little they can do directly to manage this risk, other than hope that sufficient information about a firm's solvency status will be disclosed to the market, and that the information will then be put in a form consumers can trust and understand by information intermediaries such as financial journalists and their financial advisers. Ratings agencies, analysts and actuaries also conduct assessments of a firm's solvency for brokers, insurance companies and insurance company management. Only if this information is fed down to the consumer in a comprehensible form will they be able to manage this risk directly by not taking out pension policies with companies who have a high solvency or funding risk.

### ***Governance risk***

Governance risk is addressed in several different ways by a range of actors, and the management of governance risk again varies with the type of pension product in question.

With respect to occupational DB and DC schemes, governance risk is addressed principally by the duties placed on trustees as regards the operation of the scheme. Provision is made for a minimum number of trustees to be nominated by members and modification of the scheme is permitted only

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<sup>26</sup> *Report of the Financial Services Authority on the review of the Regulation of Equitable Life Assurance Society from 1<sup>st</sup> January 1999 to 8<sup>th</sup> December 2000* (HMSO, 2001) (Baird Report). There is also a wider ranging inquiry into events at Equitable Life being conducted by Lord Penrose, due to report later in 2002.

<sup>27</sup> FSA, *Integrated Prudential Sourcebook* (CP 97, June 2001).

subject to certain statutory conditions.<sup>28</sup> Complaints about the governance of the scheme can also be made to the Pensions Ombudsman who may investigate complaints of injustice arising from maladministration or from the acts or omissions of the managers or trustees of the scheme.<sup>29</sup>

In order to provide further protection against fraud, members of occupational schemes are covered by a statutory compensation scheme.<sup>30</sup> In addition, the government is currently consulting on proposals to require pension fund assets to be held by independent custodians.<sup>31</sup> This recommendation was made in the Myners report,<sup>32</sup> however how successful it would be in guarding against fraud is debatable: the assets of the Maxwell pension funds were held by an independent custodian.

For members of non-occupational schemes, governance risk is addressed principally by the regulations to which the providers of those schemes are subject. The key regulatory provisions are contained in the FSA's Handbook and consist of its Principles for Business, its rules governing internal systems and controls and the approved person regime.<sup>33</sup> For those provider who are incorporated there are additional requirements stemming from the Companies Acts and from the common law duties relating to directors. Those who have suffered loss arising from a firm's breach of the rules may claim compensation from the Financial Services Compensation Scheme if the firm has gone insolvent and those who have cause to complain about the service they receive whilst the company is a going concern may seek recourse to the Financial Services Ombudsman Scheme.

Following from events at Equitable Life there is particular concern at the governance risk posed by with-profits policies, whether these are run by incorporated or mutual associations. The main concern arises from the wide discretion possessed by directors with respect to key aspects of the policy. As part of its With Profits Review the FSA is currently consulting on proposals on how that discretion could be regulated.<sup>34</sup>

### ***Investment management risk***

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<sup>28</sup> Pensions Act 1995.

<sup>29</sup> Social Security Act 1990.

<sup>30</sup> Pensions Act 1995; Welfare Reform and Pensions Act 1999.

<sup>31</sup> DWP, *Independent Custodians and Pension Schemes: A Consultation Paper* (February 2002).

<sup>32</sup> Myners Report, para 8.26.

<sup>33</sup> FSA Handbook: Principles for Business; Senior Management Arrangements, Systems and Controls, and Statement of Principles and Code of Practice for Approved Persons.

<sup>34</sup> FSA, *With-Profits Review Issues Paper 4: Discretion and Fairness* (February 2002); FSA, *With-Profits Review Issues Paper 5: Governance and the Role of the Appointed Actuary* (March 2002).

Investment management risk is also assessed and managed by a number of different market actors and regulatory bodies. In occupational schemes, it is managed by the schemes' trustees, their investment consulting and actuarial advisers and in self-administered schemes, their fund managers. In insured schemes the trustees insure the obligations of the fund and the insurance company takes over its management. In private non-occupational schemes, it is the pension provider and any fund managers to whom they delegate investment management functions who manage the risk. Pension fund trustees are subject to the Pensions Act and additional statutory and equitable duties governing the nature of their duties. If they undertake routine or day to day decisions as regards the investment of the assets (and are not also beneficiaries of the scheme) they are also regulated by the FSA.<sup>35</sup> Fund managers and others who manage investments are regulated by the FSA.

In the case of occupational schemes, there is a risk that trustees will make sub-optimal decisions concerning the investment of the pension fund. Following recommendations made by the Myners Report the government is currently proposing to introduce an enhanced standard of care for pension fund trustees.<sup>36</sup> It is also proposed to introduce a set of non-binding principles for pension fund investment decision making by trustees of defined benefit and defined contribution schemes, again following recommendations in the Myners report.<sup>37</sup> The scheme is intended to be based on self-reporting by the trustees of compliance with explanations of non-compliance. OPRA is not seen as playing a role in this process, but voluntary compliance with the scheme is more likely to be forthcoming if OPRA were to have the potential to impose sanctions for continuous non-compliance without adequate justification. Self-regulation usually works best when it operates in the shadow of someone wielding a big stick.

Investment management risk stemming from the activities of fund managers is addressed in part by FSA conduct of business rules relating to churning, switching and soft commissions (payments between fund managers and brokers in which brokers provide fund managers with services in return for a certain volume of business).<sup>38</sup> There are still concerns at the opacity of fund manager's charging structures, and following government threats to increase regulation the fund management

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<sup>35</sup> Financial Services and Markets Act 2000 (Carrying on Regulated Activities by Way of Business Order) 2001, Schedule 4.

<sup>36</sup> Myners Report, ch 10; DWP, *Pension Scheme Trustees: 'Familiar with the Issues Concerned' - A Consultation Document* (February 2002).

<sup>37</sup> Myners Report, ch 10.

<sup>38</sup> FSA Handbook, Conduct of Business, COB 7: Dealing and Managing.

industry have agreed to introduce clearer statements of charges to give to pension fund trustees.<sup>39</sup> There is nothing regulation can do about poor performance itself however.

Investors in DB schemes are shielded from direct exposure to investment management risks. In contrast, investors in DC schemes bear the full force of the risk. They can manage some of the investment risk themselves by choosing which funds to invest in. However, many rarely take such an option and when they do they often opt for one which is unsuitable, adopting a strategy of 'reckless conservatism'. Even when they have invested in an appropriate fund (eg equity based when they are over 10 years from retirement) they are at risk of sub-optimal performance. It is very difficult for a consumer to manage this risk, and whilst in theory they may have the option of changing pension provider, the costs of transfer can be significant. Consumers may then in effect be locked into poor performing policies, and may only be able to extricate themselves by paying up to one third of the value of their fund in transfer charges.<sup>40</sup> This risk is lessened in stakeholder pensions as transfer charges are not permitted.

### ***Advice risk***

Advice on joining an OPS is not regulated, although if it is found to be connected with maladministration of the scheme the Pensions Ombudsman may investigate (eg advice on AVCs given by the firm managing the scheme). Advice on taking out a personal pension, stakeholder pension, FSAVCs and annuities is regulated by the FSA (including advice on contracting out of SERPS / SSP where relevant).<sup>41</sup> The key duties are the 'know your customer' and 'suitability' rules. Advisers must know the financial position of the customer and their attitude to risk, and must only recommend products that are suitable.

Despite the panoply of regulatory rules, poor advice has been endemic in the context of pensions in particular. The adequacy of the duties imposed or sanctions available is not really in issue. Rather part of the problem has been the incentive structures of both parts of the advice sector which reward volume of new sales and of particular products over others. The other has been inadequate enforcement; regulators simply asking the wrong questions of firms, looking at the wrong aspects of its operation, and failing to spot when a problem was endemic to the industry and not confined to

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<sup>39</sup> Investment Management Association, draft Pension Fund Disclosure Code (March 2002).

<sup>40</sup> Blake, *The United Kingdom Pension System*, op. cit p.32.

<sup>41</sup> FSA Handbook, Conduct of Business, COB 5: Advising and Selling.

isolated firms.<sup>42</sup> The findings of the Baird Report into Equitable Life suggests that regulatory practices had not changed significantly in the wake of the mis-selling episode.<sup>43</sup> The FSA is now changing its regulatory approach to one which is risk-based and more strategic in its operation; it is too early to tell how successful it will be.

### ***Complexity / suitability risk***

Pension products are highly complex, and there is a significant risk that a person will simply choose the wrong type of product with very disadvantageous consequences, or simply not understand the product that they have. At present, consumers face two key problems in managing complexity / suitability risk. First, they have a very poor understanding of products on offer and do not know which sort of product would best suit their needs. Second, they lack clear information on the aspects of the product that are important to them.<sup>44</sup>

The current regulatory approach to improving consumer awareness of the nature of the products they are buying is based on disclosure. Under FSA rules, consumers must be given a Key Features Document (KFD) setting out prescribed, generic information about the product and a personal illustration (PI) giving personalised information about the product based on the premiums that will in fact be paid. There are currently two reviews of disclosure underway.<sup>45</sup> In addition the ABI has introduced a voluntary initiative, the Raising Standards Quality Mark Scheme, which is intended to improve product disclosure. The Pensions Protection Investment and Accreditation Board provides independent assessment of whether or not firms have met the criteria of the scheme and guidance on how to do so.

The FSA has also begun to supplement the traditional rule-based approach to resolving problems with other initiatives. It has produced fact sheets for consumers on different products. It has also produced a decision tree to assist people in deciding whether or not to take out a stakeholder pension, and is working on producing decision trees for other types of product as well.<sup>46</sup> It is

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<sup>42</sup> See J. Black and R. Nobles, 'Personal Pension Misselling: The Causes and Lessons of Regulatory Failure' (1998) 61 *Modern Law Review* 789-820.

<sup>43</sup> Baird Report, paras 6.17-6.24.

<sup>44</sup> See FSA, *Informed Decisions?*.

<sup>45</sup> Disclosure Review is reviewing the disclosure regime for packaged products generally, including pensions; the With Profits Review is reviewing improvements to disclosure of with-profits products in particular, including pensions, and improving disclosure on significant risks: *With Profits Review Issues Paper 3: Disclosure to Consumers* (January 2002); FSA, *Informing Consumers*, DP 4.

<sup>46</sup> Available at [www.fsa.gov.uk/consumers](http://www.fsa.gov.uk/consumers).



specifically charged under the FSMA with improving consumer understanding, and has commenced several education initiatives.<sup>47</sup> It would be beneficial if some of these were extended to the workplace, as that is where those people are for whom the question of pensions are most relevant. Employers often feel they are hampered in giving advice on pensions because they do not want to fall foul of the statutory requirements to be authorised; FSA initiatives could plug this gap.

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<sup>47</sup> FSA, *Annual Report 2000-1* (FSA, 2001). Educational resources are available on the FSA website ([www.fsa.gov.uk/consumer/schools/index.html](http://www.fsa.gov.uk/consumer/schools/index.html)).

## SECTION 5: RISK COMMUNICATION

The management of complexity / suitability risk leads directly into the issue of risk communication. The channels of risk communication are not confined to industry or regulatory routes. Others, particularly the financial press, play an important role. Nonetheless, research suggests that consumers have a very limited understanding of risk.

Part of the problem is that the right type of information is not being given. The FSA has found that the KFD 'provides little to guide the understanding of consumers in assessing their own risk profile and few pointers to determine what those risks might be'.<sup>48</sup> However, it also found that consumers did not see information about risk as important.<sup>49</sup>

Consumers probably do not see risk as important because they have only a vague understanding that they might be exposed to any risk of loss at all. Indeed, there is little evidence of awareness of any of the risks identified above. Moreover, although there has not been specific research into the issue, there have been suggestions that consumers understanding of risk is not the same as that of financial advisers or product providers.<sup>50</sup> In particular consumers show very little awareness that a trade-off exists between risk and return, and what its implications are.<sup>51</sup>

The FSA has shown some awareness of this issue, and is currently proposing to improve risk communication in several ways. First, by requiring more information on risk to be given to consumers, including what assets the funds are invested in and the risks associated with those assets; whether in a with-profits policy a person is exposed to business risk as well as investment risk, and the implications of mortality and morbidity risk.<sup>52</sup> Second, by recognising that consumers understanding of risk should not be overestimated and thus adjustments need to be made to disclosure requirements.<sup>53</sup> Third by extending the use of non rule based measures such as financial planning tools to enable consumers to carry out their own financial 'healthcheck', factsheets, decision trees, comparative tables, and detailed interactive factfinds to help consumers make generic decisions on what products and services they need to consider.<sup>54</sup> The government is also

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<sup>48</sup> FSA, *Informed Decisions?*, para 3.24

<sup>49</sup> *ibid.*

<sup>50</sup> I. Berwick, 'Defining Risk Assessment' FT 1<sup>st</sup> March 2002.

<sup>51</sup> FSA, *Financial Risk Outlook 2002* (March, 2002), para 4.3.

<sup>52</sup> FSA, *Issues Paper 3, Disclosure to Consumers*, para 33.

<sup>53</sup> FSA, *Informed Decisions?*, para 3.33.

<sup>54</sup> FSA *Future Regulation of Insurance*, para 3.4.2

proposing to introduce personalised pension forecasts for individuals by 2015 so that each will know what their current level of pension provision will give them on retirement.<sup>55</sup> All of this could help, if consumers can be made aware of its existence and be persuaded to look at it. What would also be beneficial, however, would be detailed research focused specifically on consumer understandings of risk, for until that is done, advisers, regulators and consumers could continue speaking at cross-purposes about this central issue.

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<sup>55</sup> DSS/HMT, *Security for Occupational Pensions* (September 2000).

## SECTION 6: PROPOSALS FOR REFORM

There are several major reform initiatives under way covering almost every aspect of pension provision. The whole of private pensions legislation is currently being reviewed by Alan Pickering and is due to report in summer 2002. The Equitable Life affair is currently the subject of an inquiry by Lord Penrose, due to report later this year. At the FSA, the polarisation regime, disclosure rules and regulation of with-profits policies is being reviewed. With respect to occupational pension schemes the Department of Work and Pensions is currently consulting on reform of the minimum funding requirement, the duties of pension fund trustees and independent custodianship of pension funds. It is also consulting on the current rules on annuities, and has launched a loosely defined project on simplification of the pensions regime.

Suggestions for reforms are being made by many in different quarters and valuable proposals have been made by the Faculty and Institute of Actuaries,<sup>56</sup> the Pensions Institute,<sup>57</sup> the Institute of Fiscal Studies and the Institute of Public Policy Research.<sup>58</sup> These proposals include raising the age by which an annuity has to be taken out to 80, requiring annuities to be taken out only to the extent that they provide a level of income which would disentitle them to claim MIG or other means-tested benefits,<sup>59</sup> scrapping the state second pension and raising the age of state pension entitlement, and raising state pension levels in line with earnings rather than prices.<sup>60</sup>

From a risk perspective, the following recommendations for reforms could be made with respect to government, industry and consumers:

- Public policy risk:
  - for government: simplify and stabilise policy on state and private pension provision
- Employment and earnings risk:
  - for government:
    - recognition of non-earning due to periods spent in full time education (eg for those over 25) for the purposes of NI contributions

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<sup>56</sup> Papers published by the Pension Provision Taskforce.

<sup>57</sup> Eg the *Report of the Retirement Income Working Party*.

<sup>58</sup> R. Brooks, S. Regan and P. Robinson, *A New Contract for Retirement* (IPPR, March 2002).

<sup>59</sup> *Report of the Retirement Income Working Party*.

<sup>60</sup> Brooks, Regan and Robinson, *A New Contract for Retirement*.

- scrapping of the SSP and raising of the BSP in line with prices
  - improvements in the value of and entitlement to preserved benefits in OPSs
  - change to post-employment retirement rules for those with OPSs
- for industry:
  - extension of flexible contribution terms to all personal pension products
  - improved portability of pension entitlements
- for employers: improvements in the value of and entitlement to preserved benefits
- Inflation risk:
  - for industry: improving the terms of indexed annuities
- Interest rate risk
  - For government / regulators:
    - ensure solvency requirements do not incentivise funds to purchase interest-rate linked instruments unnecessarily;
    - government to recognise the importance of the gilt market to the funding of private income in retirement and to introduce forms of gilts that are suited to the liabilities of pension funds<sup>61</sup>
    - relax requirement to take out annuities and encourage increased variety of options for income on retirement
    - permit transfer between annuity contracts
  - for consumers: improve awareness of risk and options for managing it through types of annuity contracts (if in a financial position to do so)
- Market risk
  - For regulators: assist in improving consumer awareness of the relative risk of different types of products and their appropriateness as investments at different stages from retirement
  - For consumers: improve awareness; make more informed choices on investment of pension products
- Funding / solvency risk
  - For government / regulators: improve prudential standards to focus on long term financial position and ability to withstand stresses and shocks from different sources, including legal rulings and public policy changes

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<sup>61</sup> For discussion see Blake, op.cit., p.28.

- Governance risk
  - For regulators:
    - introduction of policy holder committees
    - independent review of the appointed actuary
    - enhancement of trustee's duties
  - For industry: improve transparency
  - For the consumer: improve awareness
- Investment management risk
  - For government / regulators:
    - OPRA oversight of compliance with principles of investment for trustees of OPSs
    - extension and continuation of comparative performance tables by FSA
    - facilitation of transfer between personal pension funds
    - permitting transfer between annuity contracts
  - For industry: reduce transfer and other charges, and facilitate transfer between annuity contracts if regulation permits
- Advice risk
  - For government / regulators:
    - address remuneration structures
    - continue to improve training
    - enhance monitoring and supervision practices
    - improve information to the consumer and deliver through a variety of channels
  - For industry:
    - address remuneration structures
    - continue to improve training
    - enhance internal systems and controls
  - For the consumer: improve awareness and understanding
- Complexity / suitability risk
  - For government / regulators:
    - improve nature of information given to consumers

- conduct research to improve regulator's awareness of levels and nature of consumer understanding of risk and adjust information given to them in the light of that research
- undertake workplace initiatives for informing consumers
- For industry: as for regulators
- For consumers:
  - improve understanding of the risks involved in the different pension options and options for managing those risks
  - improve awareness of the levels of saving necessary to ensure adequate provision of income in retirement and act accordingly