Pension reform in Britain: The good, the bad and the ugly

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Conference on Pension Reforms
Université catholique de Louvain
Louvain-la-Neuve, 9 November 2018
Pension reform in Britain: The good, the bad and the ugly

1 Analytical background
2 The good
3 The bad
4 The ugly
5 General lessons
1 Analytical background
1.1 A changing world
The world then

Social policy in Europe and North America in 1950 was based on a series of assumptions

• Families
  • People got married and stayed married
  • Gendered division of labour: husband typically the breadwinner, wife the carer

• Work: full-time, long-term (often lifelong) employment the norm
• Skills: once acquired were lifelong
• International mobility: limited
• Merely describing that world makes it clear how much has changed

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The world now

• Families
  • More marriages end in divorce
  • Parenthood less closely tied to marriage
  • Gendered division of labour (somewhat) less pronounced: women frequently in paid work

• Work: labour market-relations
  • More diverse: full-time, part-time, self-employed, out of labour force, unemployed; zero-hours contracts, gig economy
  • More fluid: more frequent movement across these categories

• Skills
  • Need more highly skilled workers and greater diversity of skills
  • BUT skills have a shorter shelf life

• International mobility: significantly greater, especially within the EU

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Implication 1: Less reliance on contributions related to employment status

• With multiple, changing labour-market connections, employment-related contributions less effective in bringing about good coverage
• UK example: in 2005, when needed 40+ years of contributions for full basic state pension
  • 85% cent of recent male retirees entitled to full pension
  • Comparable figure for women 30%
• Implication: consider finance from broad-based taxation
• Pension example: non-contributory pensions financed from general taxation
1.2 Economic theory
Lessons from the economics of information

• In many areas of social policy the model of the well-informed consumer does not hold

• In the context of pensions
  • A survey, 50% of Americans did not know the difference between a stock and a bond
  • Most people do not understand the need to shift from equities to bonds as they age if they hold an individual account
  • Few people realise the significance of administrative charges for pensions

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Lessons from behavioural economics

• First-best theory predicts
  • Voluntary saving to maximise lifetime utility (consumption smoothing)
  • Voluntary purchase of annuities (insurance)

• What actually happens
  – Bounded rationality
    • Procrastination: people delay saving
    • Inertia: people stay where they are; in theory it should make no difference whether the system is opt in or opt out – in practice, automatic enrolment leads to higher participation
    • Immobilisation: impossible to process information about 800 different funds (90% go into Swedish default fund)
  – Bounded will-power
    • People do not save, or do not save enough
Example Financial literacy is shockingly limited (Lusardi/Mitchell)

• Interest: you have £100 in a bank account paying 2% interest a year. How much would you have in the account after 5 years:
  • less than £102?
  • equal to £102?
  • more than £102?
  • don’t know?

• Inflation: suppose that the interest rate on your bank account is 1% a year and that inflation is 2% a year. After one year, with the money in this account, would you be able to buy
  • more than today?
  • the same as today?
  • less than today?

• Risk. True or false? Using £100 to buy shares in a single company usually provides a safer return than buying £100 of a unit trust (i.e. something that holds a wide range of shares)?

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Overview: % All Correct

And it gets worse

• Not only people who can’t (previous 2 slides), but also

• People who can but don’t: behaviour by financially knowledgeable people given time/energy/attention constraints
Implication 2: Constrained choice is part of good policy design

• Problems
  • Bounded rationality (e.g. not understand present values)
  • Bounded will power
  • Choice architecture is costly

• Policy directions
  • Constrained choice of pension provider, i.e. limited menu of options
  • Constrained choice about how much to save, i.e. savings mandate
Implication 3: Don’t overstate what financial education can achieve

- Financial education is useful and important, but there are limits to what it can realistically be expected to achieve.
- Financial education does not make us well-informed choosers of complex financial products.
- Even for a well-informed person, there are high transactions costs comparing complex options.
Implication 4: Choice and competition is the wrong model

• Pensions are complex
• Systems in which workers have to choose from competing private pension providers face information and behavioural problems and have high administrative costs
• Not a condescending attitude; we do not allow people free choice of pharmaceutical drugs; pensions are similar
• Thus the model of choice and competition is the wrong one – it uses a first-best model in second-best circumstances
2 The good
2.1 The UK single-tier state pension

- Multiple, changing labour-market connections create a case for non-contributory pensions as good (though not essential) policy
- Examples include Australia, Canada, Chile, Netherlands, New Zealand
- The single-tier state pension towards which the UK is moving is an example
Advantages of a non-contributory pension

• Strengthens poverty relief in terms of coverage, adequacy and gender balance
• Shares risk by reducing the variance of the pension system as a whole
• Can be designed to fit different budget envelopes
  • Level of monthly pension
  • Age at which pension starts
  • Possibility of an affluence test
2.2 National Employment Savings Trust (NEST) pensions

- A country may or may not choose to have funded individual accounts as part of its system. But if it does, the NEST approach is the way to do so (www.nestpensions.org.uk)
- Design explicitly based on the findings of behavioural economics
- Key elements
  - Auto enrolment
  - Curated choice
  - Centralised account administration
  - Wholesale fund management
Curated choice in NEST: the default

- Workers are automatically enrolled in a simple savings plan
- The default: a target-date fund with three phases
  - Foundation phase (first 5 or so years) is a novelty in pension design. Losses in early years are profoundly discouraging, so the strategy during this phase seeks to avoid reducing the value of the nascent accumulation
  - Growth phase adopts a less conservative approach. NEST’s aim (successful thus far) is to produce a long-run average annual net real return of 3 per cent
  - Consolidation phase starts to crystallise the gains
Curated choice: additional options

Alongside the default

• A higher risk fund, i.e. potentially higher growth
• A lower risk fund
• An ethical fund
• A Sharia fund
Opt out is low, rises with age

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Centralised account administration

• NEST maintains all individual records
• Decides in-house on overall exposure to building block funds and asset classes, outsourcing fund management to the private sector and publishing quarterly updates
Wholesale fund management: composition of funds

<table>
<thead>
<tr>
<th>Asset class</th>
<th>Investment approach</th>
<th>Fund name</th>
<th>Benchmark</th>
<th>Exposure to asset class*</th>
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<tbody>
<tr>
<td>Global developed equities</td>
<td>Passive</td>
<td>UBS Life World Equity Tracker</td>
<td>FTSE All World Developed Index</td>
<td>34.6%</td>
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<tr>
<td>Global developed equities</td>
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<td>UBS Life Climate Aware World Equity Fund</td>
<td>FTSE All World Developed Index</td>
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<td>Gifts</td>
<td>Passive</td>
<td>SSGA UK Conventional Gifts All Stocks Index Fund</td>
<td>FTSE Actuaries All Stocks Index</td>
<td>0.1%</td>
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<tr>
<td>UK index-linked gifts</td>
<td>Passive</td>
<td>SSGA UK Index Linked Gilts over 5 Years Index Fund</td>
<td>FTSE Actuaries Index Linked Gilts over 5 years Index</td>
<td>0.1%</td>
</tr>
<tr>
<td>Dynamic risk management</td>
<td>Active</td>
<td>NEST Equity Risk Management Fund</td>
<td>N/A</td>
<td>2.5%</td>
</tr>
<tr>
<td>Low-risk sterling liquidity</td>
<td>Active</td>
<td>Amundi Money Market Fund - Short Term GBP</td>
<td>SONIA</td>
<td>0.8%</td>
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<tr>
<td>Low-risk sterling liquidity</td>
<td>Active</td>
<td>BlackRock Aquila Connect Cash Fund</td>
<td>Seven-day LIBID</td>
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<tr>
<td>Ultra Short Duration Investment Grade Credit</td>
<td>Active</td>
<td>Blackrock Institutional Sterling Ultra Short Bond Fund</td>
<td>GBP 3 Month LIBID</td>
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<tr>
<td>Short Duration Investment Grade Credit</td>
<td>Active</td>
<td>Royal London Investment Grade Short Dated Credit</td>
<td>ML 1-5 year Sterling Non-Gilt All Stocks</td>
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<tr>
<td>Global ethical equities</td>
<td>Active</td>
<td>F&amp;C Responsible Global Equity Fund**</td>
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<td>0.2%</td>
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<tr>
<td>Shari'a compliant equities</td>
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<td>Dow Jones Islamic Titans 100</td>
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<td>Sterling bonds</td>
<td>Active</td>
<td>Royal London UK Corporate Bond Pooled Pension Fund</td>
<td>iBoxx Sterling Non-Gilt All Maturities Index</td>
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<td>UK direct property</td>
<td>Active</td>
<td>LGIM Managed Property Fund</td>
<td>REF/JPQ UK Quarterly Property All Balanced Funds Index</td>
<td>0.0%</td>
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<td>Hybrid property</td>
<td>Active</td>
<td>LGIM Hybrid Property Fund (70/30)</td>
<td>FTSE EPRA/NAREIT Global REITS/REF/JPQ UK Quarterly Property All Balanced Funds Index</td>
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<tr>
<td>Global property</td>
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<td>Global Real Estate Equity</td>
<td>FTSE EPRA/NAREIT Global Developed Real Estate Index</td>
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<tr>
<td>Ethical corporate bonds</td>
<td>Active</td>
<td>F&amp;C Responsible Sterling Bond Fund**</td>
<td>iBoxx Sterling Non-Gilt All Maturities Index</td>
<td>0.06%</td>
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<tr>
<td>Emerging markets (alternative index)</td>
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<td>HSBC GIFT Economic Scale Index Emerging Markets Equity Fund</td>
<td>HSBC Economic Scale Index Emerging Markets Index</td>
<td>2.3%</td>
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<td>Emerging markets (alternative index)</td>
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<td>Northern Trust Emerging Markets Custom ESG Equity Index Fund</td>
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<td>2.2%</td>
</tr>
<tr>
<td>Emerging market debt</td>
<td>Active</td>
<td>Amundi Funds Global Emerging Blended - IE</td>
<td>50% JPM EMBI Global Diversified Hedged Euro/50% JP Morgan ELM Plus</td>
<td>4.8%</td>
</tr>
<tr>
<td>Global high yield bonds</td>
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<td>JP Morgan Life High Yield Opportunities Fund</td>
<td>Bank of America Merrill Lynch Non-Financial Developed Markets High Yield Constrained Index (Hedged to GBP)</td>
<td>2.6%</td>
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<tr>
<td>Single Year Gilts</td>
<td>Passive</td>
<td>LGIM Single Year Gilt Funds</td>
<td>N/A</td>
<td>0.0%</td>
</tr>
</tbody>
</table>

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Charges

• Employers
  • 100% online platform
  • Employers face compliance costs but no charges

• Members
  • Annual management charge 0.3%
  • Temporary 1.8% charge on contribution (level playing field with private sector)
Performance net of AMC
NEST 2040 fund (March 2017)

Annualised total return, net of annual management charge
Benchmark: CPI + 3%
Assessment

• The approach respects the lessons from the economics of information and behavioural economics
  • Simplifies choice for workers
  • Auto-enrolment
• Keeps administrative costs low
3 The bad
3.1 Substance

• How earliest pension age is determined
  • UK: increases in earliest pension age are (a) ad hoc, (b) designed well but (c) implemented badly
  • Denmark: automatic indexation of pension age to life expectancy

• Combining work and pension: what flexibility to draw part pension and continue to work?
  • Deferral of the UK state pension is a binary choice
  • Partial pension is an option in Sweden
3.2 Process

• Reform too often
  – 2010-2015: two sources of pension reform
    • Pensions Minister (single-tier state pension)
    • Finance Minister (pension freedom)
  – Reforming too often and with insufficient consultation and little or no cross-party agreement is a long-term problem in the UK
  – Result: a ridiculously complex system

• Failure to fix the annuities market
4 The ugly: Pension freedom
Bad arguments

• ‘People should be allowed to do what they like with their own money’

• This line of argument presupposes rational behaviour, hence ignores lessons from behavioural economics

• We would not consider using the same argument for pharmaceutical drugs

• The extent of choice should be optimised, not maximised
The fundamental flaw in UK pension policy

- Up to age 55: policy is based on assumption that people cannot be relied on to make good choices, hence nudges like auto-enrolment into NEST
- Age 55+: policy based on assumption that people can be relied on to make good choices, hence pension freedom

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Osborne 1 (March 2014): Abolish requirement to annuitise

• Right diagnosis, wrong prescription
• Better approaches would be
  • Longevity bonds (Barr 2012, p. 160), or
  • Government-provided annuities (as in Sweden), or
  • Curated drawdown

• Predicted problems:
  • Misselling
  • High charges
Osborne 2 (September 2014): Freedom over drawdown

- Theory: welfare is generally higher with insurance than self-insurance
- Predicted problems
  - People will draw down too fast (the ‘red truck syndrome’)
  - People will draw down too slowly
Why these changes?

• Ideology?
• Short-run boost to tax revenues?
5 General lessons
5.1 Designing individual accounts: Advising Australia

• Barr and Diamond (2017) gave evidence to an Australian inquiry into the design of a default
• Our approach: people who wish to make choices about pensions and retirement should have room to do so
• But some people will not choose, some will choose badly, and choice can be costly
• Thus, the fundamental point:
  The pension system should work well for people who make no choice – and making no choice should be an acceptable option
Recommendations: Accumulation

If a country includes individual accounts (mandatory or with auto-enrolment), recommendations include:

1. A single default design
2. A simple choice architecture within the default
3. One account per person to avoid ‘lost accounts’ and reduce administrative costs
4. A single clearing house to collect contributions and distribute them to providers, as in Sweden
5. A single record keeper, as for the Premium Pension in Sweden
6. A level playing field for competition between the government-run default and private providers
Recommendations: Drawdown

1. Information on drawdown
   - Curated drawdown
     - A deferred annuity component
2. Information about annuities
3. A default portfolio
4. Survivors’ pensions
5.2 Concluding thoughts

• A more thoughtful approach to choice
  • Auto-enrolment
  • Deliberately limited choice of plan and choice within a plan

• Importance of taking a long-run view of pensions, which generally requires cross-party political support

• Awareness of new options: electronic payment opens up the possibility of basing pension contributions on consumption spending rather than income (‘How millennials and savings apps are making asset managers wake up and smell the coffee’, Financial Times, 14 October 2018)
References


Nicholas Barr and Peter Diamond (2017), ‘Designing a default structure: Submission to the Inquiry into Superannuation: Assessing Efficiency and Competitiveness’, Australia Productivity Commission, September