The provision of pensions

Lord Richardson, former Governor of the Bank of England, outlines[1] the origins of present pension arrangements and goes on to discuss various interrelated and overlapping questions concerning pension provision.

- *Pension schemes entail undertakings which will call for implementation over a future which stretches many decades ahead. The extent to which these claims on resources will contend with other claims will depend in large part on the development of the economy over the future — which cannot be foreseen at all precisely. Questions thus arise as to what is sometimes popularly referred to as the future 'burden' of pensions.*
- *Pension undertakings under occupational pension schemes are made in connection with employment by particular firms — which usually make membership a condition of employment. Existing practice may disadvantage certain classes of members, as for example people who move from one employer to another. Questions may arise as to how far these inequalities can or should be remedied — bearing in mind the interests not only of all employees but also of employers.*
- *Questions arise about the tax treatment of contributions to pension funds, which encourage saving in this form.*
- *There is a lack of precision as to the legally-enforceable rights of members of pension funds. This question, when thought through, may be seen to have wide implications.*

Finally, Lord Richardson comments on the role of the pension funds in the capital market.

Pension schemes have assets exceeding £100 billion and now dominate the collection of long-term personal savings and their investment. This gives pension funds a key role in the capital market, with whose working the Bank has a general concern and in which also, as manager of the national debt, it has a special interest. Pensions are not merely big business but of great importance to individuals. The funds deployed in respect of a typical member of an occupational scheme are large in relation to those he actively manages for himself, and how they are managed could have at least as much significance for him.

In a review such as I shall attempt, questions must arise as to how far arrangements are well tuned to our needs. My aim is not to propose answers to such questions: but rather to place the issues currently under consideration in a more comprehensive context. The issues involved are large and complex, and deserve debate and assessment. This they have clearly now begun to receive.[2]

Since the last war there has been a great elaboration of the arrangements in place to provide an income for people after retirement, both through State schemes and through occupational pensions. I will primarily be discussing the latter, though at times I shall also refer to the State scheme with which occupational schemes are inevitably related.

Demographic and historical background of present pension arrangements

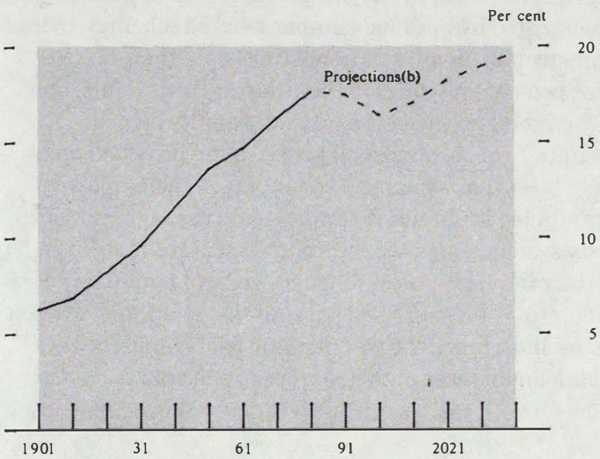
Currently about one in six of the population is of pensionable age, that is (on the definition under the State scheme) sixty-five years and over for men, and sixty years and over for women. At the turn of the century the proportion was far lower — only about one in sixteen. There are now nearly 10 million pensioners, of whom most receive the State retirement pension, compared with nearly 7 million in 1951. There has, in short, along with a fall in the proportion of children in the population, been a considerable increase in the proportion of the elderly; this increase has also resulted in higher public spending on the provision of health and social services, and of housing suitable for them. Despite the greater number of married women at work the ratio of the number of the labour force to the number of pensioners has fallen from 3.4 in 1951 to 2.8 now.

Recent projections by the Government Actuary suggest that the number of pensioners, after falling slightly to the

(1) In the third Shell International Lecture at St Andrews, Scotland, on 2 November 1983.

(2) It would be right for me to mention at this point the papers by Professor Harold Rose and John Kay prepared for the Bank's Panel of Academic Consultants (Bank of England *Panel Paper No. 20*, 'The economics of pension arrangements'), and Stewart Lyon's 1982 Presidential Address to the Institute of Actuaries on 'The outlook for pensioning' which have been of material assistance in ordering my own thoughts; and the many useful comments on earlier drafts of this lecture from Tom Heyes, Brian Corby and Marshall Field, and colleagues in the public sector. Among these last I should like to mention especially Mr J C R Dow, Mr A R Threadgold and Mr M E Hewitt of the Bank of England without whom the lecture would neither have been begun nor completed.

Chart 1
Population of pensionable age[a]



(a) Sixty-five and over for men, sixty and over for women.
(b) Projections for 2021 and 2041 are from 'Projections of the costs of occupational pensions' by J L Field, *Journal of the Institute of Actuaries*, June 1983. Earlier estimates and projections are from the *Annual Abstract of Statistics*, 1983.

end of the century, may rise from $9\frac{1}{2}$ million to about 12 million by the year 2030. On this basis, depending on the birth rate between now and then, the ratio of members of the labour force to pensioners will fall further to somewhere between 2 and 2.4.[1] The problem of an increasing number of pensioners in the population would, of course, be aggravated by any move towards earlier retirement.

An ageing population is not peculiar to this country. Comparable figures for other industrial countries show that the proportion of pensioners in the population is expected to change little before the turn of the century in most countries—with the exception of Japan, where a 50 per cent rise is predicted. But in all such countries, the proportion is set to rise in the first quarter of the next century, with the greatest rise in North America. These demographic trends, particularly those in the early part of the twenty-first century, are one element in the future picture. The other element is the increased scale on which pensions have come to be provided.

The growth of pension provisions

Universal provision by the State of a retirement income in old age has come only since the last war. In Victorian times, provision for old age was the responsibility of the individual or the family. The change began with Lloyd George, who introduced, before the First World War, non-contributory, but means-tested, pensions; and started contributory national insurance. The extension of national insurance to old age pensions, in 1925, marked the beginning of a contributory State pension scheme, based largely on pay-as-you-go principles.

Then came the Beveridge Report and the National Insurance Act 1946, which instituted universal contributory pensions, intended to provide, with other benefits, a minimum subsistence income for all. The 1959 Act added graduated, or earnings-related, State pensions from which companies who operated a satisfactory occupational scheme were permitted to contract out. Finally, the Social Security Pensions Act 1975 provided indexed earnings-related State pensions at a much higher level. Members of schemes providing benefits higher than the earnings-related State pension could be contracted out. Twenty years' contributions are required for full benefits under the new scheme, which will therefore not take full effect until the late 1990s.

We now have a mixed system for the provision of pensions: in part, a universal State scheme; in part, optional arrangements whereby firms and persons, encouraged by the tax laws, supplement what the State has promised to provide. Within this framework the growth of occupational schemes has been rapid.

In 1936 the membership of occupational schemes was only $2\frac{1}{2}$ million. By the early 1960s the coverage had grown to 12 million, or somewhat over half the number of employees. Since most schemes are relatively recent, most are immature. At present those receiving occupational pensions—that is, former employees, and their widows or other dependants—number about 4 million, compared with almost $9\frac{1}{2}$ million receiving State pensions. Although membership of occupational pension funds has been stable for a couple of decades and may continue so, the proportion reaching retirement age will increase in future years, and people are likely to continue to live longer and draw pensions for more years. By the early decades of the next century the number receiving occupational pensions is likely to grow to 6 or 7 million—half as many again as now.

In the course of time, the benefits from occupational schemes, including those for widows and dependants, have increased. Because of inflation there has been a general move to relating pensions to the final salary earned in employment. By this means such schemes have become effectively indexed to the inflation that takes place during a working life. In the private sector at least, they remain far less completely indexed to the inflation that takes place during retirement, although many employers provide *ex gratia* supplements. For contracted-out schemes, the State will guarantee an indexed minimum pension, varying according to past earnings.

The average size of occupational pension paid at present is about 20 per cent of average earnings, about the same as the single person's basic State pension. But the average includes many whose pension is very small—too small, for instance, to make their recipient's total income liable to income tax. In part this may be because inflation has eroded the real value of pensions in payment; but the average pension of new pensioners seems to be only a little higher than the average for all pensioners. This low level of occupational pension in payment probably also reflects the fact that a number of schemes take into account State benefits when

(1) Source: J. Ermisch, 'Paying the piper: demographic changes and pension contributions'; *Policy Studies No. 1*; Policy Studies Institute, London, 1981.

establishing members' pensions, that many schemes have not been in existence for very long and that labour mobility results in separate small pensions for workers who move.

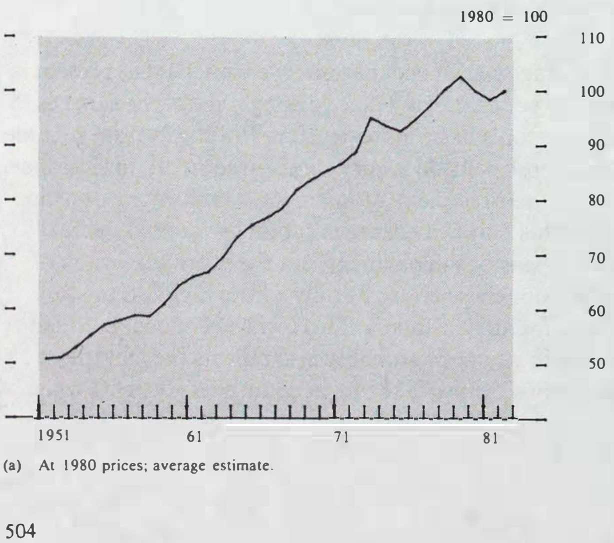
On account of the more generous provisions which are now in course of being implemented as people retire, both State and occupational pensions are due to rise. The average occupational pension is likely to rise, even on conservative assumptions, from about 20 per cent of average earnings at present to over one third of average earnings, which together with the basic State pension will bring total retirement income to over half average earnings by the end of the century. Though the basic State pension is not due to increase in real terms, there will be considerable growth of the proportion of each person's pension which is earnings related. As a result, a single person's State pension for those not contracted out of the State earnings-related scheme is likely to rise from 20 per cent of average earnings at present to about 40 per cent.

I must stress the heterogeneity of pension schemes. We are most aware of the really large funds. But in total there are about 90,000 schemes, of which 75,000, mostly very small, are not contracted out of the State earnings-related scheme and merely supplement the benefits of the latter. In many cases, the funds are managed for the schemes' trustees by merchant banks or, particularly with small schemes, by insurance companies.

Occupational schemes are far more widespread in the public sector than in the private sector. Occupational pension schemes cover over 90 per cent of those employed by the public corporations, 70 per cent of those employed in central and local government, but only 40 per cent of those employed in the private sector. The largest 175 schemes cover about 7½ million employees, of whom 5½ million in 100 schemes are in the public sector.

This multiplicity of pension schemes has evolved in an unco-ordinated, and largely unregulated, way. In the United States occupational schemes are similarly diverse. In Europe the State's role is more important. In Germany there is a mixed system: the State provides relatively high pensions, on a pay-as-you-go basis; and these are complemented by optional company-based schemes; these schemes usually involve notional funding—the employer records pension liabilities in the company's accounts, and the firms' ability to meet the pension liability is then insured. In France, almost all pensions are provided on a pay-as-you-go basis financed by employer and employee contributions: a first tier is administered through the social security system, and a second complementary tier through obligatory industry-based schemes. In both countries pension provision is effected without the creation of explicit pension funds. Since the war all industrial countries have seen both an increase in the number of pensioners, and an improvement in real income provision for retired persons.

Chart 2
GDP at constant factor cost[a]



(a) At 1980 prices; average estimate.

The problem of rising pension provision

The economic growth from the mid-1950s to the mid-1970s provided a substantial increase in national income. In line with the prevailing philosophy, a good share of this went to welfare expenditure. There were also promises of increased pensions, which constitute a claim not on present, but on future, resources. I turn now to consider how far this is likely to create a problem and what sort of problem it might be.

The developments that I have just discussed mean that total pension payments will increase considerably for two sorts of reasons. First, the pensions promised under both State and occupational schemes have become more generous, and the full effects have yet to appear. Second, as we have seen, there will be a marked increase in the number of pensioners in the early decades of the next century. To finance the increase in total pension payments arising for these reasons, taxes or contributions may have to rise.

The future scale of pension payments will also depend on how fast earnings grow. For under both the State and occupational schemes the scale of pensions is geared to earnings. In real terms, therefore, the growth of pensions will be related to the growth of the real earnings of those in employment, and thus be related also to the rate of growth of real national output. This means that the cost of pensions will, to some large extent, be related to our ability to meet the cost. Pensioners will share in prosperity, but will do less well if we all do less well. Nevertheless, the flexibility is not exact; the share of pensions in personal disposable incomes relative to wages and salaries will be higher if economic growth is slow than if it is fast.

This question of the future burden of pensions has been much argued over. Let me hazard a simplified account. Suppose, first, that there were no pension arrangements; people would then have to provide individually for retirement in other ways, and would probably do so by saving for that purpose—though they might choose to provide for a lower standard of living in retirement than that which they can now expect. It can be argued that whatever they save leads to investment and so to additional economic growth: to that extent, the consumption of pensioners entails no burden on others. But in fact the economic system may not work with such perfect precision: the effects on investment, and still more on economic growth, may be much weaker than such an argument requires. I conclude therefore that, even without organised pension schemes, provision for old age could present some sort of burden on the active population. The retired would be rentiers living off the fruits of past savings; but their consumption could still entail a restriction on what was available to others. There would, however, be a safeguard in so far as their investment had been in equities. If output was in fact not increased, the income from their investment would be likely to be smaller.

This same line of argument has been advanced in favour of pension schemes which are funded. It can be argued that they—unlike the pay-as-you-go State schemes—result in extra saving; and the argument is, as before, that the extra saving will provide extra investment and sufficient extra growth to support the pensions. As I have already indicated I find this chain of argument less than fully reassuring. I conclude that funded pension arrangements could also result in some sort of burden in future.

As I have already argued some potential problem could arise because of the juxtaposition of a degree of rigidity in the terms of pension expectations, and great uncertainty about the future growth of the economy. Growth may be unexpectedly slow by reason of many factors, as the last decade has shown. This uncertainty sits uneasily with promises (or apparent promises) to pay, many decades ahead, pensions which are fairly inflexible in real terms.

To some large extent, the uncertainties about the whole economy have their counterpart in the uncertainties facing an individual fund. In principle a funded pension scheme makes explicit, to both employer and employee, the full cost of labour services at the time when labour is used and when the liability to provide a pension is undertaken—and not only later, when the time comes to pay the pension. This is a cardinal merit in a funded, as opposed to an unfunded, scheme. In practice, however, the employer cannot be certain that the scale of contributions which he is advised to pay into the pension fund will prove sufficient to pay the future pensions which he has promised. The requisite scale of contribution depends not only on some matters which are amenable to actuarial prediction such as life expectancies. More importantly, it also depends on developments where prediction is much less precise—such as the future real return on assets invested, which is a joint product of prices and interest rates and to some degree economic growth. Variance from the assumptions can have large effects on the required contributions, as was shown by the large 'topping-up' of funds during the later 1970s.

As I shall note later, the commitments by employers to occupational schemes are in some ways ill-defined. A move to a clearer definition of employers' obligations might be associated with their legal commitments being less than the benefits now normally provided. Such a move, along with the provision of benefits over and above the legal obligation on a non-committed basis, might have the effect of increasing the flexibility of future pension provision. At an extreme, the need to provide flexibility in future pension claims upon resources could be an argument for defining pension rights, not in terms of benefits related in a specific way to final earnings, but in terms of contributions. For what the contributions earned a member over his working life would then depend more directly than now on the working of the economy: when growth was fast, real investment returns, and hence pensions, would tend to be higher, and vice versa.

Under present legislation pension arrangements, up to defined limits, enjoy tax advantages. The Revenue's rules for occupational schemes, which set an upper limit to the ratio of pension to final salary, tend to encourage final salary schemes; and if it were thought desirable to encourage consideration of remodelling schemes on the defined contributions, or money purchase, principle, the present rules might need to be modified. The rules concerning the conditions for contracting out of the earnings-related part of the State pension scheme might also need to be reviewed.

It is no accident that money purchase schemes are now uncommon. They went out of favour for two interrelated reasons: the first was experience of the low or negative real rates of return on previously invested assets, particularly fixed interest securities, which produced lower pensions than expected; the second was the strongly entrenched feeling that pensions should ensure a standard of living in retirement close to that shortly prior to retirement. Defined benefit schemes were seen as offering greater certainty in this respect. We have recently seen the re-emergence of a positive real return on fixed interest bonds and equities which, perhaps along with the existence of indexed bonds if these become more widely available, could allow reappraisal of the advantages and disadvantages of money-purchase as against final salary schemes.

Any modification of present arrangements would require careful consideration and discussion, and detailed negotiation between management and their employees. Members would need to think carefully what they would gain and what they would lose from a change; and firms would need to consider equally carefully what undertakings they could give.

I have in this section been considering the possible future burden of pension promises. I started by looking at this question from the standpoint of the economy as a whole. I conclude that if there is a need for change as far as occupational pensions are concerned, change will come firm by firm. Given the need for detailed consideration by those involved with each scheme, change could hardly be rapid.

The effect of occupational pension schemes on labour mobility

I turn now to consider a feature of occupational pension schemes which has recently attracted considerable criticism. Occupational pension schemes, as now formulated, favour some classes of members and disadvantage others. In particular, except for moves within the public sector, they tend to penalise those who move from one pensioned employment to another, as compared with those who stay the whole course with one firm. The increasing pace of change makes it likely that many more of us will make at least one move during our working lives.

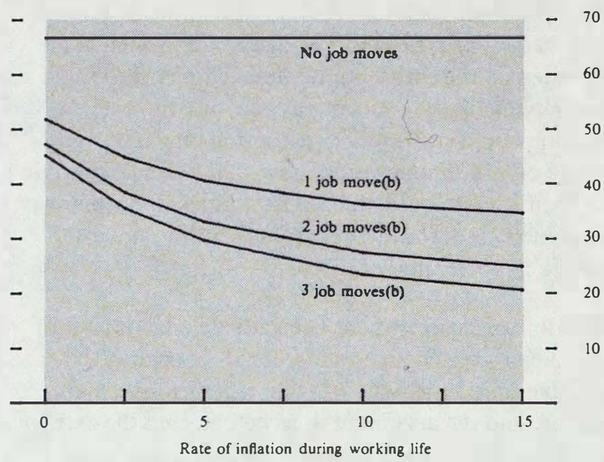
How large is the penalty? Pensions now typically depend on a proportion of final salary multiplied by years of service. A person changing jobs half-way through his life thus has half his working life yielding a pension appropriate to his salary at mid-career, and only the remaining half at the rate appropriate to his status at the end of his career. For a person who enjoys a typical growth of real income through his working life, it can be calculated that, with zero inflation, his total pension will be only three-quarters of the pension of someone who serves his whole career within a single pension scheme. When the rate of inflation is considerable, the loss of pension is much greater. Assume for instance that the rate of inflation has been 10 per cent over the relevant period, and assume too that deferred pensions (as is usual) are not indexed, the total pension of a person who moves once in mid-career will then be reduced to little more than half what it would be if he had stayed in his first employment. When the 1975 Social Security Pensions Act is fully in operation in the 1990s, the indexation of the guaranteed minimum pension will mitigate but not eliminate this problem. Such a diminution of their future pensions must be felt especially seriously by involuntary movers, such as those made redundant by the changing industrial structure, or by technological change.

For voluntary leavers, the diminution of pension expectations may make them less ready to move. It is true that the voluntarily mobile may be the ambitious and able, who often better their current earnings by a move—or who may anyhow not be too much concerned by diminution of their ultimate pensions. But this diminution of pensions must impose some brake on labour mobility.

That occupational schemes have such a bias should not perhaps be surprising. Part of the reason for their rapid growth was that they provided a way, which tax arrangements encouraged, for companies to reward loyalty and reduce labour turnover. Complete equality of treatment as between leavers and stayers might be thought unduly to penalise employers who had invested heavily in training staff. Some half-way house would clearly be possible.

One approach would be to modify existing arrangements, without radically transforming their general structure, so as to increase the transferability of pension rights, or alternatively to uprate or index deferred pension rights. Transfer of pension rights will not, of course, by itself increase their value and will always be complicated by the likelihood that the actuarial assessments on which pension rights are based are liable to differ as between different funds. The alternative, of uprating deferred rights has been supported by the Occupational Pensions Board, and I welcome as a helpful step its recommendation (recently

Chart 3
Initial pension as a proportion of final salary in a $\frac{1}{60}$th scheme (forty-year career)[a]



(a) Assumes 3% per annum real income growth. No allowance is made for uprating deferred pensions.
(b) Jobs of equal length.

endorsed by Mr Fowler as a possible basis for legislation) of uprating deferred benefits by up to 5 per cent per annum. It should be recognised that improvement of the position of early leavers must damage to some extent the position of those who stay—either directly by reducing their net benefits, or as the result of imposing additional costs on their employers.

One solution which has been discussed in this context is the substitution of the money purchase principle for the final salary principle on which most existing schemes are based. It is true that a move to the former would, eventually, remove most of the difficulties of the early leaver. Without affecting the rights of others, and without imposing additional costs on the firms they left or joined, movers could then withdraw the total contributions on their account (plus the net accumulated investment income derived from those contributions), or could take a deferred pension which would depend on the future performance of the fund. But a change of this sort might have to apply only to future service and would then take several decades to come into full effect. As I have already indicated, however, such a major alteration of the basis of pension schemes would affect the general pension rights of all members of occupational schemes, in ways that would be difficult to predict. The case for the money-purchase principle as a means to greater mobility must be considered as part of a much wider discussion of the general structure of occupational pension arrangements.

The tax treatment of occupational pension contributions

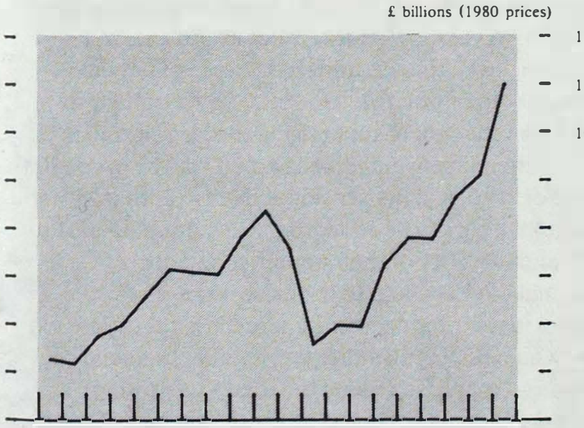
I turn now to consider the incidence of our tax laws, which give a heavy inducement to regular saving undertaken through financial institutions in a form to which the individual is committed for a term of years. Occupational pension schemes benefit from this fiscal advantage.

Some other sorts of saving—saving, for instance, invested directly in government bonds, or in equities—have to be made out of income on which tax has been levied. The income earned on such investments is also taxed as it arises. By contrast, contributions to occupational pension funds (and to the pension funds of the self-employed), as also the interest profits and dividends earned by these funds, are exempt from taxation. The pensions ultimately paid are taxed as earned income. The benefit of saving through a pension fund is thus essentially that tax is deferred, so that reinvesting the proceeds allows compounding of pre-tax, not post-tax, returns. Over periods of several decades this makes a major difference—a difference of 20 per cent or more after twenty years with the nominal interest rates which have ruled in recent decades. In addition, pensioners are allowed to receive as a tax-free lump sum up to $1\frac{1}{2}$ times final salary; that increases the gain in the latter example to over 33 per cent. Though any calculation is subject to a wide margin of error, the benefit of these provisions—or from another point of view their cost to the Exchequer—has been estimated to be about £3 million a year.

The preferential tax treatment of saving through institutions is often regarded as a distortion of the capital market. An almost opposite view has however been argued—that the real distortion lies rather in the way that most types of property income are taxed, to which the tax treatment of pension contributions is an exception. Thus it is argued that the present tax treatment of saving, which I have just described, involves a double taxation of saving. The remedy, proposed nearly thirty years ago by Lord Kaldor and more recently endorsed by Professor Meade and his committee, would be to move from a tax which was based on income to a tax based only on that part of income which was spent; thus exempting from tax not only saving which, for instance, took the form of pension contributions, but saving of all sorts.

Such a change in the tax system would have some theoretical appeal, as well as very considerable administrative complications, at least in the transition. But for present purposes, I can, I think, take it that so large a reform is not going to be introduced quickly; and that the immediate question is what we should think of the exceptions to the present general structure. Perhaps one consideration is that two major motives for saving are to provide for one's old age, and to purchase a house to live in. The purchase of pension rights and of houses for owner-occupiers are both now given favourable tax treatment; perhaps, therefore, we have already moved some of the way towards the substance of a Meade-type expenditure tax. That might argue in favour of leaving things somewhat as they are, rather than abolishing the present favourable treatment of pensions—though there might still be a case for re-examining the scale of the preferential treatment now given to pensions and owner-occupied housing.

Chart 4
The growth of pension fund assets at constant prices[(a)]



(a) Personal sector equity in life assurance and pension funds deflated by implicit deflator of consumers' expenditure, 1980 = 100.

Legal and regulatory aspects

The questions which I have discussed so far have been broad questions concerning the economic impact of pension funds. I will turn now to questions relating to the legal framework within which pension funds operate, which are also important. There is a growing feeling that some changes may be necessary: these might have important implications for the other questions I have discussed.

The legal framework which governs pension funds owes more to evolution than to premeditated design. The extension of trust law to cover pension schemes has, nevertheless, been patently successful in allowing the large-scale development of pension funds, with assets permanently alienated from those of the companies setting them up. The variety of discretionary arrangements which it has permitted is, in one sense, a major strength. Present arrangements, however, may have led to imprecision or confusion between the different roles of the interlocking parties to pension schemes; and, in inflationary times especially, may have led to a greater variety of treatment of pension claims than may now appear desirable.

The major imprecision lies in the pension relationship between the employer and employees in a defined benefits scheme. In law, it is the pension fund, not the employer, that will pay the pension. But membership of an occupational pension scheme begins with employment by a particular employer. It is the employer who has set up the scheme, who often requires the employees to join it, who tells them that they can expect a pension proportionate to their final salary when they reach retirement age and who makes contributions to the fund upon actuarial advice. Consequently employees might well believe that their rights to a pension rest upon their contract with the employer. If they think about the matter at all, they could be forgiven for regarding the pension fund simply as a convenient way by which their pension claims are kept separate from other claims upon the employer.

At present, employment legislation requires the employer to give new employees a written statement of the terms of employment, including any terms and conditions relating to pensions and pension schemes. Employers usually refer employees to a booklet describing the pension arrangements. But it appears that the contents of the booklet do not themselves constitute part of the contract of employment, so that the terms and conditions described in it may well not be legally enforceable. Nor has case law yet firmly established the nature of employees' claims against their employer in respect of pension rights. Any obligation on the employer to top-up schemes in actuarial deficiency, for example, may well be more moral than legal. At present, the legal rights of employees may well be less than they think, and the pensions they receive may in many cases be greater than that to which they are strictly entitled.

Since an employer's ability to provide for pensions in the distant future is uncertain, he may well see a certain advantage in this lack of clarity, and prefer to retain a degree of discretion. For circumstances could prevent the firm from increasing (or even continuing) existing contributions; in an extreme case it might become insolvent; and the future investment performance by the fund is also uncertain.

Nevertheless, ambiguity on a matter so important to employees as the employers' obligations to the fund can scarcely be regarded as fully satisfactory. I raise for consideration the question whether the employer should not be required to inform employees as part of the employment contract, not only of his current practice with regard to his pension obligations, but also of the extent of the employees' legal rights. Scheme members would then have a clearer basis on which to seek redress for any complaints. The form of such a new obligation upon employers would need to be the subject of further discussion and consultation. There is a similar case for shareholders to be informed more fully as to actual and contingent pension liabilities along the lines of the latest exposure draft produced by the Accounting Standards Committee.

Faced with the need to be specific, employers might well wish to limit their formal commitment; rights established on a binding basis might then be less than the benefits normally now provided in practice. This would not, in principle, prevent an employer from seeking to provide, on a non-committed basis, benefits over and above the legal commitments he formally undertook and on a scale comparable to what he now provides. Whatever the ultimate practical effects, a new requirement of this sort would prompt close and widespread examination of the issues discussed earlier in this lecture.

Another feature of the present arrangements is potential tension between the legal responsibility of the trustee, which is to the members alone, and the economic position of the fund, which is dependent upon the employer. This appears most clearly when the company appoints one of its own managers as a trustee. If pension rights were defined in the employment contract, making clear the extent of the employer's commitment to the scheme, this possible conflict would be diminished; management of the fund would appear more clearly separate from the employing company; and the position of trustees would be freer from ambiguity.

There is a strong and related case also for fuller disclosure of the performance of pension funds. The introduction of workable requirement should be greatly assisted by the groundwork done by the accountancy profession, and the steps now being taken by the actuarial profession to introduce standards of reporting of the actuarial position of a fund. If pension fund accounts were required to be disclosed in detail, not only to members, but also to a central registry where they could be inspected by others interested including shareholders, the performance of pension fund managers would be open to wider scrutiny.

It can be argued that disclosure of information would not sufficiently safeguard against the possible mismanagement of pension fund assets. I come then to the question whether there would be need also for a new regulatory authority charged with the prudential supervision of pension funds.

Some supervision is entailed in obtaining tax-exempt status from the Inland Revenue; and, for those contracting out of the State earnings-related pension scheme, in meeting the requirements of the Occupational Pensions Board in respect of, for example, self investment. But among major financial institutions, self-administered pension funds are least subject to official prudential supervision. Even though pension funds represent the collective rather than the individual interests of their members, they are no less custodians of their members' savings than are banks of their depositors', or life assurance companies of their policy-holders'. Given the great variety and size of funds, the diversity of their assets, the long-term nature of their liabilities, and the absence of the market discipline of withdrawals, pension funds might be thought to present more scope for inadequate management than do other financial institutions. There is, moreover, no machinery for enforcement of members' rights against trustees, short of a High Court action (which is likely to be costly, time consuming and perhaps ineffective); greater official supervision, as in the case of other financial institutions, would lessen dependence on such procedures.

To these arguments in favour of a regulatory authority there are, however, powerful counter arguments. At the practical level, there is understandable reluctance on the part both of practitioners and of government to embark upon the task of supervising the large number of self-administered pension funds. Moreover, the prudential record of defined benefits pension schemes (admittedly still immature) appears to be good, thanks no doubt in part to the skill and integrity of their actuaries and other professional advisers, and to the close interest of employers in their funds. Some characteristics of pension funds—which distinguish them from other financial institutions—may also reduce the need for external supervision: they do not compete for the savings of the public; the employer has an interest in their performance; and in single-employer pension funds the continuing close relationship between employer and employee gives those representing the members opportunities to monitor and influence the conduct of those funds. This is reinforced where, as is increasingly common, trustees include employee representatives.

These competing arguments leave me unready at present to come down in favour of a system of full prudential supervision of occupational pension funds. If we could move with reasonable promptness to a situation in which members' rights were clarified , and the information necessary to monitor the management of the funds was regularly available, that would be a considerable advance. The greater body of information thus created would provide evidence against which the case for supervision might then be more readily judged.

Pension funds in the capital markets

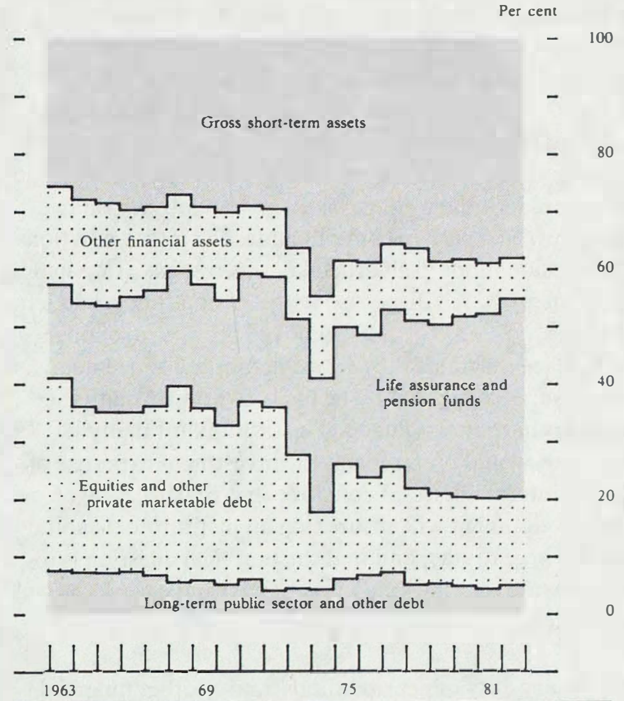
I consider last the important role that pension funds play in the capital market. I sought at the beginning of this lecture to outline the powerful trend in the course of this century towards increased provision for retirement. The growing role of the pension funds is to be seen as a reflection of this social trend. They act as the channel, collecting the savings made for this purpose, and directing them towards those who make use of these savings. The kind of saving that society now makes must be borne in mind in judging the question of how adequately the financial intermediaries discharge the task of providing finance for industry. These are very wide questions; it is right that I should conclude this lecture by considering them, broad though my treatment of them must be.

The rapid growth of the pension funds entails that they are still, as it were, immature. The sums coming in as contributions to pension funds currently exceed the value of pensions in payment—by about £4 billion a year. Since the annual income from the dividends and interest received on their investments is of the same order, saving via the pension funds is now some £8 billion or £9 billion a year—a large proportion of personal sector saving.

Many small pension schemes use life assurance companies in effect to invest the money for them; and a further part of personal saving is in the form of life insurance policies. The issues I wish now to discuss arise for both sorts of institution; contractual saving through pension funds and life assurance companies now represents about 7 per cent of personal disposable income. Persons also put part of their saving into tangible capital assets, notably houses and the assets of unincorporated businesses; and have other contractual commitments, in particular to repay mortgage debt. The rest of longer-term personal saving used to be important but has for many years now been negative: in particular, individuals are gradually disposing of their equities, which are being bought by the institutions. Holdings of claims on pension funds and life assurance companies have in effect taken the place of investments that were formerly held directly by individuals in companies.

As a result of the continuing massive accumulation of funds in the hands of these institutions, they now hold nearly half of the equity of UK listed companies—pension funds alone own over a quarter—and more than 40 per cent of market holdings of national debt. Twenty-five years ago these proportions were only a third as great. The institutions are also the largest investors in commercial property; and since 1979 when exchange control was removed they have built up sizable holdings of overseas securities. Since the funds are still immature, acquisition of financial assets will continue for several decades although at a declining rate; in twenty-five years' time they could own considerably more than half of UK equities and UK national debt.

Chart 5
Shares of personal sector gross financial wealth



It is possible to feel a degree of unease at this massive institutionalisation of the capital market. But it is important, I think, to try and dissect the reasons. It is not that our capital market is inefficient, or has become noticeably less so as a result of the dominance of the institutions. Institutional investors, indeed, need to match their preponderantly long-term liabilities with long-term investment assets; and this has been the foundation of our long-term capital market, which is the envy of many other countries. In recent years, it is true, the capital market has provided less new industrial finance than formerly. But this has in large part been the effect of inflation, which has made firms prefer to borrow from the banks, on shorter and variable rate terms—as it has also biased firms' own investment decisions by shortening their horizons and making them seek a quick pay-back.

One should also note that, though the growth of the institutions involves some centralisation of investment decisions in few hands, this has by no means created a situation of monopoly. What is true, however, is that the institutions are, in degree, constrained by trustee and similar obligations to give weight to safety in their portfolio management.

It is difficult to judge how far our capital market is now more risk averse than in earlier periods. But if there has been such a shift, I suggest that the underlying reason is not so much the growth of financial institutions as the change in society, and the change in the sources of saving to which this has given rise. Fifty or a hundred years ago, wealthy individuals played an important part in the provision of finance, in part because rates of income tax were low. Their place has been taken by a multitude of less wealthy people, who expect to live longer, saving for their old age; and how they wish their saving placed is inevitably different.

The fiscal privileges given to saving for retirement are often seen as partly to blame for the bias towards unrisky investment. But I wonder how crucial they are in this respect. If the tax privileges were abolished or diminished, saving might well be considerably reduced; but a large part of personal saving would probably still be saving for old age, which would for the most part still go to relatively safe investment. Nor perhaps I might add is the intermediation of the pension funds itself crucial in this respect. If we had arrangements which dispensed with pension funds, and left employees as free as the self-employed are now to choose how to place the funds they set aside for their retirement, much of such savings would be likely to flow through the hands of other sorts of financial institution; for many individuals would prefer to use the investment expertise of financial intermediaries. I conclude that the direction of social development will ensure that an institutional capital market is here to stay; and that the practical question is to seek to ensure that the kind of market we have works as well as possible.

The primary duty of pension funds, and of other financial institutions, is to ensure the best return on the money entrusted to them for the individuals whose interest they represent. It is desirable also that they should provide adequate finance for industry. There should not in principle be any conflict between these two objectives provided that profitable investments can be identified. In practice, however, the poor profitability of British industry has acted as the main constraint upon the provision of funds — from both internal and external sources — for a major expansion of new investment.

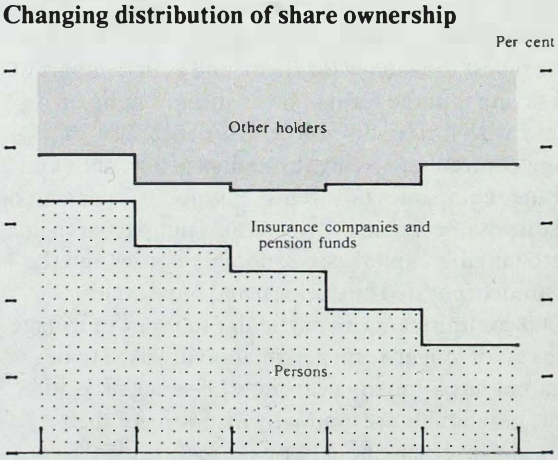
Nevertheless, some critics have put the cart before the horse and ascribed inadequate industrial investment to a failure of the financial institutions. This has led to the proposal of a measure of State direction over their investment decisions, or the setting up of a public investment agency to which the institutions would contribute a proportion of their inflowing funds.

There are, I think, powerful reasons not to go down this road. First, it is not the case that industry cannot now get the funds it needs, though it may well be averse to paying the going market rate on them. As witness to this, industrial and commercial companies have raised almost £2 billion in new equity and loan stock issues in the first nine months of this year. This is in addition to their medium-term borrowing from banks, and finance raised through leasing, both of which have grown rapidly over the last decade, filling the gap left by the long hibernation of the now reawakening corporate bond market. Second, any large-scale public fund would face the same problems of portfolio management that the institutions now face; there is no reason why it should deal with them better, and, to the extent that decisions were politicized, it would be likely to deal with them worse. Consequently, and third, the creation of such a fund to which the institutions would be compelled to subscribe would not be in the interests of the individuals with whose collective savings the institutions had been entrusted.

The fundamental problem is not to be found in the structure of the financial system but in the low profitability of much of British industry. This is unlikely to be overcome — indeed it is more likely to be perpetuated — by compulsory diversion of savings into channels where they would not flow voluntarily. In taking this position, I do not assert that there are no ways in which the provision of finance to industry could be improved — only that we must search for improvements which also serve the interests of the institutions' ultimate clients. The areas where I suggest we should look most closely are in the institutions' performance as major shareholders in most listed companies, and in their ability to recognise worthwhile new projects, particularly those involving relatively high risk.

Greater concentration of share ownership diminishes the ability of larger institutions to sell the shares of companies with which they are not satisfied and likewise makes it less easy for them to buy, over a short timescale, significant blocks of shares of companies they favour for their portfolios. Such adjustments of portfolios must clearly remain an essential element in the market process. But for the larger funds, an investment manager may sometimes

Chart 6
Changing distribution of share ownership



Sources: *The Pattern of Ordinary Share Ownership*, J Moyle: CUP, 1971. 'Ownership of company shares: a new survey', M J Erritt and J C D Alexander, *Economic Trends*, September 1977, HMSO. *The Stock Exchange Survey of Share Ownership*, November 1983.

have little real alternative to continuing to hold a particular corporate stock. In such cases, and surely indeed more generally, it must be in his interest to exercise an effective role as a proprietor. In recent years larger institutional investors have taken this role increasingly seriously, and have sought to improve their understanding of the businesses in which they are major investors, and to strengthen their relationships with the chairmen and boards which, under our corporate structure, are accountable to them in common with other shareholders. Special sensitivity will always be needed both in sustaining the necessary relationship of trust and confidence, and in paying regard to the interests of other shareholders. Nevertheless, the institutional investors can on occasions help to precipitate a change, desirable in the interests of all shareholders, which a wider group of small or individual shareholders would have difficulty in bringing about.

It is also becoming more common for a trust manager to be authorised by his trustees to put a proportion of his portfolio into new or relatively new — and thus inevitably more risky — ventures. If successful, the rewards can of course be great; but success here typically requires not merely the provision of finance, but an active function of entrepreneurship going beyond what fund managers can in most cases themselves individually supply. They will rarely have the particular specialised capability to appraise and undertake propositions that do not involve quoted securities or a conventional physical asset such as property. The creation of new enterprises, particularly in new technologies, frequently requires the combination of finance with well-conceived business propositions, and the assembly of the right people with technology, management skills and drive. The recent development of venture capital businesses and other intermediaries, funded in large measure by the institutions, should here be able to perform a useful role. Similarly, the cultivation of closer relationships between established companies and their institutional shareholders should assist both of them in identifying worthwhile opportunities for the investment of risk capital in the expansion and modernisation of existing enterprises.

It is important that possibilities in these and similar directions should be fully explored. Developments along these lines, although gradual and piecemeal, are I believe more hopeful than administrative modification to the present institutional structure.

Conclusions

I have discussed many issues in the course of this lecture, and will now try to restate my main points.

I began by considering the possible course of pension income up to the first quarter of the next century. Pension undertakings fall to be honoured long after they are made and my conclusion was the very simple one that, if the economy were to grow slowly, the relative rigidity of the terms in which undertakings are couched could create a problem.

I then went on to consider how this general proposition applies to the important part of our present mixed pension system with which I have been chiefly dealing, namely the occupational pension funds. The uncertainties as to the future development of the whole economy are reflected in the uncertainties that face employers and trustees of pension funds in deciding what scale of contributions is required to meet their pension commitments. I discussed the possible need to introduce greater flexibility in this link; and, as an extreme, a move to a system where pensions depended on what had been contributed and had been earned on invested funds (the money purchase principle). Greater flexibility would, however, necessarily entail greater uncertainty for members of funds as to the size of their future pension. Any such modification of present arrangements would therefore entail detailed discussion, firm by firm and fund by fund between management and their employees; and could not happen quickly.

I have argued that ways need to be found to lessen any impediment to mobility resulting from the loss of pension rights now incurred when people move from one pensioned employment to another. Possibilities include increasing the transferability of pension rights; or (as recommended by the Occupational Pensions Board) uprating deferred benefits. Though the adoption of the money purchase principle could eventually facilitate labour mobility, it would for the reasons I have just indicated offer no immediate solution; and would need to be considered in the wider context I have discussed.

There is now a lack of clarity as to the legally-enforceable rights of members of pension schemes. The entitlement to pensions of which new employees are informed may be rather of the nature of moral commitments than rights that can be enforced in the courts. I raised for consideration the suggestion that, if firms were required to define legally-enforceable pension rights, that would produce a desirable clarification of the position for all concerned in pension undertakings—shareholders, managers of firms, employees, and trustees and members of pension funds. To achieve such a definition would however entail careful consideration by all concerned of the substantial issues I have raised. I suggested also that there was need for fuller disclosure relating to the performance of pension funds. I preferred to come to no immediate conclusion as to the possible need for official supervision of pension funds.

I argued that the present dominance in the capital market of the financial institutions in general, and pension funds in particular, has to be seen as part of a broad social trend and not primarily as an effect of the tax advantages now allowed to saving through institutions. Though the latter are often regarded as a distortion of the capital market, I was not convinced of the case against them — though I suggested that the scale of tax privileges now granted to saving through institutions, and also to investment in housing, might need to be reviewed. I argued that, to the extent that the investment of inflowing funds tended to be biased against risky outlets, this was in large part an inevitable consequence of the kind of saving that society now undertakes. Though the primary responsibility of pension funds is to their members, there is however also need to ensure that they provide appropriate finance for industry; and I touched on some aspects of this interrelationship. I argued that the creation of a State investment fund, to which the institutions would be required to contribute, was not a solution to the fundamental problem of low industrial profitability.

The provision of pensions is a very large subject, which has many aspects; and I hope that what I have said will be of service in putting its different aspects into mutual relation.