Quicklook books

Know the basics in 90 minutes

# *Quicklook at* **Pensions**

## About Quicklook at Pensions

THIS book is a "must read" for anyone concerned about a pension, or simply interested in the ways in which this vast industry affects all of our lives.

Most people rely on pensions for a significant part of their lives. Until now, the subject has been forbidding. There are so many different types of pension, some private, some provided by the state. None of them are simple.

The world of pensions and its many complexities has been badly served by most commentators. All too often, anything written about it is too technical for the layman to understand, too narrow in its approach and/or comes with "spin". A lot of the available material is produced by those with some sort of financial product to sell. Quicklook at Pensions is not selling or spinning anything.

Pension funds affect, and form part of, the huge, but bewildering, world of finance. We see how they are structured and administered, who does what in the industry and get an insight into how money entrusted to pension providers is invested. There are a great many interesting careers in the sector – we see what they are.

All of the main types of pension (state and private) are explained.

There are many pitfalls for the unwary. Big, possibly life changing, decisions may have to be taken. Key things to think about are set out clearly.

**Quicklook at**

# *Pensions*

Martin Fagan

Quicklook
books

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Chapter One

# *What is a pension?*

A PENSION is a special savings vehicle to provide an income at a later date. That income is itself also referred to as "a pension".

Pensions are not new. The first scheme was organised for Royal Navy officers in 1670. Since then the range of pensions available has grown enormously in scope and complexity. There are many forms of private pension, usually linked to employment. In the UK and many other countries, most adults are entitled to a State pension, often in addition to one or more private pensions.

Pensions are of vital importance to most people in later life and often determine their lifestyles and living standards.

The provision of incomes for millions of people of pensionable age is extremely expensive. The sheer vastness of the sums involved in the UK pensions industry inspire awe and boggle minds. According to the Office of National Statistics (ONS), the value of assets held in UK-funded pensions in 2009 was £1.924 trillion (yes, that's £1,924,000,000,000). In its Global Pension Assets Study for 2010, pensions consultants Towers Watson found the UK is the third largest pensions market in the world, accounting for 9% of total global pension fund assets which Towers Watson survey says is $26 trillion US dollars. The UK now has more invested in pension funds than the value of its Gross Domestic Product ("GDP"), which, for 2010 was £1.45 trillion.

The pensions industry is a vast one, containing many large companies and employing a great many, sometimes highly paid, people with a wide range of specialist skills. The pension funds which they administer support almost all types of economic activity. As a consequence of the investments that are made, decisions taken by major pension funds can affect the fortunes of huge businesses, or even countries: Such is the power of the money that they control.

The importance of pensions to individuals and the whole economy has inevitably led to repeated interventions by governments. The results of such attempts to regulate have not always been happy but have most certainly led to great complexity.

In the face of many of the forces which affect pensions, governments are relatively powerless. Changes in the age profile of the population and major shifts in the world economy all have a great impact. A fundamental problem is mortality – or rather, the lack of it. The longevity of the whole western world is increasing. This is a major dilemma for pension planning because, to varying degrees, pension funds use income from today's workers to pay for today's pensioners. There are currently fewer than 3.5 workers for every pensioner in the UK; by 2035, this ratio will have fallen to around 2.5 to 1. This is a massive shift and represents a major problem for those responsible for managing pensions.

The world of pensions is a world of problems, big money and constant change. It is of huge importance.

Chapter Two

# *The anatomy of a pension fund*

## Structure

THE money in a pension fund has to be looked after responsibly and paid out properly when required. Those in charge must follow the rules. The general law controls much of what they do. In addition, all pension schemes are subject to written documentation (usually long and complicated). This covers all important points, such as who is covered by the scheme, what benefits are provided, who is in charge of the money and what can be done with it.

### Trusts

Many pension schemes are linked to employment. Money is paid in- often by both the employees (who will in due course become pensioners) and also the employer. The resultant fund is pension money. Arrangements are made to keep it separate from other money. This is done by taking advantage of the law of trusts. Money can be administered by people in accordance with the terms of the scheme – the pension fund "trustees". They can do this even though it is not their money. Thanks to the law of trusts, the money is kept safe for the beneficiaries of the scheme. Their employer can go bust but the money is still there to pay pensions.

The protection provided by the law of trusts is also important when the time comes to pay pension benefits- often for many years. The benefits can be paid from protected trust money. This may have originally come from a long extinct employer, or even a separate pension company. The fact that they are no longer around does not matter if, as is common, the pension benefits are being paid from ring fenced funds. Added safety is provided because these funds are usually held in the form of British Government securities called “gilts”.

## Gilts

Most governments borrow. The British Government has a long history of borrowing. It pays interest. The borrowing takes many forms, but most gilts are issued throughout the year by the Debt Management Office and are essentially investment bonds backed by HM Treasury. They are considered a very safe investment, as the British Government has never defaulted on its debts and this security is reflected in the UK’s AAA rating for its debt. When the DMO issues a gilt it will have a date on which the original investor will be paid back their capital (anything from three years to “undated”, where the gilt has no redemption date) but will receive an agreed annual rate of interest on the money the investor has lent the government.

Since gilts are regarded as very safe, they are used as the bedrock of many pensions. The pension fund can buy the right range of gilts, which pay a reliable stream of income, in the form of interest, which can match the outgoing payments to the pensioners covered by the scheme. The gilts are held within a trust.

The combination of trust protection and the use of gilts to fund pension payments means that pension income, once it starts, is normally very secure.

## Pension companies

There are many companies which provide pensions. Some such as Liverpool Victoria and the Co-operative Society are mutual companies and are effectively owned by the beneficiaries (i.e. the individuals who will be entitled to pensions) rather than shareholders. Most are profit making companies, who provide pensions in return for money and seek to distribute profit made from their operations to their own shareholders. This is derived from their (often very complicated) fee structures.

Running a company pension scheme, via trustees, is often done. However it can be very demanding. Any employer representative can find the task time consuming and prone to conflicts of interest. Some or all of the work, particularly associated with the investment of the pension fund money, can be farmed out to a pensions company.

Pensions companies can run almost all aspects of an employer's pension scheme. They also attract a great deal of direct business from self employed people.

Pensions companies are of course themselves carefully regulated by law. The pension funds which they administer are trust funds and thus still there for pensioners even if, as occasionally happens, the pension company goes bust.

## Who does what?

As major businesses, pension companies employ the full range of specialists which such companies require, at director and subordinate levels. For example, these days the IT department will be important. In addition, they have specialists dedicated to their industry. They deal with the tasks of marketing pensions, trying to maximise the pension fund, deciding what the liabilities are and then paying the benefits.

## Marketing pensions

Pensions are marketed through a myriad of sales channels, from the big life companies maintaining their own sales forces to independent financial advisers (IFAs) and even online third parties who act like "brokers" for the pensions industry. Some life companies also have "agents", who act for them in a freelance capacity and can sign individuals up to pensions offered by that life company, but not others. These are known as "tied" agents rather than IFAs.

The larger asset management companies, such as Fidelity, offer pensions as part of their product offering in their investment fund range, which they market directly to the public or via IFAs.

## Fund managers

Everyone benefits if the pension fund increases in value. Subject to the rules of the scheme, this may make the pension payments bigger. The need to top up the fund may reduce. The operator of the scheme

# *About the author*

**Martin Fagan** started to write about personal finance when he got sick of playing guitar in a rock band. That was over 20 years ago. Since then, he has written about money on every level for many publications, but always with the consumer in mind.

Staring as an editor with a corporate publishing company, he edited and wrote for magazines published on behalf of blue-chip financial services clients, such as INVESCO, John Govett, Singer & Friedlander, Framlington, Fleming, Aberdeen Asset Management, M&G, Lincoln International, Bank of Ireland, Prudential, Woolwich, Abbey Life and Alliance & Leicester.

He was offered the editor's job with *Personal Finance* magazine, where he stayed for nearly eight years, and also edited its sister publication, *What Investment*.

While editing financial magazines, he regularly appeared as a financial pundit on *Tonight with Trevor McDonald*, BBC Breakfast Time, Channel 4 News, BBC's *It's your Money* slot on BBC News 24, Radio 4's *Today* programme, *Scotland Today* and the (now defunct) Money Channel.

He currently divides his time between writing for a wide range of financial titles and websites, including the FT's investment magazines, *Pensions Week, Consumerchoices.co.uk*, *The Economist Intelligence Unit*, *Moneywise* and *Investor Today* – and making guitars in his garage.

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This book is a "must read" for anyone concerned about a pension, or simply interested in the ways in which this vast industry affects all of our lives. It is a basic but thought-provoking guide to a forbidding subject.

There are many different types of pension, some private, some provided by the state. None of them are simple. There are many pitfalls for the unwary.

Immense sums are tied up in pension funds. We see how they are invested and how this part of the world of finance operates.

- There are many interesting careers in the sector – we see what they are.



## About the author

**Martin Fagan** has been writing about finance for over 20 years. He has written for and edited a number of magazines focussed on the industry. He has often appeared as a commentator on it on TV and radio.

Martin's interest in the impact of the workings of big institutions on individuals has led him to take a keen interest in the pensions industry, which is very prone to ups and downs, regular changes – and the occasional scandal.

When not considering these matters, he can often be found making guitars.

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