

Understanding Pensions

Martin Sullivan

Routledge International Studies in Money and Banking

Understanding Pensions

With birth rates falling at the same time that average age is rising in the developed world, the pensions time bomb is ticking more loudly than ever. Understanding how pensions work, their history and their future is absolutely essential.

This book thoroughly explains to readers the unique concepts and terminology which underpin pensions. It focuses first on the rationale for pensions and their evolution, before moving on to an explanation of the latest controversies regarding pensions. The glossary of pensions terminology in the final section of the book virtually ensures its place on many academic bookshelves.

This timely volume is an extremely useful contribution to this important issue. Of use to policy-makers as much as to students and academics of finance and public policy, *Understanding Pensions* should prove to be a popular addition to the literature.

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For Kerstin

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Abbreviations

ABI	Association of British Insurers
ABO	Accrued Benefit Obligation
ACA	Association of Consulting Actuaries
ACT	Advance Corporation Tax
AFPs	Asociaciones de Fondos de Pensiones
APP	Approved Personal Pension
ASB	Accounting Standards Board
AVCs	Additional Voluntary Contributions
BIM	Bishopsgate Investment Management
BSP	Basic State Pension
CARE	Career Average Revalued Earnings
CPF	Central Provident Fund
DB	Defined Benefit
DC	Defined Contribution
DRC	Delayed Retirement Credit
DSS	Department of Social Security
DTC	Dividend Tax Credit
DWP	Department for Work and Pensions
ERISA	Employee Retirement Income Security Act
EU	European Union
FASB	Financial Accounting Standards Board
FRS 17	Financial Reporting Standard 17
FSA	Financial Services Authority
FSAVCs	Free-Standing Additional Voluntary Contributions
GAD	Government Actuary's Department
GAR	Guaranteed Annuity Rate
GDP	Gross Domestic Product
GMC	Guaranteed Minimum Contribution
GMP	Guaranteed Minimum Pension
GPPP	Group Personal Pension Plan
GPS	Graduated Pension Scheme
HRP	Home Responsibilities Protection
IBO	Indexed Benefit Obligation

IRAs	Individual Retirement Accounts
LAUTRO	Life Assurance and Unit Trust Regulatory Organisation
LEL	Lower Earnings Limit
LPI	Limited Price Indexation
MCC	Maxwell Communications Corporation
MFR	Minimum Funding Requirement
MGN	Mirror Group Newspapers
MIG	Minimum Income Guarantee
MNT	Member Nominated Trustee
MWR	Married Women's Rate
NAPF	National Association of Pension Funds
NDC	Notional Defined Contribution
NI	National Insurance
NICs	National Insurance Contributions
OASDI	Old-Age, Survivors and Disability Insurance
OECD	Organisation for Economic Cooperation and Development
OMO	Open Market Option
OPB	Occupational Pensions Board
OPRA	Occupational Pensions Regulatory Authority
PAYG	Pay-As-You-Go
PBGC	Pension Benefit Guarantee Corporation
PBO	Projected Benefit Obligation
PCB	Pensions Compensation Board
PPF	Pension Protection Fund
PPP	Personal Pension Plan
PRF	Personal Retirement Fund
RPI	Retail Prices Index
S2P	State Second Pension
SAS	Self-Administered Scheme
SERPS	State Earnings-Related Pension Scheme
SFO	Serious Fraud Office
SGC	Superannuation Guarantee Charge
SIB	Securities and Investments Board
SIP	Statement of Investment Principles
SIPP	Self Invested Personal Pension
SMPI	Statutory Money Purchase Illustration
SPA	State Pension Age
SSAP	Statement of Standard Accounting Practice
SSAS	Small Self-Administered Scheme
SSB	Short Service Benefit
UEL	Upper Earnings Limit
UFPS	Unified Funded Pension Scheme

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Introduction

Benjamin Franklin once famously remarked that there were two certainties in life, death and taxes. When Franklin made this observation, in the eighteenth century, most people died young. We should not be surprised, then, that he did not include living to a ripe old age in his list of life's certainties. Living to a great age is not a certainty today. For growing numbers of people, though, it is a distinct possibility. Children born in the year 2000 in France, Germany, the UK and the USA can, on average, expect to live for more than 77 years. Their Japanese counterparts have an average life expectancy of over 80 years. In Britain, the number of congratulatory messages the Queen sends each year to new centenarians has quadrupled since she was crowned in 1953. What is more, life expectancy is projected to go on rising in the coming decades.

Unlike longevity, the length of time people typically spend in paid employment has not been increasing. In fact, the opposite has happened. Since the 1970s, the average age at which people in Britain and many other developed countries cease working for a living has been falling steadily. In other words, there has been a significant increase in the proportion of peoples' lives spent in retirement. This has raised pensions to a level of importance never seen before. In the past, pensions were a means by which people insured against the unlikely event that they would become too old to support themselves by working. Today, pensions act more like retirement endowments, because most people can expect to stop working long before they die.

Pensions have long been the subject of fierce controversy. Although few would argue against the need for pensions, a debate has raged for more than a century over the most appropriate way to provide them. This is because pensions can be provided through a variety of mechanisms which differ in their advantages and disadvantages. The debate is not just about the pros and cons of one approach to pension provision compared with another, but about whether, and how, different approaches can be combined to produce an optimal retirement income system. Although the intensity of the debate has ebbed and flowed over time, it has never been stronger than it is at present.

2 *Introduction*

It is not the purpose of this book to enter directly into the current debate about pensions. Rather, it aims to shed light on the issues being debated by providing a clear and accessible guide to the unique language and concepts of pensions. It is intended to be a source of information and analysis which will be of interest to academics, students, pension industry practitioners, journalists and those with a general interest in the subject of pensions. Information is presented on the pension arrangements in various countries, including Australia, Britain, Germany, Italy and the United States. The constraints of time and space, however, make a comprehensive analysis of different national pension systems impracticable. The British pension system is described and analysed in the greatest depth. There are two reasons for this. First, Britain is the country whose pension arrangements the author knows most about. Second, lessons can be learned from Britain's recent pensions experience which have relevance for other countries.

The book is organised into three distinct parts. [Part 1](#), Pensions: Principles and Practice, considers the rationale for pension provision, describes the evolution of public and private pensions and explores the ways in which pensioners' incomes have changed over time. It also outlines the perceived demographic challenges to public pension schemes and considers different national responses to these challenges. [Part 2](#), Pensions: Issues and Controversies, provides analysis of a range of contemporary issues in the areas of public and private pension provision. Uncertainty is a major theme in the analysis of these issues. [Section 2.1](#), for example, highlights the speculative nature of population projections and casts doubt on the argument that public pension schemes will ultimately be blown apart by a 'demographic time bomb'. Other important themes running through the analysis in [Part 2](#) are paternalism, choice, fairness and the role of regulation. Finally, [Part 3](#) consists of an extensive glossary of pensions and related terminology.