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Pension Provision: A Lateral Approach

By Muhammad "Icki" Iqbal

Societies always consist of those that have and those that do not. In the United Kingdom one split is between those who belong to a good defined benefit pension scheme and those that do not. The former is a dying breed. The regulators don't make it easy for those who want to set up their own pension plan.

My daughter, who is a solicitor, showed me an illustration she had received on her pension plan. The plan was taken out in the mid-thirties for monthly premiums of £300. Benefits at age 65 are illustrated assuming an investment return of 4.1 percent. The projected fund is £211,000 but, the quote says, it would only be worth £109,000 if inflation is 2.5 percent p.a. in the intervening period. The fund would purchase a pension of £275 month, which would increase with RPI and 50 percent spouse's pension on her death.

She asked me, "Tell me why I should bother with a pension?" That was a difficult one to answer. Pay £300/month for thirty years to get £275/month for 5, 10, 20, 30, 40 … who knows how many years but on average, say 20 years. Doesn't strike me as a good bargain.

There are two problems here. First, charges are an extortionate 1 percent per year. In the bad old days of the Wild West, before the regulators got rid of all the cowboy practices, charges appeared high because they were front end loaded and to some extent were high because you got advice with it. Now, you get poor products with no advice. That is the price the consumer lobbyists exacted from the industry. Other than to note it, we can't put the clock back.

But the other problem is an interesting one. The fund at 65 is converted into a pension assuming an interest rate of -0.60 percent, a negative real rate of return. I know we live in the age of quantitative easing when governments are pumping in money and keeping interest rates artificially low; but is it reasonable to assume that it will persist in the future? Either there will be an almighty explosion or inflation will rise and with it bond yields? At the very least isn't an explanation appropriate?

I wonder if it is time to give financial products a miss. The sector is bloated, the money earned can be obscene. The sector has lost touch with reality. If retirement provision is left to the individual then it need not be money. For example food can be provided by pre-purchasing say, a supply of proteins, carbohydrates and other things to be delivered in the future. Instead of a pension the individual could get coupons which are in effect inflation-proofed. These coupons have to be purchased. They could be purchased when you are working but who would issue them? If it were a supermarket then the supermarket takes the inflation risk.

> "If retirement provision is left to the individual then it need not be money."

The individual is not insulated from risk. He takes a different form of risk. Firstly, he risks the solvency of the supermarket. Secondly he takes the quality risk. In the United Kingdom, Marks & Spencer might have superior quality compared to say Asda but how could you be confident of their relative position thirty years hence? There are other issues: You would need a very tight definition of food items. Had coupons been issued in the 1950s would they have provided just meat pies and chips and peas?

If the idea were to get off the ground then one can imagine a market developing in tradable coupons so that, for example, someone who's turned vegetarian can swap his carnivore coupons for a vegetarian one. One can also envisage different grades of coupon, "Basic," "Regular" and "Finest." A more basic question is whether to supply cooked food or the ingredients.

Suppliers of coupons would need a market in which they can lay off the risk. They must be prepared to buy-back the coupons before they "vest." However if someone has purchased food that's gone out of fashion, everyone would be trying to trade the coupons in and its price would drop. Laws of economics can't be circumvented.

Shelter is another issue. If you don't own a house then you have to find the resources for rent. Can rents be pre-purchased? If you have been able to purchase a house/flat in the Earner phase, you have housing stock which can be retained or traded for one more suited to your present requirements.

What about utilities? Heating, lighting and water? Again you either have funds to meet their cost or pre-purchase coupons. The latter ought to be easier than in the case of food as units of power (or water) can be readily defined. Again these are long-term liabilities and their providers should be subjected to solvency requirements comparable to that of a life company. We remember that Enron went under because they provided banking products without the same regulations. Anyway, what energy are we talking about?

Local Tax, is an interesting one. Local government provides a range of services. In order to pay for them, they receive a grant from the central government but the amount is not sufficient. Rates are set at a level necessary to extinguish the shortfall. Being the difference between two large numbers, it is highly sensitive to minor changes in either.

Pre-purchasing rates raises several issues. Would you have a clear idea when 45 as to what local services would be important to you when 75? Even if you did, what is the guarantee that the local government would be able to deliver? They have to look at the majority view of the residents in their domain. Indeed, which local authority would you be concluding a contract with? You may move when you retire.

Even if all of these issues can be addressed, put yourself in the position of the local authority. If the services and rates are fixed for those who pre-purchase and the central government squeezes the grant, the increase in the pay-as-you-go rate would be highly geared if books are to balance. In the limiting case of everyone pre-purchasing, it can be seen that the problem is insoluble. The local government would be forced to dip into the prepayments that should be set aside to cover future services.

I conclude that local government services can't be pre-purchased.

Purchasing leisure should in theory be feasible. But in practice successful delivery might be a problem.

The travel agent would be pre-purchasing deals with foreign hotels and resorts and their assurances might not be worth relying on.

Finally, funeral costs can certainly be pre-purchased.

PURCHASING COUPONS

A Buyer's Perspective

If an individual prefers to buy goods and services as and when needed, then he's well advised to buy an orthodox annuity to avoid the longevity risk. If he wishes to avoid the inflation risk than he can pre-purchase coupons. The quality of the seller's promise is the foremost issue:

1. What is their track record?
2. How consistent has it been?
3. Will it change over time?
4. Can each year of promise (the year it is made rather than the year it is to be delivered) be secured with appropriate assets?
5. If it is, what is the counter-party risk?
6. How does it propose to deal with "catastrophe risk" e.g., crop failure?
7. What about political risk?
8. OK, I will be protected against inflation but what if there is deflation? How likely is deflation?

Is diversification desirable? To use the food coupon example, does one buy coupons from a number of supermarkets? Can one live with the curates egg of a food choice?

One has to ask whether people would actually buy coupons, which gives them inflation protection, longevity protection and assurance of delivery, or whether they'd prefer cash, which doesn't provide the same protection but has ultimate flexibility. The difficulty would be not knowing what we would need in the future. That certainly applies to leisure but could also apply to food and shelter.

The irony is that the best time to buy coupons is times like the present when inflation is low as the price would not be excessive. When the inflation threat is real the coupons would be very expensive.

Example (the figures are illustrative, not real): Price of a kilo of lamb today: £10 say

Inflation rate (predicted)	0% pa	5% pa	15% pa
Long term interest rate	½% pa	4% pa	12% pa
Price of coupon*	£436	£726	£1,311
Cash price 35 years hence	£520	£2,939	£74,264

* The coupon guarantees a kilo of lamb a week for a year after 35 years. The cash price of the meat 35 years hence is also shown. When inflation is really low, one thing a buyer of a coupon should consider is the likelihood of there being deflation so that goods would actually cost less in the future.

The coupon can guarantee delivery for the rest of life from the date specified, so that you are protected from both inflation and longevity. Alternatively it could be for a specified number of years. The latter would be much cheaper, but of course you don't get longevity protection.

A Seller's Perspective

In my view, the most important fact to consider is the risk of retrospective judgment of a promise made today for delivery thirty-five years hence. Talk to any life insurance company that had transacted with profits business. Consider two scenarios:

1. If you've promised a kilo of lamb but lamb is out of fashion as a source of protein who's to say what the Ombudsman would say?

2. What if you've factored an assumption regarding future inflation into your pricing but then there is deflation. Will there be consumer pressure of "mis-selling?" If there is, would the politicians and the regulators cave in?

At the end of the day tightness of definition is your only defence but it may not be enough.

Assuming that can be solved, the other issues are:

1. Securing the goods promised

2. Do you enter into a forward contract with a farmer or farmers? How good is their promise? Or do you purchase a financial instrument? If you do the latter how does the issuer of the contract ensure delivery?

3. Capital required

4. As an issuer of a long-term contract, will you be treated as a life company or be treated as an investment bank? Either way do you have to set up a separate company to deliver it?

5. Counter-party risk

6. Longevity risks

7. Skill-mix. Will the Finance Director, used to fast moving consumer goods, be capable of dealing with long-term risks? Witness the problems of banking conglomerates since the repeal of the Glass-Steagall Act.

I'm not convinced that the idea will fly. People might prefer the flexibility of cash but a time will come when anger at bankers' salaries and excesses of hedge funds might goad people into seeking alternative solutions. □