PROMOTING
GROWTH AND
SHARED PROSPERITY
IN THE UK

IPPR

PUTTING PENSIONS TO WORK

BRIEFING

ECONOMIC EASING AND THE ROLE OF PENSIONS IN PROMOTING GROWTH

Kees de Koning

December 2011
© IPPR 2011

Institute for Public Policy Research

ABOUT THE AUTHOR

Kees de Koning has worked for the International Labour Office and as a senior international banker and an executive in asset management.

ABOUT IPPR

IPPR, the Institute for Public Policy Research, is the UK's leading progressive thinktank. We produce rigorous research and innovative policy ideas for a fair, democratic and sustainable world.

We are open and independent in how we work, and with offices in London and the North of England, IPPR spans a full range of local and national policy debates. Our international partnerships extend IPPR's influence and reputation across the world.

IPPR
4th Floor
14 Buckingham Street
London WC2N 6DF
T: +44 (0)20 7470 6100
E: info@ippr.org
www.ippr.org
Registered charity no. 800065

This paper was first published in December 2011. © 2011
The contents and opinions expressed in this paper are those of the author(s) only.

POSITIVE IDEAS
for CHANGE

ABOUT PROMOTING GROWTH AND SHARED PROSPERITY

This major programme of work aims to identify public policies that will promote the economic growth needed to return the UK to full employment and ensure that the benefits of future prosperity are more equally shared.

For more information, see:
http://www.ippr.org/research-projects/44/7144/promoting-growth-and-shared-prosperity-in-the-uk

In his autumn statement in November 2011, the chancellor George Osborne proposed tapping into the assets of private pension funds to help finance a National Infrastructure Fund. In this paper, I propose an alternative scheme for using pension savings to boost growth.

Pensions savings in the UK

With the phasing out of defined benefit (DB) pension schemes and the expansion of defined contribution (DC) schemes, the risks associated with failing to build up a sufficient private pension pot have been transferred from companies to individual pension savers. It goes without saying that very few individual pension savers have the time or the tools to effectively manage their pension savings themselves. It is also fair to say that the current system of managing investment risk by the professional fund management groups leaves much to be desired. To quote Professor Burton Malkiel of Princeton University in the US: 'time and time again, two-thirds of the active managers perform worse than the stock index'.

The current state of affairs in the UK pension market can be illustrated with some key facts:

- Pension charges can swallow up to 40 per cent of pension savings over a worker's lifetime.
- Which?, the consumer group, calculates that the average UK pension fund had a turnover of 108 per cent last year. This implies 54 per cent of its shareholdings were sold and 54 per cent of other shares were bought, adding about 1.5 per cent in annual charges.
- Over the last three months alone, falling markets, rising inflation and plunging annuity rates have seen the income to be taken out of a typical pension pot drop by 11 per cent.
- The UK Pension Protection Fund reports that the aggregate deficit of funded pensions soared to £159 billion in October this year – up from just £8 billion in June – on a total asset base of just over £1 trillion and total liabilities of £1.16 trillion. This leaves companies facing a huge long-term financial risk, unless markets improve.
- About half of all pension savers have lost confidence in the merits of saving for a pension, according to the National Association of Pension Funds' annual survey in 2011.
- European leaders are, by necessity, fully occupied with rescuing the euro, taking the spotlight away from pensions and economic growth issues.
- Private sector pensions (the DC schemes) are 'significantly flawed' and the entire industry needs a 'radical rethink' if workers are to have enough money on which to retire, according to Mark Hyde Harrison, the Chairman of the National Association of Pension Funds.

In the current financial climate, companies have found it very difficult to continue with DB schemes as all investment risks, as well as the risks of employees living longer, are the responsibility of the employer. Moreover, on an annual cashflow basis, DB schemes are more expensive for employers, costing on average some 11 per cent of annual gross salary, as compared to around 6 per cent for DC schemes. The result is that most employees are now faced with DC schemes and therefore the associated investment risks.

The UK government's objective is to provide a basic state pension and to encourage greater private pension savings – the latter is to be achieved through a higher participation rate, an increased contribution per pension saver – from the saver themselves, their employer and through tax relief – and a cheaper set-up for administering such contributions.

These objectives are encompassed in the Pensions Act 2008, which provides that in 2012 an automatic enrolment programme will commence, beginning with the largest employers and limited contribution levels, gradually expanding to smaller companies and a higher level of contributions. The automatic enrolment programme is sorely needed, as the participation rate in private pension savings schemes has rarely been above 70 per cent of all employees and has currently reached its lowest level for 55 years. The participation rate has generally been lower in the medium-sized and small companies than in larger firms, and younger employees tend to have a lower participation rate. Recently the government decided to postpone the automatic enrolment scheme for SMEs by one year as a balancing act between the need for higher pension saving participation and the ability of SMEs to pay for it.

The question is this: how can the confidence of an individual who is saving for a pension pot over a 40-year period be restored, so that they feel secure in setting money aside to secure an income after retirement?

No individual saver can answer this question on their own – however, the answer can be found in the institutional framework that surrounds the saver. One should not look to the government in isolation, nor to employers or the pension fund providers. The likely solution is that all three constituencies are part of the overall picture and therefore also part of the overall solution. In the next section, I explore the macro-economic benefits of such tripartite cooperation in support of pensions saving.

The macro picture

When governments struggle to refinance their debts at sustainable interest rates, one cannot expect them to inject more cash into their own economy. Instead, the opposite is true: taxes need to be raised and the costs of the civil service and welfare payments have to be cut.

When banks are forced to manage doubtful government debts, they need to make provisions – this impairs their equity base, which in turn reduces their capacity to lend to private sector enterprises, large or small. When a central bank can no longer stimulate the economy by lowering its base interest rate and instead starts injecting money by buying up government bonds (as in quantitative easing), then this money-printing action puts an upward pressure on inflation and so reduces the return for investors, including pension savers and pensioners.

When individuals are hit with rising prices, higher taxation levels and lower income growth levels – the latter both in working life and, through low interest levels, as pensioners – then their tendency is to tighten their belts and reduce consumption levels.

When companies are faced with slow or non-existent growth levels, they will attempt to increase efficiency levels in order to maintain profitability levels. Unemployment will rise.

When substantial export growth is unlikely, because many countries are subject to the same depressing set of factors, then all sources of economic growth are seemingly exhausted. Or are they?

In the UK, according to Aon Consulting research, in 2009 9.7 per cent of the total gross wage bill of the private company sector went into pension savings (a large slice of it into defined contribution schemes). Currently, annual contributions run at an estimated £100 billion per annum. The question is how much of this cash outflow returns directly to the

company sector? Buying gilts does not help companies: it is a transfer of (cash) assets from the private to the public sector, with the same ultimate effect as if it was a tax. Buying shares in the open market only has an effect on the share price of a company, not on any company's cash flow. As the UK pension fund market operates today, very little of the £100 billion is directly made available to the company sector.

However, positive cashflow is the key to sustainable economic growth for any participant in the economic process, be it a government, bank, company or individual.

The UK government, the banks, individuals in general, and the overseas importers are currently not in a strong enough cash-flow position to spend more. This leaves pension savings cash flow as the only viable non-inflationary source of funds for economic expansion.

What is important in analysing where the pension savings cash flow goes is that the real markets in which companies operate and the financial markets are separate entities, notwithstanding the many interlinking factors.

For instance, if pension fund managers buy equities on the stock market with new funds injected from annual pension contributions, this will increase prices on the market and lower the yield. This makes it cheaper for companies to issue new shares. But making it cheaper does not imply that companies have any cash inflow as a result. Only already-issued shares are bought and current sellers do not include the company itself. The benefit of the share price increase is indirect only and in falling markets is of doubtful value to a company. What the share price increase certainly does not do is increase production levels.

Economic easing

It is the link between pension contributions and production expansion that needs to be revisited. Whether they are big or small, if companies with a good managerial track record wish to expand their activities, they currently have two sources of funds: retained earnings and bank or – for larger companies – bond and equity market issuance.

Retained earnings play a double role: as 'quasi share capital' and also as a buffer for rainy days, especially in an uncertain economic climate. Hence many large companies have been hoarding cash, more for that rainy day rather than to build up the share capital base. If retained earnings had been used to boost share capital then this source of funds would have led to a much higher level of merger and acquisition activity, of which there is currently very little sign. Smaller companies do not – generally speaking – have the luxury of building up buffer funds in a low-growth or stagnant economy.

Do companies generally wish to expand their share capital or equity base? For listed companies the answer is likely to be 'yes', as long as it does not affect their already-depressed share price. A suggestion for how this can be achieved is set out below. For smaller companies, which depend more on bank financing, the answer is undoubtedly a resounding 'yes'. Share or equity financing, in a low-growth economy, has the great advantage of allowing production expansion to take place unfettered by onerous loan covenants or dividend obligations. Of course, this does not mean that a 'credit easing' scheme will not work; the more options available to SMEs, the better the chances are of achieving economic expansion.

To make effective use of pension fund savings, the cash flow has to be redirected – not permanently, but until such time as the economy has reached its long-term growth

potential. No private sector institution can take the lead in such redirection because such a measure would form part of the government's macroeconomic management framework. Instead, the logical place to fit it would be among the monetary management instruments of the Bank of England (BoE). The BoE already controls both the volume of funds in circulation and its price: the base rate. It also wields a tool to influence specific fund flows: quantitative easing. The redirection of pension savings would add another funds flow management tool to its monetary policy kit. However, it is up to the UK government to decide whether to adopt this macroeconomic tool, and if so which unit in the government is best placed to operate it. For argument's sake, I have assumed that it is determined to fall within the remit of the BoE.

The scheme would operate with the BoE inviting companies to request a share capital injection for the purposes of production growth. Under the banner of an 'economic easing' scheme, the BoE would subsequently subscribe for such new shares, subject to the company having fulfilled certain profit and management criteria over the last, say, three years. The transaction would take place at the prevailing share price on the stock market, or for non-listed companies at net asset values.

The BoE would not intend to hold such shares but would invite all pension fund managers to commit – up front – to buying them .However, such shares would only be delivered as and when the pension fund contributions came in. The purchase price for these shares would be the same as was paid by the BoE: the BoE acts as a temporary funder for these shares. If the pension funds oversubscribe, the allocation would be scaled back on a pro-rata basis. If undersubscribed, the BoE would, over time, sell these shares on the open market or through a private placement. The BoE could, as an element of this economic management tool, decide to accelerate or decelerate its share subscription operations.

The risks to the BoE are minimal, as the intention is that shares would be quickly sold on to pension funds. Even if the BoE is left holding any shares these are likely to appreciate in value, as higher growth rates have a strong correlation with higher share prices. In order to spread any risk, the equity stakes in SMEs could be pooled into a combined portfolio, so that pension fund managers could obtain a stake in such portfolio(s).

For clarity's sake, this scheme does not involve the £1 trillion already managed by the pension industry, but rather the new funds that are saved in the current period. With respect to these new funds, pension fund managers would have to commit to a lock-up policy for a period of, say, three years on any shares acquired through the economic easing scheme, which would need to prohibit share lending or derivative trading on these shares. Of course, a fee would have to be agreed to undertake such a lock-up.

Longer-term share holdings raise the important question of the valuation of such shares. Arguably, long-term shareholdings should reflect the long-term nature of a company's underlying performance, rather than taking the trading values on a daily basis, as is presently the case for listed equities. For long-term holdings, perhaps a more realistic and appropriate value measurement tool rests in the net asset value of a company: the surplus of its assets over its liabilities divided by the number of outstanding shares.

For listed companies, lock-up periods will mean that the new issuance of shares will have no short-term effect on the share price, making it possible to undertake expansion projects with the objective of increasing the net asset value of all shares.

The pension regulator will have to agree that pension funds are allowed to participate in the economic easing scheme and that those valuations might be adjusted to reflect the long-term nature of the share investments.

Conclusion

If the government, the private sector and pension fund managers can agree to work together then this economic easing scheme would help to ensure that companies have the funds available to expand in the most economically sensible way: by increasing share capital ringfenced for longer-term growth investments. It will also facilitate a more efficient deployment of pension savings cash flow in the company sector, a desirable objective for long-term pension savers. Another positive side effect is that, if the savings form part of a defined contribution scheme, workers contributing to the scheme will in effect become the co-owners of the companies involved. Last but not least, should an economic easing scheme be made operational, employment, tax revenue, income and spending levels would all grow, which is what Britain needs.