

PARLIAMENTARY PENSIONS BRIEF

PRODUCED FOR MEMBERS OF PARLIAMENT BY THE ASSOCIATION OF CONSULTING ACTUARIES

The Pensions Bill announced in The Queen's Speech must go beyond the detail of personal accounts and minor deregulatory measures to help existing schemes if millions of private sector employees are to be offered good pensions...

New Pensions Bill needs to remove the ban on employers offering conditionally indexed pensions

The latest *Pensions Bill* rightly has the intention to extend pension coverage to around half of the 19 million adults of working age who currently can expect no pension other than a State entitlement. The Bill is also likely to include a modest number of deregulatory measures aimed at helping to keep existing good schemes open. The big question that has to be asked, as the Government prepares its legislation, is 'whether the proposals will be enough to maintain and extend good pension arrangements?'

This latest briefing, prepared for Members of Parliament by the Association of Consulting Actuaries (ACA) ahead of The Queen's Speech debate on pensions (14 November) argues that there is a danger that the Government is under-estimating the scale of the decline in good occupational provision in the private sector. Only about 900,000 private sector employees are now members of open defined benefit schemes – under a half of the number reported by the Pensions Commission just 2 years ago. Urgent and convincing reform measures beyond those intimated to date are needed in the forthcoming *Pensions Bill* to address the decline in good occupational provision.

These measures need to be implemented ahead of the 2012 introduction of personal accounts, otherwise little good private sector provision will be left open, certainly to younger and mid-career employees.

The ACA has provided Government with the blue-print of how it can extend good private sector occupational provision by allowing employers to offer **conditionally indexed pension schemes** – risk sharing schemes - that will help close the widening pensions gap between private and public sector provision.

This briefing summarises the rationale behind this recommendation and how such schemes would work.

Government strategy is well meaning, but that's not enough

Aside from the public sector, where more employees each year (presently over 5 million) are protected by good occupational pensions, Members will be aware that occupational pensions for private sector employees – particularly final salary defined benefit schemes – are covering fewer and fewer employees as each year goes by. That trend has been apparent for a number of years and, amongst other issues, led to the appointment of the Pensions Commission.

WHAT ARE CONDITIONALLY INDEXED SCHEMES?
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The Pensions Commission reports that followed led onto the decision to restore the Basic State Pension linked to earnings and the decision to push for a major extension of pension coverage – looking to add between 7 to 10 million pension savers – through personal accounts, to be launched in 2012.

The Government has recognised that at the same time as promoting personal accounts aimed at low to middle income groups, it is important to protect and promote the good occupational pension schemes offered by many private sector employers.

Here, it is recognised that the costs and risks involved in running a good defined benefit scheme have in many cases increased markedly due to a range of factors, including improvements in longevity and mandatory measures introduced by Parliament in different times. That is why the Government launched a Deregulatory Review of Private Pensions, to identify measures that would help employers to keep open existing good schemes.

Table 1: Number of employee members of occupational pension schemes (defined benefit and defined contribution) (Source: GAD/ONS Surveys)

	Number of employee members (millions)		
	1991	2000	2006
Private sector	6.5	5.7	4.4
Public sector	4.2	4.4	5.1
Total	10.7	10.1	9.5

The Government recently announced its initial conclusions from the work of the Deregulatory Review, whilst at the same time asking for further input on issues like the best way to encourage more risk sharing schemes to be opened.

Amongst a number of reforms accepted by the Government was that the revaluation of deferred pensions in defined benefit schemes should be capped at 2½% per annum as opposed to 5% at present. This change will certainly be helpful in better controlling mounting defined benefit scheme cost, but, alongside the other measures accepted at this stage, the cost

savings are unlikely to be sufficient to change employers' minds about the future of their existing schemes.

The scale of the problem...

The reality is that few good private sector defined benefit occupational schemes are now open to new employees. ACA surveys conducted earlier this year and this month confirm **fewer than 20% of defined benefit schemes are now open to new entrants.**

Without urgent Government action, the next phase – closure of future pension accruals for existing members (which is already underway, **with now around 20% closed to future accrual**) – will occur as employers look to close off the unacceptable costs and forward risks associated with defined benefit provision as it is presently organised under UK legislation. Much of our occupational pension legislation is serving no better purpose than managing the orderly decline of a once widely applauded British success story. In short, defined benefit legislation is no longer 'fit for today's world'.

**ACA UPDATES
PENSIONS COMMISSION FACTFILE**

Open defined benefit schemes - 2005
 "In 1995 there were 5.2 million members of open private sector defined benefit schemes; **today (2005) there are fewer than 2 million with numbers falling fast.**"
 (Source: Second Report of the Pensions Commission, December 2005).

Open defined benefit schemes – 2007
 "In 2007, two years on from the Pensions Commission report, **there are about 900,000 private sector employees in membership of open defined benefit schemes.**" (Source: ACA survey of consulting firms, November 2007).

Around eight out of ten firms have closed their defined benefit scheme to new entrants

At present, employers wishing to cap their pension costs have in the main taken the simple decision – to move their employees into defined contribution schemes, where employees take on 100% of the longevity and investment risks. Whilst a few employers have steered their way around current defined benefit legislation to design hybrid defined benefit / defined contribution schemes, most have taken the view that such arrangements are overly complex to communicate.

What is very clear is that many employees do not want to take on 100% of the investment and longevity risks associated with their pension and, in truth, many are ill-equipped so to do. This is particularly the case for those in lower income groups, but by no means exclusively so.

Whilst the number of employees in defined contribution schemes has increased as defined benefit schemes are closed, the overall picture today is that **only 44% of employers now offer any kind of pension scheme, down an alarming 8% on the picture just 2 years before (source: DWP Employers' Pension Provision Survey).** There is also increasing evidence of closures of trust-based defined contribution schemes as employers opt for more lightly regulated contract-based arrangements.

So is there an alternative to this picture of decay and levelling-down?

A better way: conditionally indexed schemes

Finding ways around legislation that has become inappropriate to meet current circumstances is no way to proceed.

The ACA has put to Government earlier this year a blue-print to update the defined benefit legislation currently in place to allow employers to provide a new type of risk sharing scheme called a **conditionally indexed scheme.**

The required changes to defined benefit legislation are simple and do not require a new layer or regime, as some have suggested.

Conditionally indexed schemes are the prevalent type of scheme in The Netherlands, where defined benefit provision remains robust and the dominant form of pension provision, ensuring good pensions for millions of employees into the future.

For employers, **conditionally indexed schemes** enable costs to be capped reasonably into the future, despite changes in longevity and financial markets.

For employees, these schemes offer a pension linked to average career earnings, indexed in deferment and in payment, save on occasions in exceptional circumstances when this is against the long-term financial health of the scheme.

Thereby, unlike defined contribution schemes, where investment and longevity risks are placed squarely on the shoulders of employees, risk is shared instead between employer and employee.

So how do conditionally indexed schemes differ from final salary defined benefit schemes?

First, the similarities: if the legislative amendments were made to allow for **conditionally indexed schemes** to be offered by employers, both types of schemes would fall under the same defined benefit regime we presently have.

They would both be regulated by the Pensions Regulator, would both be required to support past and future benefits including indexation by prudent reserves under the new scheme funding rules and would both offer protections to members in terms of access to the Pension Protection Fund should the sponsoring employer fail.

The principal differences would be that under a **conditionally indexed scheme**:

- **the level of pension would generally be geared to average career earnings** (already possible under defined benefit legislation), not final salary, but
- **deferred pensions and pensions in payment would be indexed, but with annual increases conditional on the health of a scheme's finances.** In simple terms, this would mean that from time to time, the targeted annual indexation of the pension would be deferred until the scheme returned to financial good health. Typically, the index chosen would reflect price inflation, capped as at present.

Currently, under a final salary or other defined benefit scheme, the law does not allow annual indexation (up to 2½% pa pensions in payment or up to 5% revaluation of deferred pension) to be withheld even if the financial health of the scheme is poor. As a result, and as improvements in longevity stretch schemes' forward liabilities, private sector employers are often expected to find higher and higher contributions. Unsurprisingly, scheme closures follow.

The expectation would be that these new **conditionally indexed schemes**, with no past service deficit and set up under the tough new prudent scheme funding regime, would only occasionally – during difficult financial conditions – need to hold back from annual targeted indexation of pension benefits.

As new schemes, **conditionally indexed schemes** would also be designed from the outset to adjust the normal pension age to reflect changes in longevity, in the same way the Government has with the State scheme, but subject to actuarial checks that the adjustment was justified.

These **conditionally indexed schemes** are likely prove particularly popular with employers who have come to the decision to close their final salary schemes to

future accrual. At present, the only real alternative being considered is the move to defined contribution. This effectively transfers 100% of the investment and longevity risks from the employer so that these risks are 100% placed on scheme members, irrespective of their financial acumen.

Instead, a **conditionally indexed scheme** would offer a new option to employers, which in many cases might better suit the delicate balance between financial control and human resources policies designed to retain and recruit good employees.

Conditionally indexed schemes would also be attractive to the mounting number of employers who are concerned about the volatility in the pension outcome for lower paid employees from their defined contribution schemes.

The 2007 ACA *Pension trends* survey found **76% of firms employing over 250 employees support the wider promotion of these types of risk sharing schemes.** A recent *Pensions Week* survey found similar levels of support for such schemes, with 81% of firms saying changes in the law were needed to promote these schemes.

So what happens if the Government and Parliament doesn't allow the 'conditionally indexed' option?

Some might have us believe that the tweaks to defined benefit regulation so far proposed via the Deregulatory Review of Private Pensions are enough to turn the tide.

There is absolutely no evidence to support this view. Rather, there is a huge amount of evidence showing that the decline in good occupational pension provision is ongoing and extremely serious.

Closure of good defined benefit schemes is particularly affecting millions of private sector employees in their early or mid-career and virtually all new employees.

The evidence to date suggests defined contribution schemes that place 100% investment and longevity risks on members are unlikely to fill the gap.

What certainly will be unsustainable as the years go by will be if good defined benefit pension arrangements are almost solely confined to the public sector.

As taxpayers, private sector employees – already on lower average salaries – will react at some time, certainly if tax rates increase. The contrast between the Parliamentary scheme or civil service schemes, for example, and the average scheme now offered in the private sector does not really bear close examination.

A failure by Parliament to grant an option for private sector employers and employees to help bridge the pension gap with the public sector by sharing pension risks would be un-forgivable. It would represent a further major failure in pension public policy-making.

Doing nothing or not enough will not preserve existing private sector final salary defined benefit schemes – the cost and forward liabilities involved with these schemes (even if the revaluation cap for deferred pensions is reduced) will mean decisions to close will continue, but with these schemes closed off to all but a small minority of older employees.

Yes, there may be some wider pension coverage of employees via defined contribution schemes at some time. But placing 100% of investment and longevity risks on a wider band of lower paid employees will only extend the numbers vulnerable to market volatility.

Certainly, at present, the swing to defined contribution is all too often associated with low participation rates, the widespread use of inappropriate default funds by individual members lacking access to financial advice and contribution rates that will generally deliver inadequate pensions. For many on lower incomes, the level of means-tested benefits in retirement remains a very relevant issue.

Then, at some time, there is the need to buy an annuity, with all of the uncertainties this presents depending on market conditions at the time of retirement.

These are areas Parliament will have to think very carefully about when agreeing the detail of personal accounts in the forthcoming Bill.

Time for Parliament to act positively

Aside from personal accounts, Parliament can signal to Ministers in this period running up to the finalisation of the detail of the proposed *Pensions Bill* that **the Government needs to do much more than tinker with current legislation through deregulatory measures that are unlikely to have anything more than a minor impact.**

Opening up the option for the future for employers to offer good occupational schemes – **conditionally indexed schemes** – that share risks between employers and employees must be of the highest priority.

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The Association of Consulting Actuaries draws its membership from consulting actuaries working in over 80 firms throughout the United Kingdom. The major part of members' work is as advisers to UK schemes with assets exceeding £900 billion. The vast majority of the largest schemes and thousands of smaller schemes are advised by ACA members.

The ACA provides the Secretariat to the All-Party Parliamentary Group on Occupational Pensions.