

2007 Pension trends survey report...1

Views on pension reform: Pension apartheid and levelling-down of scheme contributions poses real threat



Employers fear reforms will mean levelling-down of pensions

pension trends survey: **68%** of employers expect levelling-down, but **72%** call for risk sharing schemes to combat occupational scheme decline

The Association of Consulting Actuaries' (ACA) latest 2007 Pension trends survey was conducted in January and February this year. Over 330 employers, with scheme assets exceeding £127 billion and over 2.1 million members, responded to a wide range of topical pension questions. This first report focuses on employers views on current pension policies, the Pensions Bill and responses to ideas posed by the Pensions White Paper on personal accounts.

The survey results reveal particular disquiet at the direction of public pension policy with respect to how the introduction of personal accounts will impact on existing workplace provision. Whilst a majority of employers believe the State pension reforms being passed into legislation this year will provide a

better platform upon which to build private pensions, there are much greater doubts about the developing shape of personal accounts and policy towards occupational pensions. **A clear majority of employers – 68% – expect the introduction of personal accounts to lead to a levelling-down in pension contributions.** Worse still, three-quarters say the reforms will lead to an increase in the number of closures of existing better workplace schemes.

The survey findings suggest entry into good occupational schemes looks set to be restricted. A pension apartheid is developing with close to a third of employers saying they are likely to restrict occupational scheme entry as a result of the Government's reforms. Looking at smaller

schemes over one-third of employers (36%) say auto-enrolment will lead to them considering abandoning their present occupational scheme in favour of personal accounts and a similar number are likely to reduce existing benefits to mitigate against cost increases.

On occupational reforms, there is support for reducing the cap on revaluing benefits for early leavers and for allowing employers to be able to increase retirement ages for future service benefits. A narrow majority of employers oppose the removal of mandatory indexation of pensions in payment. **Some 72% of employers support the promotion of risk sharing schemes that provide a more stable benefit platform than defined contribution.**

the key findings

pension policies will lead to levelling-down and an increase in scheme closures

68% of employers say personal accounts will lead to a levelling-down in employer contributions with 76% saying closures of better schemes will increase.

government policy in promoting occupational schemes not working

62% of employers say Government policy of promoting occupational pensions is not moving in the correct direction.

support for less regulation, better incentives and more risk sharing schemes

employers say pension policy priorities are less regulation and better financial incentives to encourage pension saving. 72% of employers support the promotion of risk sharing schemes.

personal accounts likely to bring mixed blessings in smaller firms

36% of smaller firms may abandon existing pension schemes and 36% reduce benefits to mitigate the extra costs of personal accounts. Opt out rates of 40% are seen as commonplace.

pensions apartheid: widespread restrictions on better occupational scheme entry expected

31% of employers say they are likely to restrict occupational scheme entry, auto-enrolling the balance of employees into personal accounts. This figure rises to 42% amongst smaller firms.

occupational schemes: the search for practical and acceptable reforms continues

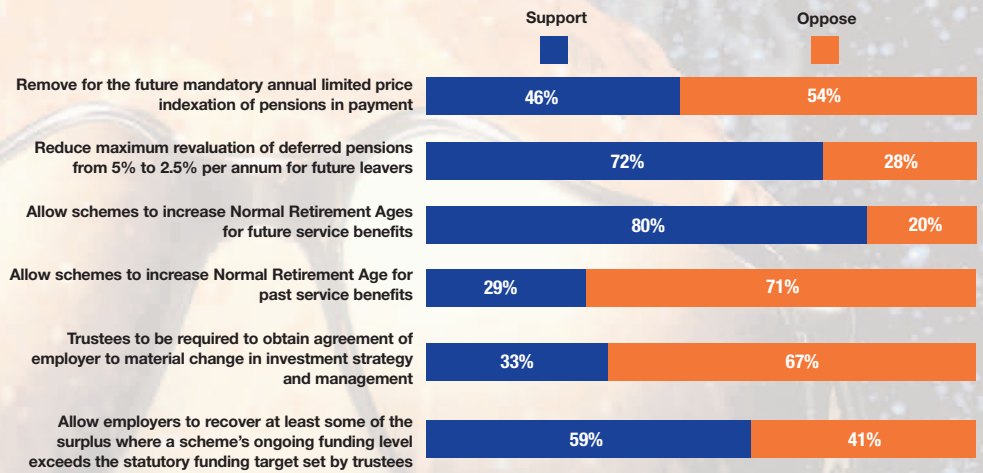
Alongside consultation on the shape of personal accounts, the Government is running a consultation exercise on the deregulation of private pensions. The expectation is that proposals will be refined during the course of this year and will be included in a Bill scheduled for the 2007/08 Parliamentary session that will also include the reforms implementing the new personal accounts regime.

The clear difficulty for Government in reforming existing occupational provision is the starting point. Clawing back guarantees awarded by Parliament to scheme members and allowing flexibility to respond to significant changes in longevity are beset with political difficulties. Employers echo the difficulties involved in reforming occupational pensions from where we start.

A small majority of employers oppose one of the much argued for reforms, to remove future mandatory annual limited price indexation. Again, whilst employers support a reduction in the revaluation cap for deferred pensioners and allowing schemes to increase normal retirement age for future service, seven out of ten oppose allowing schemes to increase retirement age for past service benefits (as allowed for under the State reforms). A majority also oppose a reform whereby trustees would be required to obtain agreement of the employer to material changes in investment strategy and management, even though the existing freedom might increase the risk to the employer in terms of forward liabilities (see Figure 1).

However, a clear majority do support employers being able to recover at least some of the surplus funding in a scheme where the scheme's ongoing funding level exceeds the statutory funding target set by trustees. There is certainly a big concern at present that as a scheme moves into a funding surplus as opposed to a deficit, existing rules are too restrictive in not allowing employers to recover excess surplus after, in many cases, high levels of contributions over a number of years.

Figure 1: A number of proposals have been floated to reduce the financial pressures on existing defined benefit pension schemes. Which of the following proposals do employers support?

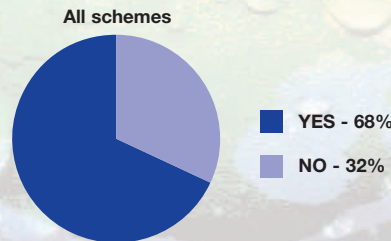


levelling-down...scheme closures

Overall, employers' views on the outcome of the latest pension reforms, and the impact of the introduction of personal accounts, are pretty gloomy.

damage than good. A real pause for thought is needed rather than driving ahead (as with past recent reforms) ignoring the feedback from key stakeholders.

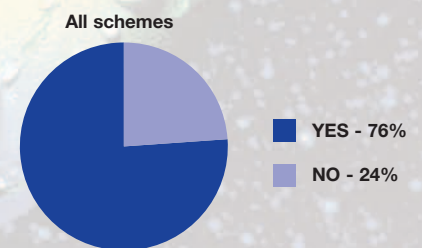
Figure 2: The government's pension reforms will lead to:
A: a general levelling-down of pension contributions per employee by organisations presently offering better pension schemes.



levelling-down and closures: confirming the results of other responses referred to elsewhere in this survey report, some seven out of ten employers expect a general levelling-down of pension contributions per employee by those organisations currently offering better schemes.

Worse still, close to eight out of ten expect the reforms to lead to an acceleration in closures of existing better schemes (see Figure 2). Given the high level of opting out expected, particularly amongst smaller firms (where provision is weakest) the question does have to be posed as to whether the total reform package could do more

B: An increase in the number of closures of existing better schemes



Given the feedback to the survey, it can come as no surprise that a clear majority of employers feel the direction of Government policy in promoting occupational pensions is viewed not be working (see Figure 3).

Figure 3: Overall, is the Government's stated policy of promoting occupational pensions moving in the correct direction?

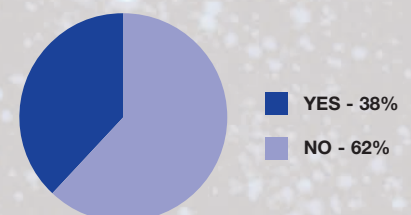


Figure 4: What should the Government's most important pension policy priorities be:

In ranked order:

1.	Reduced regulation/increased simplification
2.	Better financial incentives to encourage pension saving
3.	Remove over-regulation of good quality schemes
4.	Reduced means-testing
5.	Improve Basic State Pension

pension priorities: the pension policy priorities for Government set by employers are unsurprising (see Figure 4 above). Reducing regulation fills two of the three principal slots – justifying the present Deregulatory Review. The problem remains as to whether the necessary level of deregulation can be achieved so that employers believe a material advance has been made within acceptable timescales.

shared risk schemes: one proposal explored by the external reviewers in their consultation paper on the *Deregulatory Review of Private Pensions* is the extension of shared risk schemes, whereby pension risks are shared between employers and employees. These schemes offer the opportunity to bring better cost control for employers over the long term, whilst also providing a more stable platform for retirement income than is offered by defined contribution arrangements. Overall, 72% of employers (up 3% on 2 years ago) support public policy that promotes this type of scheme, with larger employers showing a particular interest (see Figure 5).

Looking to the longer-term, employers see the impact of legislation on benefits and funding costs as the most important issue influencing their pension thinking, followed closely by the adverse impact of the increasing amount of management time taken up by pensions due to greater scheme complexity. The increasing

trend towards defined contribution means that poor annuity returns figure as the third most important longer term issue - one which is clearly moving up the list as more employers switch to defined contribution schemes (see Figure 6).

Figure 6: What issues are most likely to have an influence on pension thinking in the longer term?

In ranked order:

1.	The impact of legislation on benefits and funding costs
2.	Increasing burden on management time due to greater scheme complexity
3.	Poor annuity returns
4.	The increasing public profile of pensions will lead to more costly/complex pension related communications
5.	Performance of investment markets
6.	Further pension reforms introducing, for example, personal accounts
7.	Impact of accountancy requirements
8.	Increasing cost of private pensions
9.	Competition for staff will lead to a need to improve firms' pension arrangements

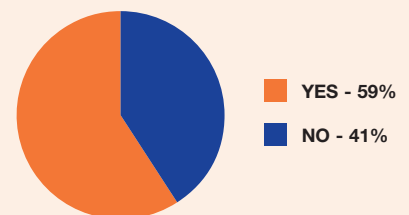
Figure 5: Do you support the transfer of risk to the individual that is inherent in the move to defined contribution pensions or do you feel that public policy should promote a new pension regime that combines better cost control for employers and a more stable benefit platform for employees through risk sharing between employers and employees?



state pension reforms: some positive news for the government

The eventual re-linkage of the Basic State Pension (BSP) to earnings as enacted through the 2006 *Pensions Bill*, is broadly welcomed by six out of ten schemes (see Figure 7). Although concerns remain over the complexity of the State reforms, a higher BSP indexed to earnings has long been sought by respondents to this survey as a firmer base upon which to build private pensions. That said, there is a substantial grouping who do not feel the State reforms will provide the stable platform required.

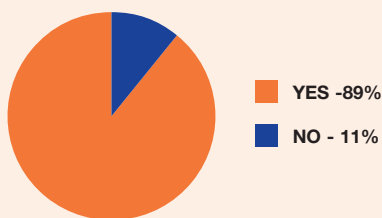
Figure 7: Overall, do you believe that the State pension reforms proposed in the 2006 Pensions Bill will provide a stable State pensions platform upon which private pension savings can be built?



They list two main reasons. First, predictably, there is the continued doubt over the high level of means-testing that will remain. Reports suggest that still around 25-30% of pensioners by 2050 will be in receipt of means-tested benefits over and above their State Pension. This is still judged to be too high a proportion of retired pensioners and, as a result, the disincentive remaining to private saving challenges the long-term viability of the latest State settlement. Set against this, there is another group that questions whether indexation linked to earnings can be afforded over the longer-term as the proportion of pensioners grows. Viability here will really rest on how well the economy continues to grow and on the attitudes of future generations of taxpayers. In reality, the latest State settlement will only persist so long as it is seen as affordable alongside other spending priorities.

The survey asked a number of questions about other State reforms. A large majority of employers favoured the removal of restrictions on existing protected rights funds – funds built up from national insurance rebates in contracted out arrangements – so these would be treated like any other pension rights (see Figure 8).

Figure 8: Contracting-out is due to be abolished for DC schemes. Do you think the restrictions on existing protected rights funds (which have been built up from NI rebates) should be removed so they are treated like any other pension rights?



The Pensions Bill contains measures to allow schemes to convert Guaranteed Minimum Pensions (GMPs) to normal pension rights. 58% of employers think many schemes will take advantage of this option, although – again – a significant minority think the difficulty of so doing will cause many not to do so, probably due to the complex equalisation issues involved.

Over time, the State Second Pension will move to be a flat rate top-up and it can be expected, given the Government's recent track-record, that national insurance rebates to contracted-out defined benefit schemes will be reduced accordingly. 64% of employers said that if this happens, then scheme benefits will be reduced, with the balance predicting that such a decision would lead to more scheme closures.



Employers have felt the heat from increasing pension costs and regulation

auto-enrolment and personal accounts: real threat of pension apartheid, levelling-down and scheme closures

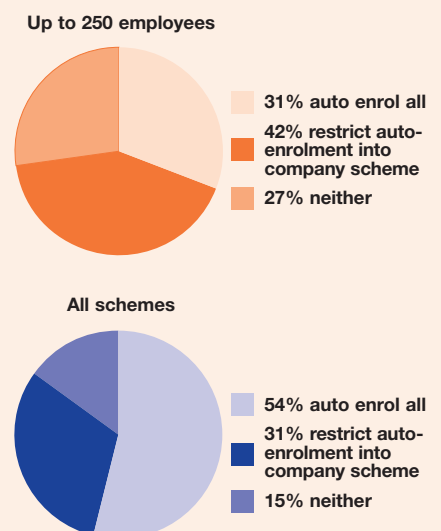
auto-enrolment: one of the 'big ideas' in the Government's pension reforms, egged on by the Pensions Commission, is auto-enrolment of employees into either occupational schemes or personal accounts. On the face of it, this seems a sensible proposal that could extend pension coverage. But, of course, there may well be unintended consequences arising from such a move.

Our survey found that at present just under a fifth of employers operate auto-enrolment into their existing scheme(s), with smaller firms (employing up to 250 employees) showing much lower levels. Here, only 6% presently auto-enrol.

Looking forward, should auto-enrolment be passed into legislation, the results may well be divisive. Overall, just over half of employers expect to auto-enrol all employees into their occupational scheme, although under a third of smaller firms expect to do this (see Figure 9). The likelihood, particularly for those in smaller firms, is that only a minority of employees by status or length of service are likely to be offered auto-enrolment into the occupational scheme. For the rest, personal accounts will be offered. Worse still, auto-enrolment could lead to up to a quarter of schemes reducing benefits to mitigate the costs of extending pension coverage and to a raft of scheme closures,

with as a result many employees being offered only personal accounts. Amongst smaller firms, around a third may consider abandoning their occupational scheme altogether although this falls to 15% across the full scheme universe.

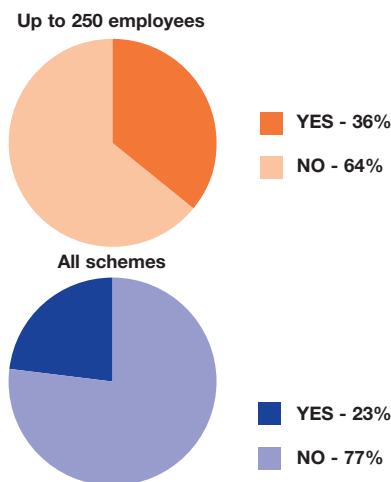
Figure 9: If you do not presently operate auto-enrolment, are you likely to decide to auto-enrol all eligible employees into your scheme from 2012 or are you likely to continue to restrict entry into the scheme, introducing auto-enrolment into personal accounts for those not offered the occupational scheme?



These results highlight a very real danger of levelling-down in occupational provision, beyond that which has already occurred (see box 'Government figures underscore pension decline').

The real problem for Government and society as a whole is that whilst the best of intentions lie behind auto-enrolment, in terms of extending pension provision, the reality may be that this move will lead to a new 'pension apartheid'. This apartheid to some extent has already occurred between employees in the public and private sector as the number of open defined benefit schemes in the private sector has declined. Auto-enrolment may build on this separation between the 'haves' and the 'have nots', as existing schemes are closed and employees are divided up between 'good' occupational schemes and lower-cost personal accounts (see Figures 10 and 11).

Figure 10: If you decide to operate auto-enrolment into your scheme, are you likely to revise the benefits offered to reduce costs?



Government figures underscore pension decline

Membership of employer-sponsored defined benefit pension schemes fell from 39% to 35% of employees between 2004 and 2005. In 1997, the figure was 46%, a reduction of 11% in well under 10 years.

Whilst membership of defined contribution schemes has increased from 10% to 15% of the working population between 1997 and 2005, driven by increases in membership of GPPs and stakeholder pensions, membership of occupational money purchase schemes over the period actually fell from 9% to 7%.

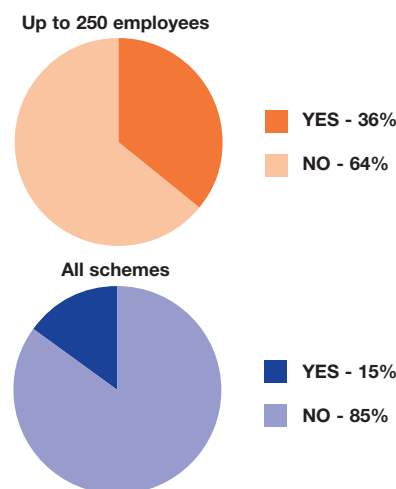
Overall, in 2004/05 only 39% of the working age population were members of either an occupational or personal pension, down from 40% the year before.

(Source: Office of National Statistics, Pension Trends, 5 December 2006)



Many smaller businesses will abandon existing schemes and reduce benefits to mitigate the extra costs of personal accounts

Figure 11: Will auto-enrolment into a pension scheme (occupational or the personal accounts regime) lead you to consider abandoning your present occupational pension scheme(s) in favour of personal accounts for all employees?



The survey suggests auto-enrolment may lead to an increase in pension coverage. Opt outs (those positively opting out having been auto-enrolled) from, respectively, occupational schemes and personal accounts are expected to be between 20% to 25%, with this rising to between 30% to 40% in smaller firms. These levels of opt out are much higher than for current schemes using auto-enrolment. Indeed, they are much closer to the level of participation where opting in is exercised. At present, where there are occupational schemes, membership levels are on average around 60% where there

is no automatic enrolment and 90% where there is, but of course occupational provision presently covers only a minority of businesses (source: Government Actuary's Report, *Occupational Pension Schemes 2005*).

scheme exemptions: under the personal accounts White Paper, organisations offering a defined benefit scheme will be exempt from offering personal accounts where employers auto-enrol all employees aged 22 or over into either a contracted out occupational scheme that passes the Reference Scheme Test or a contracted in scheme offering a minimum accrual of 1/120ths. Virtually all employers – 97% – support this exemption.

However, there is a lower level of support for the proposed exemption for businesses offering better or equivalent (to personal accounts) defined contribution schemes. The test here requires employers to match the employer's contribution into personal accounts, but would allow employees to opt for a lower level of contributions than with personal accounts. Whilst this may represent an attempt to halt closures of existing defined contribution schemes, it raises the likelihood of many employees under-saving for retirement and merely replacing some or all of the means-tested State benefits that they might otherwise be eligible to receive (see Figure 12 on page 6). This exemption must also raise issues of mis-selling if contributions are at a very low level.

Figure 12: Organisations offering DC schemes: the exemption test for defined contribution schemes (with 8% as the total default contribution) would require auto-enrolment of all employees aged 22 or over, that the scheme offers a default investment option and that it allows an employee to actively opt for a lower contribution than 4% of earnings, provided the employer contribution is not below 3%. Do you agree with this proposal?



waiting periods: the Personal accounts White Paper posed a number of options on waiting periods that occupational schemes might be allowed before auto-enrolling employees into their schemes. These waiting periods have the potential to save on administration by reducing the number of short-stayers who are signed up only to leave employment within a matter of weeks or months. The survey found the most popular option was that there should be a 3 month waiting period before auto-enrolling (see Figure 13).

Figure 13: The personal accounts White Paper says there will be further consultations as to whether exempt schemes should be allowed to have a three or six month 'waiting period' before employees (aged 22 or over) join the occupational scheme. Which of the following do you support?

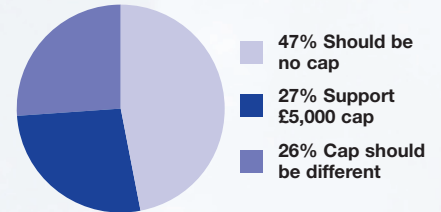
In ranked order

1.	3 month waiting period
2.	6 month waiting period
3.	No waiting period

phasing in changes: the Personal accounts White Paper proposes that phasing in changes required of exempt schemes should be over 3 years, mirroring the phasing in of personal accounts over this period. Amongst larger employers there is a 50:50 split between those favouring phasing in minimum contribution requirements (i.e. gradually increasing contributions up to the default levels) as against phasing by target groups (e.g. offering the scheme first to new entrants and at a later date to those not offered access before and then, later still, extending to those who have actively rejected membership before). Amongst smaller firms, some two-thirds favour phasing by contribution.

contribution caps: perhaps one of the more surprising results is employers' attitudes towards the cap on pension contributions into personal accounts and transfers of funds in and out of personal accounts. Here, respondents reveal a de-regulatory leaning, dismissing the ideas voiced by many that a high or no cap on contributions might further undermine current occupational arrangements. Almost a half of the respondents favoured no cap at all and a further quarter supported the White Paper proposal of £5,000 per annum. A quarter supported a different level of cap – some higher than £5,000 linking the level to tax rules, whereas others supported the lower £3,000 level proposed by the Pensions Commission (see Figure 14). Over eight out of ten employers felt personal accounts should be able to accept and pay transfers to other arrangements.

Figure 14: The White Paper proposes that to protect existing schemes there should be a cap on personal account contributions of £5,000 pa (up from £3,000 recommended by the Pensions Commission) and that certainly until 2020 there should be no transfers in (from other schemes) or transfers out (to other schemes) from personal accounts. What is your view?



Reflecting again their deregulatory bent, two-thirds of employers responding to the survey felt there should be no requirement for regulated investment advice provided personal account contributions fall within a £5,000 annual cap, but 40% favoured advice being a requirement where contributions exceed 10% of earnings.

This is the first report in a series on the results of the ACA 2007 Pension trends survey. The second report covering scheme design changes and trends in provision will be published shortly.