ACA EVIDENCE TO THE 2007 PENSIONS BILL COMMITTEE

Summary

The amendment to the Bill that the ACA is proposing would remove the current ban on new conditionally indexed pension schemes

1. Since 1997 all defined benefit pension schemes have been required by statute to index pensions in payment (at present subject to a cap each year of 2.5%). They have since 1986 also been required to index or revalue deferred members' benefits, again subject to a cap (presently 5% per annum, with the *Pensions Bill* proposing to reduce this cap to 2.5% per annum for future service pension). Indexation is mandatory and is not conditional on the financial health of the scheme.

2. During the consultation process ahead of the Bill, as part of the Deregulatory Review of Private Pensions, it became clear that the active promotion of risk sharing schemes was seen by many organisations as an initiative that could help good occupational pension provision to flourish into the future. This was recognised by both the External Reviewers and by the DWP in its responses to the Reviewers' report (22 October 2007) and then to final consultations (5 December 2007) in a paper published alongside the Bill.

3. That DWP 5 December paper (*Deregulatory review: Response to consultations*) noted:

   "an emerging view from a number of employer-related organisations that one particular proposal would make a radical difference to risk sharing possibilities: conditional indexation. Indexation would be targeted, and employers would be required to fund prudently with the intention of providing indexation. However, the provision would be conditional on the actual level of funding in the scheme. In the event of a deficit in any given year, schemes would be able to forego indexation for that year. If there was a funding surplus in following years, the first call should be upon restoring lost indexation rights. Some suggested that this approach should be ring-fenced and only applied to new, risk sharing schemes, however defined, others argued that this approach should be opened up to all existing schemes." (page 8, paragraph 1.3.1)[1]

4. The same paper indicated that whilst the Government was not to date convinced by the proponents of conditional indexation, a commitment was given 'to work with stakeholders to explore urgently the potential and practical implications' (page 9)[2]. **We have addressed the Government's concerns at a meeting with senior officials from the DWP and Government Actuary's Department.**

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[1] Deregulatory review: Response to consultation (5 December 2007),published by the DWP. ISBN 978-1-84763-189-3

[2] Ibid

5. ACA understands the attraction of allowing conditional indexation within existing defined benefit schemes in respect of future pension accruals, but is concerned about

    - dangers in communication (e.g. members not understanding that part of their pension has mandatory indexation and part has conditional indexation)
    - conditional indexation in final salary schemes making sense only in respect of pensions in payment. In terms of risk sharing, this could not be regarded as being anywhere near a 'middle way'; rather it would be seen as tinkering at the edge and hence unlikely to change the minds of those employers bent on closing their final salary scheme. It also means that any pain is borne by current pensioners, traditionally seen as the group requiring most protection, rather than spread over all members,
    - the practical complexities of operating conditional and mandatory indexation within the one scheme unless there is full ‘ ring fencing’ .of the assets backing conditionally index benefits.

6. **ACA believes conditional indexation should apply only to new risk sharing schemes**, which would be governed by existing defined benefit legislation subject to minor amendments to be included in this Bill, so that

    - employees would understand that they were joining a risk sharing scheme (i.e. there would be no potential confusion between different conditions applying to past and future pension under the same scheme)
    - there would be sufficient risk sharing to make the scheme attractive to medium to large employers (as explained in paragraphs 36 to 46 below).

No forms of risk sharing have currently been taken up in any volume because of the restrictions and uncertainties in present legislation. Also some of the offerings are too close to pure defined benefit or pure defined contribution and as such have proved unattractive to employers. With a few simple legislative changes, conditionally indexed schemes offer a genuine ‘middle way’, with a proven track-record of success in The Netherlands. The proposal has also been supported by many of the actuarial consulting firms advising medium to large employers and a wide range of other pension and industry bodies have welcomed the initiative.

It is illogical with the improved infrastructure governing occupational pensions in the private sector – new scheme specific funding, the Pensions Regulator and the Pension Protection Fund – that conditionally indexed pension schemes are banned by current legislation.

Therefore the principal amendment the ACA is seeking to the *Pensions Bill* is that Part 2 should be amended by adding provisions to end the ban on employers being able to offer new conditionally indexed pension schemes.

Background to the amendment

7. Private sector employers are continuing to decommission the defined benefit pension schemes which have historically provided comfort and security in retirement for millions of pensioners. For most sponsors these schemes have become too costly to run and the potential forward liabilities too large and uncertain to fully underwrite. The general outcome, employers changing to defined contribution schemes, means millions more private sector employees in mid-career, those who change jobs and virtually all new employees now having to grapple with much greater uncertainty over the level of their prospective pensions.

8. The ACA supports the main deregulatory change that the Government has proposed in the *Pensions Bill* to date in Part 2 of the Bill, reducing the cap on revaluing deferred rights.

9. The reduction in the deferred pension revaluation cap will have some impact on costs and so will give some additional incentive to employers to retain existing defined benefit and shared risk schemes, or to establish new ones.

About the Association of Consulting Actuaries (ACA)

10. Members of the ACA provide advice in relation to virtually all of the large defined benefit pension schemes in the UK and many of the smaller schemes. Members of the Association are all qualified actuaries and are subject to the code of professional conduct of the Faculty and the Institute of Actuaries. The ACA's 1700 members are based at over 80 firms offering consulting actuarial services.

    The ACA is the representative body for consulting actuaries, whilst the Faculty and Institute of Actuaries are the professional bodies. The ACA is the largest national body of consulting actuaries in the world.

    The ACA has also provided the Secretariat to the All-Party Parliamentary Group on Occupational Pensions since its formation in 1992.

Pensions Bill needs to do more

11. More fundamental changes are needed than are contained within the present Bill to reverse the switch away from private sector defined benefit schemes.

12. Virtually all actuarial consulting firms the ACA canvassed in early November 2007 said:

    - the deregulatory proposals to date are insufficient to encourage the continuing provision of high quality pensions.
    - more freedom is needed in benefit design of occupational schemes than is possible under current legislation.

Decline of private sector defined benefit schemes has been under-estimated

13. Urgent and convincing reform measures beyond those presently in the *Pensions Bill* need to be implemented ahead of the 2012 introduction of personal accounts; otherwise little defined benefit private sector provision will be left open, certainly to younger and mid-career employees.

14. Aside from the public sector, where more employees each year (presently over 5 million) are protected by defined benefit 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. .

15. In 1995 there were 5 million employees of private sector firms in open defined benefit schemes. By 2004, the number was down to 2 million. **The ACA's latest figures – collected in November 2007 – show this figure is now down to around 900,000**.

16. 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 better occupational pension schemes.

17. The Government's Deregulatory Review of Private Pensions was intended to identify means by which good existing occupational pensions could be encouraged by way of deregulatory measures. Unfortunately, the results to date of the review are not likely to be significant enough to meet the initial objective.

The scale of the problem…

18. The ACA survey[3] of employers conducted earlier this year and in November of actuarial consulting firms confirmed **fewer than 20% of defined benefit schemes are now open to new entrants**.

19. The next phase – closure of future pension accruals for existing members (which is already underway, **with now around 20% closed to future accrual**, up from 14% earlier this year[4]) – has started as employers look to close off the unacceptable costs and forward risks associated with defined benefit provision under current UK legislation.

20. 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 100% of the longevity and investment risks. And, of course, under defined contribution there is no mandatory indexation requirement.

21. A few employers have steered their way around current defined benefit legislation to design hybrid defined benefit / defined contribution schemes. For some types of risk sharing design, however, a view has to be taken about the interpretation of present legislation. Some employers, understandably, have not been prepared to take the risk of finding themselves in Court about some uncertain aspect in the future. In other cases, particularly where the design is not that far off defined contribution in the risk spectrum, employers have not felt the cost of the associated infrastructure has merited the small benefit to employees.

22. What is also starkly clear is that many employees do not want to take on 100% of the investment and longevity risks associated with their pension and many are ill-equipped so to do. This is particularly the case for those in lower income groups, but by no means exclusively so, where the volatility of outcomes associated with defined contribution arrangements is a major concern.

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[3] *2007 ACA Pension trends survey*, conducted in February 2007, covering 336 schemes with 2.1 million members and total scheme assets of £127 billion.

[4] Ibid

23. Only 44% of employers now offer any kind of pension scheme, down an alarming 8% on the picture just 2 years before (source: DWP 2007 Employers' Pension Provision Survey).

24. There is also increasing evidence of closures of trust-based defined contribution schemes as employers opt for more lightly regulated contract-based arrangements.

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

A better way: new conditionally indexed schemes

26. Personal accounts from 2012 will offer lower to middle income employees the opportunity to build a modest pension over the longer-term over and above State pensions. However, Government has stated on numerous occasions that **personal accounts are targeted with the intention that they <u>do not</u> deter employers from offering better pension arrangements now and into the future**.

27. It cannot be right that if an employer now wishes to offer better pension arrangements they often have to find ways around present defined benefit legislation that has become inappropriate to meet current circumstances. This is why the ACA considers that Parliament must act to allow employers greater genuine choice in what they can offer employees.

28. The ACA has already put to Government 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**.

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

30. The ACA has not proposed extending the option for conditional indexation to apply for future accrual to all existing defined benefit schemes for the reasons given in paragraph 5.

31. **The proposal from the ACA applies only to new conditionally indexed schemes started as a result of new legislation passed in the *2008 Pensions Act*.**

32. **Conditionally indexed schemes** are the prevalent type of scheme in The Netherlands, where career average defined benefit provision remains robust and the overwhelmingly dominant form of pension provision.

33. For employers, new **conditionally indexed schemes** would enable costs to be capped reasonably into the future, despite changes in longevity and financial markets. Also, such schemes would result in lower PPF levies and s75 debts than present defined benefit schemes with mandatory indexation.

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

35. 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?

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

37. 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 PPF should the sponsoring employer fail.

38. **Conditionally indexed schemes** would be able to seek qualifying scheme status discharging their personal accounts obligations under clauses 2 and 18 to 24 of the *Pensions Bill*.

39. The principal differences from current final salary defined benefit schemes would be that under a **conditionally indexed scheme**:

    - **the level of pension would be based on average career earnings** (already possible under defined benefit legislation), not final salary; and

    - **deferred pensions and pensions in payment would be indexed, but with annual increases conditional on the health of a scheme's finances**. Typically, the index chosen would reflect price inflation, capped as at present at 2.5% per annum. These schemes – because they would fall under the existing defined benefit regime – would be required to follow the tough new scheme funding requirements. Future pension increases would be backed by prudent funding reserves. There should be no moral hazard issues as trustees and employer have to agree on the reserving basis, calling upon the Pensions Regulator in the unlikely event of disagreement.. Employers would be unable to take a contribution holiday or a refund of any 'surplus unless benefits were first fully indexed., again reducing moral hazard

40. 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 safeguards (e.g. applicable only to members more than 10 years from normal pension age) and to actuarial confirmation that the adjustment was justified.

41. **Conditionally indexed schemes** would be trust-based schemes involving employee nominated trustees in line with current legislation. This governance regime allows for members' interests to be protected by trustees who would be able to utilise the expertise of professionals in the investment and administration of these schemes.

42. Importantly, **conditionally indexed schemes** offer the prospect of higher investment returns over the long term, and therefore lower costs or higher benefits, due to fewer constraints on investment strategy.

43. These **conditionally indexed schemes** are likely to prove particularly popular with employers who have come to the decision to close their final salary schemes to future accrual. The only real alternative now being considered (often reluctantly) is the move to defined contribution with all the disadvantages for employees. .

44. 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.

45. **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.

46. The *2007* ACA *Pension trends* survey[5] found **76% of firms employing over 250 employees support the wider promotion of risk sharing schemes**.

So what happens if the Government and Parliament does not allow the new 'conditionally indexed' option?

47. 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.

48. **There is absolutely no evidence to support this view**. Rather, there is a huge amount of evidence showing that the decline in private sector defined benefit pension provision is ongoing and extremely serious.

49. **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**.

50. The contrast between the Parliamentary scheme or civil service schemes, for example, and the average scheme now offered in the private sector is alarming. Personal accounts will not change this situation of disparity. The sustainability of the forward pension settlement is therefore under serious threat.

51. Doing only that which is in the *Pensions Bill* as it stands will not preserve existing private sector defined benefit schemes – the cost and forward liabilities involved with these schemes (even with the revaluation cap for deferred pensions reduced) will mean decisions to close will continue, but with these schemes closed off to all but a very small minority of older employees and with employers having few attractive options to offer in new scheme design.

Now is the time for Government and Parliament to act before it's too late.

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2 January 2008

[5] *2007 ACA Pension trends* survey, conducted in February 2007, covering 336 schemes with 2.1 million members and total scheme assets of £127 billion.