

LORDS' PENSIONS BILL BRIEFING

Produced by the Association of Consulting Actuaries

The latest ONS survey shows a 10% fall in employee membership of defined benefit schemes in one year ... fewer than a million employees now in open schemes ... one-third of private sector pension schemes open to new joiners last year were closed in last 12 months ... survey finds 91% of financial advisers expect complete closure of private sector final salary schemes to future benefits by 2012

Pensions Bill: last chance to save quality private sector pensions through conditional indexation amendment

23 October 2008: The *Pensions Bill* continues its Report Stage in the Lords on 27 October. This presents the last chance for Peers to amend the legislation to allow employers to set up new conditionally indexed pension schemes that offer a pension arrangement that not only will attract and retain employees, but that also caps employers' costs into the future. Most existing private sector defined benefit pension schemes have closed with many more on the verge, with signs that a final acceleration in closures is about to occur. The conditional indexation amendment is a first-step in urgent reform that will provide employers with greater freedom to offer a quality pension scheme for their employees that is presently banned under overly restrictive UK legislation.

Tide of events moving quickly: legislators must respond

There is now mounting evidence that, unless private sector employers are offered new pension design freedoms at a very early stage, the flight from any form of quality provision other than where this is available under defined contribution is accelerating¹. Significantly:

- The latest ONS survey², published this month, shows only 2.7 million private sector employees (down 10% in a year) are now members of defined benefit schemes (although 5.2 million public sector employees enjoy such schemes). An ACA survey in 2007 found fewer than 900,000 private sector employees are in schemes open to new members.
- Within the past few weeks, a survey by Aon shows that more than one-third of private sector pension schemes, which were open to new joiners a year ago, have now closed. This is supported by the ACA's own findings - our biennial survey of pension trends for smaller employers³ - covering employers with fewer than 250 employees - indicates that 91% of these employers have closed defined benefit plans to new entrants and 48% have additionally closed them to future benefit accrual.
- A Scottish Life poll of financial advisers this month has found 91% of respondents expect the complete closure of private sector final salary schemes to future benefits by 2012.

Where defined benefit schemes are closed, employees inevitably end up in defined contribution plans since there are currently no realistic or legal risk sharing options that employers are prepared to offer.

Whilst defined contribution schemes can provide good pension benefits, particularly where employer and employee contributions equate to 15% of earnings or more over a lifetime, the lower paid may not be well placed to deal with the volatility of pension outcomes often associated with such schemes. Certainly, there is no superiority in terms of pension outcomes that can be assigned to defined contribution schemes that would suggest they should become the dominant design.

¹ Most recently, see *Does the exodus signify genesis* published by PricewaterhouseCoopers, June 2008 and *Pension plan design survey*, published by Watson Wyatt, July 2008 and Aon 2008 Employer survey, August 2008.

² ONS 2007 *Occupational Pension Schemes Annual Report* published September 2008

³ ACA 2008 *Smaller Firms Pension Survey* published in September 2008.

Indeed, the DWP's own research has found that over two-thirds of individuals feel that a private pension linked to the Stock Market is 'too much of a risk'. Exposing an increasing proportion of private sector employees to 100% of pension investment and longevity risks via defined contribution is therefore suspect, at best⁴. As each month goes by, this risk transfer to employees who are often ill-equipped to cope with the financial decisions involved is taking place, with private sector employers feeling they have little option but to move into defined contribution as they feel they can no longer justify the forward liabilities and risks associated with existing defined benefit legislation.

The legislative amendment for one form of risk sharing – enabling sponsors to offer a conditional indexation scheme – have been worked on for over two years by both the ACA and the Association of Pension Lawyers, in discussion with senior officials at the DWP. These amendments are ready for introduction into the Bill in its final stages in October 2008 – the DWP has had ample time to make any amendments that they feel are needed to the proposal.

But do employers want risk sharing schemes?

During the Commons Committee stage of the Bill, the Pensions Minister, Mike O'Brien MP, in opposing the conditional indexation amendment, conceded a consultation on risk sharing schemes in general, which closed on 28 August 2008. That same day, the DWP issued the results of a survey⁵ of 30 employers (yes, just 30) which suggested little employer enthusiasm for risk sharing. However those conducting the survey found (to quote), 'most employers were either not aware at all or their awareness was limited to the concept of risk sharing only'. Only around half (15 employers) were able to comment either way on the two models of risk sharing outlined in the consultation paper.

The research did note, however, that risk sharing is most likely to be considered as employers move from defined benefit (exactly the current situation and hence the need for legislation now) and (to quote) 'it was accepted that employees would almost certainly prefer to move to a risk sharing approach rather than to a defined contribution scheme'.

The reality is that until such time that employers can choose to open a conditionally indexed scheme (or any other type of new risk sharing model) they, and their advisers, will not consider such options in detail as they are banned from such options at present.

The overall approach of greater freedom in pension design was recently endorsed by Richard Lambert, CBI Director-General, who said, in a speech bemoaning the shortening lifespan of private sector defined benefit pensions:

"Give companies the freedom to design schemes that work and then leave them alone, so long as the funding and covenant is there to meet pensions, and scheme members understand what is on offer."⁶

In the UK, existing private sector DB schemes are largely final salary based (although 80% are now closed to new entrants) and must offer mandatory indexation of benefits. Mandatory indexation of pensions both before and after retirement in defined benefit schemes is unique to the UK. No other Parliament in the world has placed such an onerous obligation on private sector firms to take on an open-ended commitment in terms of the costs and liabilities involved.

⁴ *Attitudes to Pensions: The 2006 survey, published by DWP, pages 5-7*

⁵ *Employer attitudes to risk sharing in pension schemes, DWP Research Paper No.528, published August 2008*

⁶ *Defined benefit pension costs, speech by CBI Director-General, Richard Lambert, 30 July 2008.*

Why 'freeing up' pension design cannot wait

The detail of how conditional indexation schemes would work is, in reality, far more advanced than the detail of some aspects of personal accounts where, for example, the administration of collecting contributions and the charging basis are still very uncertain. However, the implementation of personal accounts legislation is not being delayed even though consultations continue on key aspects of the Bill. The conditional indexation amendment should therefore find its way into the Bill before it is finalised.

Importantly, under the amendment to the Bill:

- Conditional indexation would not apply to the benefits offered by existing types of defined benefit schemes – for simplicity, the amendment only applies to new conditionally indexed arrangements set up after the Bill becomes an Act. Extending conditional indexation to existing schemes is more complex, but needs to be considered in the next wave of reforms to extend pension design freedoms.
- The amendment in no way stands in the way of existing types of risk sharing arrangements (although the reality is that very few have been taken up by employers due to the complexity and limitations of current legislation and the communication issues involved).
- The amendment does not stand in the way of other possible types of risk sharing arrangements that might be forthcoming from the risk sharing consultation, which are not ready for this Bill, but which should be included in next year's legislative programme.

What do conditionally indexed schemes offer?

For those many mid-sized and larger employers prepared to share risks with employees⁷, conditionally indexed schemes offer a pension arrangement that not only will attract and retain employees, but that also caps employers' costs into the future.

Conditionally indexed schemes provide employees with a far less volatile pension benefit than defined contribution schemes. Key features are:

- Pensions are based on career average earnings and pensionable service.
- Future pension increases are pre-funded, but are conditional on the level of scheme funding.
- Save on occasions when the scheme funding falls below 100% (the 'condition'), pension benefits would be indexed in line with a scheme specific index, typically price inflation up to a 2.5% cap per annum.
- Restoring any indexed increases not granted would be the first priority when the scheme funding level rises above 100%.
- Employer contribution rates would normally remain stable whether the scheme funding level is below or above 100%.
- Funding would be based, as with existing defined benefit schemes, on the new prudent funding standards set by the Pensions Regulator, who would regulate such schemes.
- The schemes would be subject to a PPF levy securing further protection for members (but with lower levies based on the lower risk profile of such schemes).
- These are trustee-run schemes offering the prospect of higher investment returns over the longer term, and hence a lower expected cost of each £1 per annum of pension than in a defined contribution arrangement, due to fewer constraints on investment strategy.

A full description of how conditional indexation schemes work is contained in the ACA's Written Evidence to the Commons Bill Committee. Advice on the legal aspects has been given by the Association of Pension Lawyers.

⁷ ACA surveys in 2006 and 2007 have found over 70% of employers support risk sharing being promoted by legislation.

It's time to act

Conditionally indexed schemes are the first important step in re-invigorating quality private sector pensions in the UK – the only new form of risk sharing pension design that is ready to implement NOW by way of modest changes to existing legislation.

Removing the ban on employers offering conditionally indexed pension schemes needs to be included in this year's *Pensions Bill* so those many private sector employers about to close their final salary schemes have a new attractive pension design option.

THE FUTURE PENSION PROSPECTS OF 2.7 MILLION EMPLOYEES IN THE PRIVATE SECTOR ARE AT RISK. Conditional indexation will enable employers to cap their pension costs whilst offering their employees a more stable benefit platform than defined contribution.

Personal accounts and the minor deregulatory measures in the Bill to date are not nearly enough to encourage ongoing quality private sector workplace pensions. And, importantly, private sector employees cannot be in a position where their pensions are hugely inferior to public sector employees. Conditionally indexed schemes could help close this gap and overcome what will otherwise become a major political problem in the period ahead.

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