



NEWS RELEASE

EMBARGO ON PUBLICATION UNTIL: 29 MARCH 2007

Shared risk pension schemes will enable employers to offer less volatile pensions, whilst also controlling their long-term costs...

ACA SAYS GOVERNMENT CAN RE-ENERGISE WORKPLACE PENSIONS BY BACKING NEW SHARED RISK SCHEMES REFORM

26 March 2007: Workplace pension schemes in the UK can be re-energised by a radical extension of the ways in which risk can be shared between employers and employees, says the Association of Consulting Actuaries (ACA). Members of new *shared risk* schemes would benefit from pensions that are less volatile than money purchase arrangements, whilst employers will be able to control costs in a way they cannot with final salary schemes, the majority of which are now closed to new entrants and increasingly to future accruals.

The ACA has put to Government, as part of its Deregulatory Review of Private Pensions, how new *shared risk* schemes could work to fill the gap being left as final salary schemes close to new entrants and future accrual. The ACA says that it is vital such schemes are encouraged by legislative reforms in the 2007/08 session of Parliament, in advance of the introduction of personal accounts, which may otherwise cause a general 'levelling down' of provision.

"Many employers can no longer take on the forward financial liabilities associated with final salary schemes. Equally, the usual alternative – money purchase – presents members with an unknown and potentially volatile amount of pension," commented ACA Chairman, Ian Farr.

"The answer for many employers and members is *shared risk* schemes. By their design, these will enable employers to control costs into the future even if there are down swings in investment returns and continued improvements in mortality. For members, the advantages will flow from a more stable benefit platform than money purchase provides and regular indexation of benefits supported by the new prudent funding regime."

Under current legislation, occupational pension schemes are classified either as defined benefit (usually final salary based), under which normally all of the investment and longevity risks are taken by the employer, or as money purchase/defined contribution, where all the risks are borne by the employees.

Those few existing occupational pension schemes which have been designed to share risks between employer and employee have had their risk sharing ability restricted as they have been classified as defined benefit schemes.

The House of Commons Work & Pensions Committee recommended last year that “the Government considers whether more needs to be done to create an overall level playing field in which risk-sharing schemes, as well as DC and DB schemes, can all develop to their full potential...”¹. And the recent consultative paper from the external reviewers (Chris Lewin and Ed Sweeney) to the Deregulatory Review of Private Pensions added, “we are interested in exploring ways in which the regulatory environment might be shaped to encourage risk sharing, because if present trends continue, employees may bear all of the risk. We are attracted to a system under which the employer’s legal obligations properly match the promise made”².

The new category of *shared risk* schemes proposed by the ACA would allow creative new benefit designs and would sit between the existing categories of defined benefit and money purchase schemes.

For those employers who are still providing final salary or other defined benefit schemes and who wish to review their existing arrangements, a new *shared risk* scheme for future service benefits would enable the employer to continue to take some of the risks rather than leaving them all to be taken by the employees, if instead a money purchase scheme was to be put in place.

For those employers who have already replaced their final salary scheme with a money purchase scheme, the possibility of a new *shared risk* scheme would allow the employer to take some of the risks presently placed on employees rather than leaving them completely exposed to money purchase volatility.

Pensions under a *shared risk* scheme would be based on the member's average pensionable earnings during the period of scheme membership rather than the member's pensionable earnings

¹ Fourth Report of Session 2005-06, House of Commons Work and Pensions Committee, on *Pensions Reform*, page 50, published 22 July 2006.

² *Deregulatory Review of Private Pensions: A consultation paper* by Chris Lewin and Ed Sweeney, page 8, published March 2007.

at retirement (as is the case in a final salary scheme). The pension earned for each year of service would be re-valued from that year to the date of retirement and increased when in payment (up to the 2.5% pa indexation cap in current legislation).

Each year's pension would be a defined benefit, but future annual revaluations to that pension to the date of retirement and future annual increases when in payment would be **targeted**, supported by a funding reserve based on prudent actuarial assumptions under the new scheme specific funding regime. As each year passes, the year's revaluation and pension increase would then automatically become a defined benefit subject to the funding position of the scheme not showing a past service funding shortfall at that time.

New *shared risk* schemes would include those types of cash balance plan, where the retirement benefit is defined as a capital sum at normal pension age and then converted into pension at that time, provided they met the relevant criteria.

The ACA says *shared risk* scheme members should be protected from pension losses by the Pension Protection Fund, but with lower levies on employers reflecting the lower risk associated with such schemes.

See *Note for Editors* for a summary of the advantages for employers and members of *shared risk* schemes (page 4 of release).

“There is a once-in-a-generation opportunity for Government to re-energise the provision of employer sponsored occupational pension schemes in the UK by providing a new 'third way'. New *shared risk* schemes would sit comfortably between the existing defined benefit and defined contribution types of scheme,” commented Ian Farr.

A paper on *Shared Risk* schemes and a *Questions & Answers* briefing are available on the ACA website at www.aca.org.uk

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Notes for Editors

What would be the key attractions of a shared risk scheme for employers and employees?

For employers and employees: an employer could expect to provide a pension similar to a defined benefit pension based on a member's average pensionable earnings revalued to retirement and increased in payment in line with price inflation (subject to the statutory 2½% annual cap) but for a stable contribution rate into the future.

For employers: unlike an existing defined benefit scheme, however, there would be under the rules of *shared risk* schemes the flexibility for the employer to:

- not grant a year's revaluation or pension increase if a past service funding shortfall emerged (but in practice, over the long term, past service funding surpluses, emerging because of the new scheme specific funding requirements, would be expected to finance reinstatements)
- reduce the rate of future service pension accrual
- increase normal pension age for active and deferred members subject to sufficient evidence of increasing life expectancy and to certain protections for scheme members
- wind up the scheme without providing full future revaluation and full future increases to pensions in payment (although the expectation would be that, over the long term, sufficient past service funding surplus would have been built up to secure most of the potential future revaluations and pension increases).

In practice, many employers may mitigate the above effects by making modest additional contributions.

For employees: importantly, because of the mechanisms for the sharing of risks between the employer and scheme members and by way of the modest pooling of risks amongst scheme members, the benefits provided by a shared risk scheme should form a much more stable platform for income in retirement than would be achieved by the same contributions paid to a defined contribution arrangement.

The **Association of Pension Lawyers (APL)** has provided input to the ACA on the main legislative changes, which are surprisingly few, required to facilitate *shared risk* schemes.

About the Association of Consulting Actuaries (ACA)

The **Association of Consulting Actuaries (ACA)** is the representative body for consulting actuaries, whilst the Faculty and Institute of Actuaries are the professional bodies. The ACA has over 1500 members working in around 80 firms. ACA Members are all qualified actuaries and are subject to the code of professional conduct of the Faculty and the Institute of Actuaries. Advice given to clients is independent and impartial. The ACA forms the largest national grouping of consulting actuaries in Europe.