



The ACA proposes promotion of risk-sharing schemes to protect individuals as an alternative to the investment risk inherent in the Pensions Commission's NPSS recommendation...

Actuaries believe good employers will want to do better than Lord Turner's NPSS, and call for forthcoming Pensions White Paper to give genuine boost to risk-sharing schemes

14 February 2006: The Association of Consulting Actuaries (ACA) says the Pensions Commission's NPSS proposals carry too much investment risk for employees, particularly the lower-paid, and has urged the Government to encourage new risk-sharing models as well as better supporting good existing workplace pension schemes.

The ACA believes the Pensions Commission is wrong to assume that employers would not support better schemes than the proposed NPSS. Encouraging good employers would be much better than seeing pensions 'dumbed-down' as the Pensions Commission suggests. The ACA paper argues that the Government's forthcoming White Paper on pension reform, due this Spring, should include:

- promotion of new lower-cost risk-sharing schemes, such as career average or cash balance plans with employer contributions of around 10% and employees of 5%, as an alternative to the NPSS, particularly for mid-sized and larger employers;
- greater flexibility on retirement ages and pension increases to give the sponsors of all existing risk-sharing schemes financial "safety valves". This would also encourage a generation of new schemes; and
- 1% NI reduction to employers who run existing and new schemes that are superior to NPSS to reward and encourage them to do so (costing approximately £1.7 billion per annum).

The ACA says that the key Pensions Commission reform for private pensions – the auto-enrolment of employees not covered by better workplace schemes into a defined contribution based NPSS – might extend pension coverage, but could also seriously undermine existing better provision, level-down the package presently offered to millions of employees and open up lower income groups to 100% investment risk.

To underscore the investment risk to individuals of the NPSS, the ACA has questioned the indicative target pension income outlined in the Pensions Commission Report. The Report suggests an NPSS pension of between 15% to 18% of earnings for the median earner after a fairly full working life. The ACA's says this range of outcomes is far too narrow, bearing in mind it anticipates equity investment returns for the majority of the working lifetime. NPSS also envisages "life-styling" the investment choice, which means lower NPSS returns in say the ten years prior to retirement. Hence, the outcomes could be considerably lower (and certainly more volatile) than suggested. Indeed, falls in equity markets could well result in negative real returns for those retiring at particular times.

The ACA says a new incentive for workplace schemes would not be enough to encourage sponsors to start new risk-sharing schemes. It is also essential to reinstate the safety valves necessary for sponsors to continue to offer risk-sharing pension schemes.

In particular, present cost pressures for sponsors of risk sharing defined benefit schemes have arisen from unexpected improvements in longevity. Sponsors should be allowed to retrospectively change pension age under their schemes to reflect changes in longevity, albeit with a minimum of say 10 years notice, in exactly the same way as is being proposed by the Pensions Commission for the future of the State scheme.

Three key legislative changes are also needed, says the ACA, as follows:

Increases to pensions in payment: there is an urgent need to remove requirement for Limited Price Indexation increases (price inflation subject to a 2½% increase in any year) in respect of future service benefits. *This would bring risk-sharing schemes into line with money purchase/defined contribution occupational pension schemes. Employers would still be able to provide non-discretionary or discretionary increases to pensions in payment, reflecting the condition of the scheme.*

Revaluation of deferred pensions: for early leaver benefits before they come into payment, revaluation should be changed to price inflation up to a maximum of 2½% in any year. This would reduce the yearly ceiling from 5% to 2½%. The ceiling should also apply to each year and not cumulatively over the whole period in respect of future service benefits. *Reducing the annual ceiling from 5% to 2½% is consistent with the reduction for pensions in payment brought in by the Pensions Act 2004. This change will ease the design of career average schemes and reduce costs in existing schemes.*

Allow normal pension age to be increased on grounds of improved life expectancy: subject to a report from the Scheme Actuary, and agreement by The Pensions Regulator, normal pension age should be allowed to be increased in respect of past, as well as future, service benefits with members affected being given appropriate notice (e.g. 10 years in advance). *The actuarial value of the pension would be maintained as the pension is expected to be paid for a longer*

period. Such a change would mirror reforms proposed for the State sector by the Pensions Commission.

The ACA paper notes that their proposals reflect Lord Turner's call in a speech made in 2003 which detailed the value of risk-sharing schemes. Then, Lord Turner, said:

*"The big problem with DC schemes is the irrational volatility of return. And it would be possible to construct part DB part DC contracts which remove that risk from the individual to the corporate but leave the other two risks with the individual. It would be possible to structure pension contracts which assure workers a proportion of average salary rather than final salary, and which promise it at a retirement age not precisely fixed in advance...And if we did create such contracts we would remove the inflexibility of DB schemes in the face of rising life expectancy, remove a significant element of risk, and make it easier to create incentives for later retirement...And I suggest we should be encouraging employers, and actuaries should encourage employers, to think of these intermediate approaches, or of other varieties of intermediate or hybrid risk-sharing approach. If we want to maintain an element of private provision which is defined benefit at least in the sense of not being exposed to equity price volatility, we are going to have to think flexibly and creatively about the precise risk-sharing balance between employers and the individual."*¹

"Our recent *Pension Trends Survey*² found 69% of firms wanted public policy to seek a better risk sharing balance, with 63% supporting active encouragement of lower-cost risk-sharing schemes. Unfortunately, the eventual Pensions Commission report did not think creatively about how to promote risk-sharing schemes," said ACA Chairman, Adrian Waddingham.

"Without the kinds of reform we are proposing, increasingly risk-sharing schemes will be confined to the public sector. Such an outcome must be judged to be a terrible failure in public policymaking and one that is unacceptable for the millions of employees engaged in the private sector, all of whom in some way will be funding those superior pensions retained by public sector employees".

The ACA added that the key reforms to State pensions proposed by the Pensions Commission – a higher Basic State Pension indexed to earnings, paid gradually at a later date to reflect improvements in longevity – are to be welcomed and are fundamental to the success of any private pension solution built on top of State reforms. The ACA feels, however, that to pass the Government's 'simplicity test' further work should be set in hand to consolidate the two State pensions into one scheme from an early date.

¹ Extract from Lord Turner's speech to the Actuarial Profession on *The Macro-economics of Pensions*, 2 September 2003.

² ACA 2005 *Pension Trends Survey* completed by 390 firms with scheme assets exceeding £131 billion and over 2.8 million members.

For the full submission made to the Government and Pensions Commission go to www.aca.org.uk (see 'Policy Statements').

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Note to Editors:

The **Association of Consulting Actuaries (ACA)** has over 1500 members working in some 80 firms. Members are advisers to UK pension schemes with assets in excess of £700 billion, including the vast majority of larger schemes and thousands of smaller arrangements. The ACA forms the largest national grouping of consulting actuaries in Europe.