With public sector strikes threatened on every side over the Government’s proposals to reduce public service pension costs to the taxpayer, imaginative developments in public policy could herald a new, fairer pension deal for all...

Bridging the gap between private and public sector pensions

This issue of Placard focuses on the highly topical issue of public sector pensions and the wider policy commitment to reinvigorate workplace pensions. It comes at a time when the trade unions seem set upon a major battle with the Government on what they see as a general levelling-down of public sector provision, with many workers also paying more for their pensions. We examine whether the reforms offer the opportunity to close the pension gap with the majority of private sector employees, who presently can only look upon public sector pensions – current or as proposed for the future – with envious eyes. We ask whether we are groping towards a position where, with an improved and consolidated State pension, the Government could look to freeing-up pension designs so private employers could again think beyond offering pensions where employees are forced to take all of the longevity, investment and inflation risks.

To many people working in the private sector there probably remains an air of astonishment that given the state of the public finances, employees in the public sector should expect to hang onto levels of pension benefits that are now all but extinct for those presently working in the private sector. To expect taxpayers to meet the growing gap between contributions collected and pensions paid out, seems to make the case for reform all the more urgent.

It would be expected that the Government’s policy would therefore be warmly endorsed by the majority of private sector workers, but – in reality – there seems to be at best only a lukewarm public sentiment in that direction. Has the Government misjudged the public mood and, if so, why?

Changing sentiment

It is probable that a number of factors have combined together to explain the apparent lack of enthusiasm for Government policy towards public sector pension reforms.

First, the public – including many public sector employees – seem not to understand the reforms. They have been effectively portrayed by the trade unions, as Michael Johnson argues in this issue of Placard, as an across-the-board attack on the living standards of generally lowly paid public service employees. Despite the support of much of the printed media, the Government message on behalf of the taxpayer has failed to gain traction.

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Second, the Government has probably underestimated the strength of feeling in the private sector about (mostly adverse) occupational pension developments in the sector over the last 20 years. The loss of ‘good’ pensions by many has largely been accepted, with only the occasional whimper of protest. Private sector employees have seen continued employment as the priority and there is lower trade union representation on the whole. One senses that grudging acceptance has now begun to turn to mounting resentment, exacerbated by the publicity around the often more favourable treatment extended to senior executives in some large corporations (especially where those executives have demonstrably failed to perform on any measure of business success).

Third, the Government’s pension strategy has been undermined by our poor economic performance since 2008 and the impact that the public policy response has had on the outturn of market-related pension and savings products. Newspaper headlines underscoring typical 30% reductions in defined contribution pension ‘pots’ over the last 3-years alone, and annuities delivering pensions reduced by a similar proportion over the same period, do not encourage those working in the private sector that they are getting a ‘fair deal’. Increasingly, one senses the unspoken desire is for private sector employees to get a better deal, not for public sector employees necessarily to be edged ever nearer to the same unsatisfactory deal!

Unsurprisingly, there is a mounting disinterest from private sector employees (many of whom are now coping with reduced living standards) in contributing towards volatile market-linked pensions, a concern for those looking to auto-enrol employees largely into such vehicles from 2012.

If the Government feels some better, albeit reduced, pension deal for public sector employees is possible, shouldn’t something better be possible for private sector employees too?

On the other hand, might the years of over-regulation and employers’ increasing risk aversion now make any material improvement in private sector pension schemes immensely more difficult (at least without some clear incentives)?

In this Placard, ACA Chairman, Stuart Southall, responds to Michael Johnson’s call for the adoption of market-linked pensions for the entire public sector, by calling for ‘middle way’ approaches that close the pension gap between public and private sector employees, with a wider sharing of the risks involved in delivering pensions across-the-board.

Adam Gillespie, Editor

Cabinet Office Minister, Rt Hon Francis Maude MP has struggled to get the Government’s public service pensions message across to a wider public.

A survey by Survation published in November, commissioned by Unite, of 1,000 adults found the trade unions were three times more trusted than the Government for providing accurate information on the affordability of public service pensions.
Public Sector Pensions: a catastrophe for UK plc

By Michael Johnson, Research Fellow, Centre for Policy Studies

Summary

- To-date, the Coalition has been outmanoeuvred by the trade unions in its negotiations over public sector pensions. This matters; cutting the cost of public sector pensions by 25%, for example, would save taxpayers billions of pounds every year, stretching into the future. The present value of such an annuity saving would be over £100 billion in today’s money.

- The unions have also comprehensively outwitted the Coalition in the media war, harnessing to full effect the opportunities for obfuscation and bamboozlement offered by the pensions theme.

- In early November, the Coalition announced some concessions in its public sector pension negotiations with the unions. They verge on an unconditional surrender to the unions, perhaps on a scale unprecedented in the history of public sector labour negotiations. The price will be paid by those who are not at the negotiating table; the private sector and the young. The latter could be summed up as simply an extension of the on-going perpetration of generational injustice.

- By agreeing to exclude those within ten years of retirement from any deal, as well as increasing the pensions’ accrual rate, the Coalition has wiped out, for the next ten years, any scope for meaningful cost savings. The only remaining benefit, within that timeframe, will be additional employee contributions, a mere trickle when compared to the burgeoning cost of meeting pensions in payment.

- The concessions are summarised in a dangerously vague Treasury publication, “Good pensions that last”. The Foreword, by the Chief Secretary to the Treasury, irresponsibly refers to “no more reform for at least 25 years”. Over that timeframe, no one knows how our economy will perform, or what the additional costs may be from increasing life expectancy. Furthermore, the paper lacks any estimates for the cost to taxpayers, but there is a passing reference to a cost cap on taxpayer contributions, but no detail. It is crucial that the design of this cap is robust enough to properly protect taxpayers.

- Today, the cashflow gap (between contributions and pensions in payment) is forecast to be £9.7 billion in 2014-15, up from £4.5 billion for 2010-11. At best, additional employee contributions will reduce this by £1.8 billion in 2014-15; the cashflow gap will therefore still increase to nearly £8 billion (and rising).

- The gap is to be plugged by the Treasury; this, together with employer contributions, leaves taxpayers meeting at least 80% of the cost of public sector pensions. Consequently, whatever the agreed increases in employee contributions, they will be small relative to the total cost of pensions, and of limited benefit to the Treasury. The real economic benefits only arise well beyond ten years hence, principally powered by Lord Hutton’s proposal to link the retirement age to the
Summary continued..

retreating State Pension Age. Economically helpful in the future, but of no political value today.

- The ONS calculation – that public sector workers receive pay packages 13% higher on average than those in the private sector – is a significant underestimation. If fails to take account of the pensions of today’s public sector workers being between double and treble those of similarly skilled private sector workers. Furthermore, within a few years, the private sector will have become a DB pension desert, in which pensioners assume their own longevity risk.

- Ideally, the forthcoming strikes will enable the Coalition to walk away from the negotiation table and reconsider its strategy. It should first end contracting out of the State Second Pension (S2P) and implement an improved (and simplified) State Pension, raising it to the much mooted £140 a week. This could be more than adequately financed by a combination of a £3.9 billion annual saving on NICs rebates, a reduction in means-tested benefits (saving up to £8.6 billion annually) and ending higher rate tax relief (£7 billion annual saving).

- By putting in place a bedrock of retirement income above the means-testing threshold, the Coalition could claim to have addressed the unions’ legitimate concerns over pensioner poverty. It would then be in a much stronger position to negotiate a route map to a wholly DC-based framework for public sector pensions, to include compulsory NEST participation (funded by whatever contribution rises are agreed, to avoid the “pay twice” problem).

- Unfunded schemes should be replaced with a notional DC framework, after an interim period of CARE-based DB. The (funded) LGPS should be restructured as a single giant fund, representing the consolidation of today’s 101 separate funds. This would give it real clout to negotiate with the industry in the interests of its members. It should be overseen by a single, trustee-based, body.

- One important consequence of a pure DC framework for the public sector would be that all of the State’s limited capacity to absorb pensions-derived longevity risk would be concentrated into an improved State Pension. Ultimately, public and private sector workers with similar skills and responsibilities should have broadly equivalent incomes in retirement.

- In the interim, the unions may accept the deal currently on the table, but this could ultimately prove to be a Pyrrhic victory. The price is likely to be subsequent job losses, to exert some control over the cost of future pensions.

- This leaves one final question, to the Prime Minister. He recently made it clear that the pensions being offered to the public sector are “far, far better than pensions in the private sector”. Why should they be?

Introduction

In March 2011 Lord Hutton’s Independent Public Service Pensions Commission published its final report. It was prompted by the widespread recognition that public sector pensions are unaffordable, and hence unsustainable. Indeed, today’s framework is similar to a Madoff-style pyramid, now collapsing under the weight of insufficient contributions, rising longevity (the DWP expects more than ten million people in the UK today to live to see their 100th birthday) and an ageing workforce (i.e. fewer workers to support each pensioner).

The Coalition broadly accepted Lord Hutton’s recommendations for watering down the quality, and thereby the cost, of public sector pensions. In so doing, it assumed a Herculean
challenge, notably with union negotiations over the structure of the reforms. A period of staff consultation has followed, with the intention that agreed changes will be introduced from April 2012.

This timetable is extremely tight. The Isle of Man’s Government started similar negotiations, in respect of its (mere) 9,000 public sector workers, more than four years ago. The process continues to drag on, burdened by multiple rounds of consultation. Consequently, implementation has yet to start, and once it does, transition is still expected to take up to a further seven years.

But the timetabling difficulties are mere details. Even if Lord Hutton’s proposals were to be implemented as they stand (i.e. before the recent concessions), from the perspective of economic and fairness (vis-à-vis the private sector), they remain wholly inadequate.

The shortfall will still grow

Public sector pensions are mainly unfunded; they operate on a pay-as-you-go (PAYG) basis, contributions being immediately recycled in order to pay current pensions.

This PAYG approach leads to opacity, not least because the immediate funding requirement is disconnected from the cashflow consequences of pension promises. It also harbours behavioural risk, notably the temptation for employers to defer some of today’s employment costs. But the most serious unintended consequence of the PAYG framework is the perpetration of generational injustice.

Five years ago, contributions and pensions were roughly in balance. But this is changing. This year, public sector pension payments are expected to exceed pension contributions by £5.8 billion. Even if Lord Hutton’s proposals were to be implemented in full, by 2015-16 the gap is expected to be £8 billion, and rising. This worsening cashflow shortfall has to be plugged by the taxpayer.

It is therefore clear that reforms are required that go well beyond Lord Hutton’s. Without them, we will continue to impose on successive generations a legacy of rising contributions (and taxes), to pay the previous generation’s pensions.

Few opportunities for quick wins

Lord Hutton’s proposals will start to produce meaningful economic benefits in 15 to 20 years’ time, primarily through his (sensible) proposal to link the retirement age to the State Pension Age. But this is too distant to be of any immediate value: in today’s hard times, the Chancellor needs immediate cashflow savings. Here, public sector pension reform has little to offer. There is little scope to increase employee contributions as the impact of so doing is too immediate (witness the current opposition), and while pensions in payment could be reduced, this is seen as politically impossible (Note 1, below).

That only leaves reforms such as putting an end to contracting out of the State Second Pension (S2P). The Government would then no longer have to pay NIC rebates, producing an immediate cashflow saving of around £1.5 billion per year in respect of public sector employees (Note 2).

Unresolved unfairness

Historically, the more generous public sector pensions have been justified by pay being lower than in the private sector.

Table 1 (over page) debunks this argument. It shows that both mean (i.e. average) gross pay and total reward are higher in the public than in the private sector, by 4% and 13% respectively.

However, this data significantly understates the value of public sector pensions as “total reward” only reflects employer contributions, which bear no resemblance to the cost of meeting the pension promises. In particular, the “price” of public sector workers continuing to enjoy certainty of income in retirement, until the day they die, is ignored. This still has to be paid for, by taxpayers. In addition, public sector workers bear no investment risk, their pensions being (mostly) unfunded.

Note 1: Albeit not in other countries. Dutch and Swedish pension schemes, for example, incorporate mechanisms to reduce pension payments in the event of financial distress.

Note 2: Public sector employer rebates are not a ‘saving’, the cashflow being circular, i.e. within government.
Using pension contributions as a proxy for pensions’ value, it is evident that the pensions of today’s public sector workers will be between double and treble those of similarly skilled private sector workers.

Private sector DC occupational schemes’ contributions typically total 12% of salary. This is roughly a third of PWC’s estimate that private sector workers would need to contribute about 37% of their salary to their pension pot over their working lifetime, to match the retirement income paid to a public sector worker on an equivalent wage. Thus the “total reward” differential, in favour of the public sector, is much wider than reported by the ONS.

The cost of providing certainty of income in retirement is now prohibitive, as the private sector has discovered. This is because people are living longer in retirement. And, as the population ages, so the number of workers supporting each pensioner is declining. Consequently, the burden on taxpayers is likely to rise, leaving the (on average) less well-off private sector workers with less to save for their own retirement.

Today, almost all private sector workers have defined contribution-based (DC) pensions, through which they assume their own income-in-retirement risks. Unless they purchase a lifetime annuity at retirement (which is increasingly expensive), their subsequent income is uncertain because they do not know how long they will live, nor how their assets will perform. It is surely unreasonable to expect them to assume, and pay for, the longevity risk of others.

The unions’ perspective

Lord Hutton justifies his proposals by, quite rightly, emphasising the unaffordability of today’s public sector pension arrangements. Unfortunately, Chart 1B (over page) in his final report would appear, at first sight, to support the union’s claim that there is no affordability issue. It shows a projection of the cost of unfunded (Note 4) public sector pensions falling from a peak of 1.9% of GDP (this year) to 1.4% of GDP by 2060.

Chart 1B is repeatedly coming back to haunt the Coalition. Unsurprisingly, the unions have latched on to it, to justify their case that there is no issue concerning pensions affordability.

There are several assumptions behind the chart which the unions do not acknowledge. For example, the projection assumes that pension accruals and pensions-in-payment will grow with CPI, rather than the more costly RPI. But the unions are opposing this change. Analyses from both the NAO and the OBR irrefutably demonstrate that unless CPI is adopted, the cost of pensions, as a percentage of GDP, will rise. The unions cannot have it both ways. They either accept that CPI should be used in calculating future pension payments; or they should not use this Chart as a demonstration of long-term affordability.

Chart 1B assumes that the public sector workforce will grow at 0.25% a year. This assumption seriously influences the calculation of the cashflow shortfall. For example, if the workforce were to contract (a real possibility), then the cashflow shortfall would be exacerbated (there being fewer contributors, but not fewer pensioners).

Note 3: Source—ONS Economic & Labour Market Review Table 1, September 2010. Underlying data from the 2009 Annual Survey of Hours and Earnings (ASHE), 12 November 2009.

Note 4: i.e. excluding the 15% of public sector pensions that are funded, notably the Local Government Scheme (LGPS).
Chart 1B also assumes that real earnings will grow at 2% a year, which is probably over-optimistic, not least because of the increasing competitive pressure from the emerging markets. The productivity growth assumption, also 2%, is also questionable: it is quite feasible that our ageing workforce could become less productive than previous, younger, workforces. These two assumptions have a major impact on the GDP growth projection. If they turn out to be over-optimistic, then the cost of pensions, expressed as a percentage of GDP, will be higher than otherwise.

The author has made several Freedom of Information requests of the Treasury and GAD for the model underlying Chart 1B, to re-parameterise it with, for example, 1% for real earnings and productivity growth. To date, these have been denied on technicalities, the response always arriving on the 20th business day after the request was made (the maximum permitted response time). Spanish practices at work.

The unions are winning a high stakes negotiation

The economic implications of the negotiations over public sector pensions are perhaps as great as any other negotiations between government and unions in history. The cost of pension benefits are expected to rise from £25 billion (2009-10) to over £60 billion (2059-60) a year. Cutting the latter by 25%, say, would save the Treasury (and taxpayers) billions of pounds every year, stretching into the future. The present value of such an annuity saving would be well over £100 billion in terms of today’s money.

Despite the importance of these negotiations, the Coalition would appear, so far, to have been out-manoeuvred by the unions. The Chief Secretary to the Treasury’s media blitz ahead of the one day strike (June 30) came over as informing the unions of the pre-determined outcome, which would not have helped relations around the negotiating table. Much more serious, though, is the unions’ success in persuading the Coalition to accept separate negotiations for each of the main pension schemes, a delaying tactic that puts more pressure on the Coalition’s own tight deadline.

The unions are also winning the media campaign, not least because of their preparedness to take advantage of, in any discussion of pensions, the unparalleled opportunities for obfuscation and bamboozlement. They happily co-mingle the facts, and languages, of funded and unfunded schemes to suit their purposes, unchallenged by interviewers who are even more unfamiliar with the subject (Note 5). Ministers have been equally unconvincing, not least because they would appear not to have been fully briefed, particularly in respect of the nuances of Chart 1B.

Note 5: For example, Evan Davis interviewing Dave Prentis (Unison General Secretary), The Today Programme, 15 June 2010. Davis asked questions about unfunded schemes; all of Prentis’s answers concerned funded schemes.
Recent concessions: the cost cap

The recent Treasury publication “Good pensions that last” describes the latest concessions by the Coalition. Almost in passing, it refers to a cost cap on taxpayer contributions, but provides no detail; “further discussions of the design of the cost cap will need to take place in due course”. This cost cap must be robust enough to ensure that unexpected cost increases are not simply absorbed by taxpayers. There are two components to consider; the trigger for action, and the resulting scheme adjustment.

The Trigger

The trigger must be readily quantifiable, ideally focused on cashflow, rather than any nebulous or subjective concepts such as actuarial assessments of liabilities. Crucially, it must take account of the huge cost leakage, the cashflow gap between total contributions (employer and employee) and pensions in payment, currently plugged by the Treasury.

Scheme adjustment (i.e. the cost control lever)

Designing the trigger is easy, relative to determining what happens if it were pulled. The Dutch experience of controlling the cost of their CDC schemes is salutary; the triggers are clear, but then lead to a menu of options for discussion by schemes’ trustee boards, comprising employer and employee representatives and an independent Chairman (Note 6). Dutch triggers have been pulled, but subsequent agreement as to the course of action has been, as best, a protracted and painful process; the main outcome has been extensive wrangling and procrastination. Thus, plans for scheme adjustment that lack specificity should be avoided; they lead to stalled corrective action. And anything that is ludicrously complex presents a communications nightmare (a mistake made by the Swede’s with their Balance NDC scheme, for example).

Unsurprisingly, employees are more sensitive to their contributions being increased than less immediate scheme design changes, such as reducing the future accrual rate, the revaluation rate for benefits already accrued, or the indexation of lump sum payments or pensions in payment. But the Treasury only receives an immediate cashflow benefit from higher employee contributions. Choice gives people a sense of being in control, so employees could be asked to choose between higher contributions or more distant structural changes, but choice introduces significant complexity; best avoided. One “back door” cost control lever would be to simply cut public sector employment.

“No more reform for at least 25 years”

The Foreword of “Good pensions that last”, written by the Chief Secretary to the Treasury, irresponsibly refers to “no more reform for at least 25 years”. Over that timeframe, no one knows how our economy will perform, or what the additional costs may be from increasing life expectancy.

Furthermore, this commitment gives rise to a Pandora’s box of unintended consequences, not least that it risks jeopardising Steve Webb’s simplification of the State Pension. This includes putting an end to the Second State Pension (S2P), and with that, contracting out (which includes the public sector). This should lead to a reduction in scheme benefits, because schemes would no longer need to replace employees’ lack of S2P. Committing to “no more reforms for at least 25 years” could make that rather tricky.

An alternative approach

The Coalition should step back from the current negotiations and swiftly raise the State Pension to at least £140 a week, for every individual (irrespective of marital status). This was originally proposed as Coalition policy in 2010, but little has been heard of it since.

By putting in place a level of retirement income above the means-testing threshold, the Coalition could claim to have addressed the unions’ legitimate concerns over pensioner poverty. It would then be in a much stronger position to negotiate a route map to a wholly DC-based framework for unfunded public sector pensions, based on the following principles.

Note 6: For detail, see ‘Self sufficiency is the key’, Michael Johnson, CPS, February 2011.
**Unfunded schemes: NEST and notional DC**

All public sector employees should be compelled to participate in the DC-based NEST *(Note 7)*, with additional pension provision provided by notional DC schemes. NEST participation would represent the start of tip-toeing towards a partially *(Note 8)* funded framework. It would be funded by the Treasury foregoing the cashflow from the widely-anticipated additional contributions, but “spend to save” thinking is not entirely alien to it. Furthermore, the opportunity to encourage a savings culture amongst 20% of the working population should be seized (subsequently boosting investment).

The bulk of public sector pensions should be provided by an unfunded (“notional”) DC arrangement, along the lines already adopted in Sweden and elsewhere. Individuals would each have a notional account detailing their (and employer) contributions, but the cash would continue to flow to the Treasury, and would therefore be available to be paid contemporaneously to retirees. A rate of return would be “deemed” on the contributions (GDP growth should be used, not least to reflect the state’s ability to pay) and, at retirement, the notional account would be converted into an annuity using a market-based rate.

**Implementation of a pure DC framework**

The Coalition should pursue a public sector pensions reform “two step”. There should be an initial ten year phase of NEST participation and watered-down DB provision, along the lines that Lord Hutton has proposed (i.e. career-average rather than final salary-based). The latter would then be replaced by the notional DC schemes.

The Coalition’s notional DC intentions should be signalled ten years ahead of introduction. Reforming public sector pensions is foremost an exercise in effective communication and negotiation, rather than a technical challenge. The challenge includes determining the size of contributions, accrual rates, and so on. This should be determined at individual scheme level, through negotiation between employers and unions. Central government should not be involved; its role should be limited to setting two crucial boundary conditions:

- public sector employers would have to become pensions self-sufficient within ten years, to coincide with the introduction of the notional DC schemes. Thereafter, the Treasury door would be shut, i.e. any cashflow shortfalls would have to be met by employers; and

- the taxpayers’ contribution would be capped at 65% of pensions in payment.

How employers achieve pensions self-sufficiency should be entirely up to them; they should have complete discretion.

**Funded schemes: The LGPS**

There is one patently clear initiative to take that would significantly improve the affordability of the LGPS; the 101 separate funds should be merged to create a single giant fund with over £140 billion in assets. This would give it real clout to negotiate with the industry in the interests of its members. It should be overseen by a single, trustee-based, body. Many of the LGPS funds are sub-scale schemes producing sub-optimal outcomes, notably in respect of:

- their inability to harvest economies of scale or exercise leverage on investment price. The annual administration cost of a (private sector) scheme with more than 50,000 members is £15 to £30 per member, compared with £200 for a scheme with less than 1,000 members; and

- weak governance. Generally, the smaller the scheme, the less resource is available for investment design and communication with members. The “governance dividend” attributed to large DB schemes is estimated to add 0.5% to annual returns.

Research (independently verified by APG) suggests that had, ten years ago, the LGPS funds been merged into 14 regional funds, each LGPS member (contributing, deferred and retired) would be better off by £275 p.a. over the interim 2001-09 period. This exceeds the £900 million annual saving that the Coalition is looking for by 2015; fund merger would strengthen the unions’ case for a smaller rise in contributions.

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**Note 7:** The National Employment Savings Trust, auto-enrolment of private sector employees commences in 2012.

**Note 8:** Fully funding the public sector’s pension liabilities should be, at best, a very distant objective (requiring the accumulation of over £1 trillion of assets, in today’s money terms.)
Furthermore, it could be a hugely valuable source of common ground between unions and the Coalition (and taxpayers). Such common purpose is rare and should be used for relationship building to help overcome greater challenges within the negotiations.

**A Pyrrhic victory?**

Paradoxically, the unions’ success, to date, could ultimately be their undoing. Such is the opacity of pensions that few within the public sector appreciate just how good the current offer is. Enthused by their success, the memberships are intent on striking, but are they about to snatch defeat from the jaws of victory? Could this be a tactical error of Scargillian proportions? Striking is likely to swing public opinion against the public sector, perhaps encouraging the Coalition to pull the current proposals and walk away from the table.

Alternatively, the unions may accept the current offer, but this could ultimately prove to be a Pyrrhic victory. Without meaningful reform today, the pain will only be deferred; future governments will be obliged to take more drastic action, which would include (further) cutting public sector jobs.

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**What do employers in the private sector want from the review of public service pensions?**

The ACA’s *2011 Pension trends survey* was conducted during the summer of this year with 468 private sector employers of all sizes responding to the questionnaire.

On public service pensions, employers were strongly supportive of the Government’s approach to public service pensions, including the retention of defined benefit provision—albeit scaled back—even though such provision is now generally not present in the private sector.

**Question: How should public sector pensions change?**

- **Public service pensions should be scaled back**
  - Yes: 85%
  - Stay as is: 11%
  - No: 4%

- **Defined benefit provision should continue**
  - Yes: 40%
  - Stay as is: 16%
  - No: 44%

- **Pension age should increase to SPA**
  - Yes: 91%
  - Stay as is: 7%
  - No: 2%

- **Member contributions should increase**
  - Yes: 79%
  - Stay as is: 17%
  - No: 4%
Increasingly, risk sharing is being talked about as the future for ‘good’ workplace pensions. But why isn’t risk sharing widespread already and does it offer a longer-term solution to the growing pension apartheid between public and private sector employees?

Risk sharing – making it happen

By Stuart Southall, Chairman, Association of Consulting Actuaries

Over the last few months we have seen increasing interest in risk sharing as a means by which better private sector workplace pensions can be delivered. The ACA has been arguing for legislative reforms to foster such schemes for over a decade now, and it was encouraging to hear the Pensions Minister, Steve Webb, in recent speeches say that he ‘would look again’ at how such schemes could be encouraged. This follows not long after Lord McFall’s endorsement of such arrangements in his Workplace Retirement Income Commission report.

First, for those less familiar with the more esoteric areas of pension provision – what does ‘risk sharing’ mean? In simple terms, risk sharing schemes sit between defined benefit (DB) schemes and defined contribution (DC) schemes. In a typical DB schemes all the inflation, investment and longevity risks fall on the employer and a ‘guaranteed’ benefit is targeted. At the other extreme, in a typical DC scheme these same risks fall exclusively on the individual (with no guarantee of pension benefits until the individual’s ‘pension pot’ on retirement is converted into an annuity). At present, risk sharing schemes have no separate legal identity under our pension system and genuine arrangements are few and far between. Where they do exist, they generally have to be assembled using both the DB and DC legal frameworks – hardly an incentive to innovate!

Stuart Southall sees a ray of hope in the Pension Minister’s recent pronouncements

Fresh interest

Undoubtedly, the fresh interest in risk sharing has come about for two main reasons.

First, is the quickening pace of closures of existing final salary (DB) schemes; most have long since closed to new entrants but more and more are now stopping continued accrual of benefits for those already in them.

Second, there is mounting evidence that employees are increasingly being ‘turned-off’ by the volatility and delivery of pensions from many existing workplace DC arrangements and personal pensions. Whilst it seems inevitable that an increasing number of private sector employees will be enrolled in workplace DC arrangements as auto-enrolment comes online from late 2012, current voluntary uptake and persistence is looking pretty sickly given pressures on take home pay and typical DC pension performance over the last decade. Whilst there seems to be a general acceptance that improvements are needed in respect of DC governance and greater transparency on costs, DC pensions should not be the only realistic option available to employers under UK law.
Figure 1 (above) illustrates the basic spectrum of a workplace scheme design. For example, a cash balance scheme targets a defined pension pot at retirement (rather than a defined pension), which members use to purchase an annuity at retirement. This removes much of the longevity risk and investment risk from the employer, whilst still providing some certainty for the members.

Whilst the murmurs of pension discontent from employees in the private sector are muted, private sector workers are increasingly being required to finance much of the pension benefit ‘guarantees’ offered in the public sector. The apparent inability of the Government to communicate the value of the ‘guarantees’ remaining to public sector workers is well described by Michael Johnson in his article in this issue of Placard.

Johnson takes the view that what is presently being proposed by Government remains unsustainable, both in terms of cost and in terms of equity with the private sector. What is on offer for public sector employees does remain comparatively expensive and defined benefit based and the most recent concessions announced in early November significantly water-down the public expenditure savings sought. Johnson’s longer-term solution is to plan to phase out public sector DB provision and serve notice that public sector employees be moved for the future onto NEST plus ‘notional DC’, closing the pension gap, in terms of the type of scheme on offer, with the private sector.

**Illusory DC reform**

Whilst a severely deteriorating economic climate might enable Government to progress a ‘Johnson’ public sector pensions manifesto, it’s not at all clear that such a major reform of public sector pensions is achievable nor that his recommended outcome should be viewed as the only option. Certainly, if the November concessions represent ‘real politik’ then we are miles away from the Johnson model and in some danger of being unable to make further substantive reforms for 25 years (the Government’s latest proposal) irrespective of how the economy and public expenditure fare.

Where Johnson is probably right, is in his opinion that the taxpayer cost of unfunded public sector pensions (the cost of current pensions being paid out now, less current contributions) may rise quickly. This increase would come about if economic growth rates were to fall short of Treasury estimates (which they are quite markedly, and as recognised by the Bank of England in recent growth downgrades) and if the reduction in the number of public sector employees is more rapid than has been previously forecast (which it is).

Where I judge he may be wrong is that ‘notional DC’ is unlikely, when applied in the public sector, to be anything like DC in the private sector. Is it realistic to see volatile changes (particularly sizeable reductions) in pension “pots” applied to public sector employees in the way they have been imposed on private sector employees? I think not – the equality of notional DC in the public sector versus real DC in the private sector would therefore be illusory.
A new ambition

What also concerns me is that there remains a feeling that equality in this DC direction smacks of a levelling-down rather than an attempt to find a framework that encourages a 'good' affordable level of pension provision for all – public and private sector employees alike.

If it is possible for us to afford mildly watered down defined benefit pensions for the public sector, it cannot be beyond our ambition to find ways to deliver affordable, sustainable and more certain private sector pensions. What we must escape in so doing, is expecting private companies, challenged by competition in the markets for their products, to provide 'good' pensions that they are constrained from controlling in terms of costs and liabilities because of legal and regulatory diktats that undermine their business as well as on-going pension provision.

Given the recent announcement by the Government that in the future the State Pension Age will be linked to increases in longevity, schemes could be given similar powers to increase their normal retirement ages in line with the increases in longevity in a timely way. This would remove some of the longevity risk inherent in final salary schemes, making them more affordable (and in line with State benefits).

Until recently, the Department of Work & Pensions (DWP), whilst examining various initiatives, has repeatedly opined that risk sharing is possible under current legislation and that the real problem is that there is no demand or consensus from private sector employers to offer such workplace schemes. In short, they have taken the view that the growing liabilities that have emerged over the years in DB schemes have discouraged employers from offering alternative arrangements where risks to the employer remain, even in a reduced form, for the foreseeable future.

Hence, the move towards DC seems to have been judged to be ‘inevitable’ and ‘un-stoppable’. The DWP has not felt it worthwhile to invest time and energy into identifying how to encourage risk sharing options beyond that which is presently possible (which, as I have said, means running schemes that combine the complexity and regulatory load and costs associated with both DB and DC pension rules).

Indeed, the DWP has gone further than not encouraging initiatives. It has positively “kicked into the long grass” risk sharing proposals to hold back compulsory indexation when defined benefit schemes are in deficit and collective defined contribution arrangements – despite evidence of considerable cost savings and the successful operation of such schemes elsewhere in Europe.

And even more recently, it has closed what it has seen as a loop-hole, where the courts judged that some DC schemes offering a limited guarantee should not, because of those guarantees, be deemed to be DB schemes. A late amendment to the 2011 Pensions Act effectively means that such schemes offering a limited guarantee are to be re-classified and backdated as DB schemes, with all the extra regulatory costs and commitments involved.

Employer support for risk sharing evident

Even though surveys we and others have conducted (see Figure 2) show that there is indeed demand from employers for the freedom to offer new risk sharing pension options, finding a way to implement such new options is challenging. Opportunities to ‘think outside the box’ seem to be stifled by a blinkered denial that anything can be done to offer private sector employees a better outcome than tweaking DC (tweaks that inevitably add to costs, thereby reducing returns).

Indeed, government strategy (and that of all the major political parties) for private sector pensions now seems to hinge on improving the Basic State Pension. Whilst laudable, there may be sustainability issues in the longer-term if pension ages (as has occurred to date) do not keep pace with longevity improvements. Above this, the policy ambition is auto-enrolment into current open schemes where they are available (the vast majority now being DC), or into new low-cost DC schemes, with modest minimum contributions that are unlikely to deliver adequate pensions for most.
Beyond this, one suspects there is an (as yet) unspoken hidden agenda for the future of greater compulsion if the auto-enrolment initiative stalls and, over time, higher minimum DC contributions from both employers and employees.

**Getting there: a better pension settlement for private sector employees**

How can we move forward to a pension settlement that is fairer for private sector employees whilst not placing unreasonable burdens upon employers? Importantly, a private sector pension settlement must do more than is presently the case in order to ensure the majority of private sector retirees in years to come have an adequate income in retirement, without relying on widespread recourse to State benefits, which in themselves are looking increasingly unaffordable. The removal of the default retirement age should mean employers take a more active role in ensuring their older employees have suitable retirement provision in place.

Part of the solution probably needs to be an acceptance that the replacement income being targeted by workplace pension schemes at retirement is more modest than the two-thirds of final salary often hitherto sought. Risk sharing schemes might also concentrate on providing a more certain replacement income up to a ‘middle income’ level, with the higher paid topping-up their pensions by way of a DC supplement.

Whilst current economic conditions look likely to prevent immediate actions that would add to public expenditure costs in terms of government financial incentives to promote pension provision, here are five key suggestions, all of which will require legislative change before any significant costs are incurred:

- **Employers with pension schemes offering guarantees to be given override to cap scheme costs**: all sponsors of private sector pension schemes offering a ‘guarantee’ (DB or risk sharing) should be given a statutory override (over scheme rules) enabling them to control annual pension costs by a range of reasonable, pre-agreed and transparent means. Such means could be, for instance, by way of adjustments to pension indexation, accrual rates and pension age, including the ability to adjust accrued benefits to spread these over proven average increases in retirement years, subject to notice. The objective would be that over a 3-year cycle, sponsors would take actions so schemes by and large remain fully funded, so they do not have sudden shocks of extra scheme costs (with the added accounting reporting consequences thereof). This capping of pension costs is not dissimilar to that which has increasingly been applied or advocated in the public sector.

- **Collective DC arrangements**: legislation should be enacted to allow collective DC pension arrangements to be provided by employers (single or multi-employer), as found elsewhere in countries like The Netherlands. These schemes could deliver significant cost reductions in terms of both administration and investment as compared to current
contract-based DC arrangements, whilst also benefiting from trustee control.

- **Elderly care, short-term savings and early access:** legislation should be enacted to allow workplace ‘pension arrangements’ to also encompass short-term savings arrangements (and the ability to easily move savings between short-term and retirement savings), as well as encompassing elderly care savings/insurance facilities.

Under the Government’s tax simplification agenda, tax regimes need to be harmonised and simplified to allow the easy movement of savings between higher tax relief (on pension savings) and lower tax relief (on short-term savings). Given the ongoing trend towards later pension ages, it is unrealistic to expect younger employees to save into pensions without some early access option. Ideally, this should be possible by way of individuals drawing on short-term savings. Early access to pension savings subject to a limit (but for a very limited number of purposes) should also be allowed, particularly if a stronger compulsory regime is introduced.

- **Compulsion and incentives:** all private and public service employees from a date such as 2020 should be required to save in a pension from age 30 at a minimum level set by Government (with no general opt out), with higher tax incentives for individuals contributing above minimum contribution levels and new financial incentives for employers who contribute above a statutory minimum employer contribution (accepting that contracting-out rebates are to be abolished).

- **Simplifying red tape and regulation:** it has been a ‘goal’ of successive governments to simplify pension red tape. In reality this has been an abject policy failure in the pensions sector, with additional regulation over the last 20 years adding hugely to the bureaucracy involved.

Given DWP and HMRC resources and the ‘conservative’ nature of the departments, my recommendation is that Pension and Treasury Ministers appoint a small panel of private sector pension specialists, including pension lawyers, with a full time out-sourced support, to examine all existing pension (and tax related) legislation. The aim should be to consolidate and rationalise pension legislation to the minimum possible and to draft legislative changes with two key aims; namely:

1. to protect existing pension scheme members (but reviewing where risk mitigation has become too onerous); and

2. to ensure legislation is updated to allow for a wide spread of flexible risk sharing pension designs that can be cost effectively delivered by private sector employers over the long-term.

This work should be completed within 18-24 months, with a view to legislating at a time when (hopefully) the economic position has improved. Furthermore, the project should be embarked upon with a clear intent to make changes; not just to consult and talk about them endlessly without action then following on.

**Fine words are not enough**

Politicians of all persuasions have for years sounded ‘on side’ about taking action to reinvigorate private sector pensions. In reality, much more time and effort has been expended on measures designed to protect existing members’ DB benefits, with little achieved or done to reinvigorate ‘good’ pension provision for future generations of private sector employees. Whilst some would see auto-enrolment as reinvigorating pensions in the private sector by offering the opportunity to spread provision more widely, the minimal levels of contributions, if they persist, are likely to leave many new savers dismayed at the outcome.

It is my contention that if employers are able to see that better, less volatile risk sharing pensions can be delivered, with designs flexible enough that it is possible to quickly control and cap costs in the event of, for instance, further sharp advances in longevity or a sudden slump in investment performance, then many will be prepared to offer that approach, as times go by.
The trend may indeed be slow with employers remaining suspicious of Government resolve in not adding new regulatory burdens without proper consideration of their long term consequences, but certainly there will be no improvement in what can be offered to private sector employees unless the legislation is enacted, allowing these new design freedoms to be available.

There are a few other important changes that would greatly improve the chances of new risk sharing designs taking off.

First, personal taxation needs to be reduced to give real room for extra pension savings, particularly at low and middle income levels. It is pointless to expect those with no room to save to do so – it is the duty of all political parties to act more responsibly than they have over the last 20 years to promote an economic climate that both encourages and enables saving and personal financial accountability.

Second, whilst unsuccessful laws which run against the public good should not be broken, equally they should not be defended on the basis ‘we cannot do anything about them’. Government and Parliament must have the authority and strength of purpose to change such laws, even if this means challenging, for instance, the application of human rights or other unhelpful legislation emanating from Europe.

The gradual uptake of more risk sharing schemes in the private sector will help to close the gap with employees engaged in the public sector, who seem likely to retain pensions of a much more generous nature than those generally applying in the private sector at present. If that gap is not closed, then in an increasingly uncertain world, we stand the danger that there will be an imbalance in talented people attracted into public as opposed to private sector employment, to the serious long-term detriment of our economy.

The views in this article are those of Stuart Southall and do not necessarily represent those of the Association nor of his employer Punter Southall Limited.