



A NEW BREED OF SHARED RISK SCHEMES TO RE-ENERGISE THE PROVISION OF EMPLOYER SPONSORED OCCUPATIONAL PENSION SCHEMES IN THE UK

Why the need for an extension of risk sharing?

In recent years, the vast majority of private sector defined benefit pension schemes in the UK – mostly final salary schemes – have been closed to new entrants (and some to future accrual). In both large and smaller businesses they have been replaced by defined contribution/money purchase schemes. This trend is likely to continue, with an increasing number of final salary based defined benefit schemes stopping future accrual of benefits.

The main reasons for this rapid change in provision are well explained in the reports of the Pensions Commission. In summary, employers have felt unable to finance the cost of current levels of defined benefits where the whole of the benefit is guaranteed particularly given the lack of control over the level of future contributions. The result is that currently in about 95% of occupational pension schemes in the UK either 100% of the investment and longevity risks are taken by the employer (mostly through final salary defined benefit schemes) or 100% of these risks are taken by the employee (through defined contribution schemes).

The main problem with defined contribution/money purchase schemes for low to modest earners is the volatility of the amount of the fund at retirement where contributions have been accumulated in equity type investments, and the lack of attraction to removing that volatility by investment in bonds due to the lower expected investment return.

The situation could be transformed by the introduction of a ‘third way’ - a radical extension of the current possibilities for risk sharing between employer and employees in occupational pension schemes.

This ‘third way’ would help to address concern at the potential for the levelling down of existing provision and help boost occupational provision, complementing the extension of pension coverage through personal accounts. It could also help to bridge the growing polarisation of public and private sector pension provision.

Why a new category of shared risk schemes?

Under current legislation, occupational pension schemes are classified either as defined benefit, under which normally all of the investment and longevity risks are taken by the employer, or as 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 and complicated as they have been classified as defined benefit schemes.

The new 'third way' would be a new category of **shared risk schemes** which could incorporate creative benefit designs and would sit between the existing categories of defined benefit and defined contribution schemes.

New shared risk schemes would allow employers much more control over their pension costs than is possible with existing defined benefit schemes and, importantly, provide employees with a much more stable benefit platform than is possible with defined contribution schemes.

New shared risk schemes can benefit from lessons learnt from past experiences, from the role of the Pensions Regulator and from the safeguards provided by the Pension Protection Fund.

Having considered different ways of extending risk sharing, we have concluded that the introduction of a new 'third way' is much more practical than changing the requirements for defined benefit schemes, as to do so would undermine and confuse what is, and has been, meant by a 'defined benefit'.

The Association of Pension Lawyers has provided input to the ACA detailing the main legal changes required to facilitate the introduction of new shared risk schemes. The number of changes required to existing legislation is surprisingly small.

For which employers would new shared risk schemes be suitable?

An employer offering a shared risk scheme would be exposed to more limited and controlled risks than under a typical existing defined benefit scheme, primarily because of the facility to share risks with the participating employees. As risks will not have been eliminated, it is expected that these new schemes will appeal mainly to medium to large employers.

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 a defined contribution scheme was to be put in place.

For those employers who have already replaced their final salary scheme with a defined contribution scheme, the possibility of a new shared risk scheme would enable consideration to be given to amending the new defined contribution scheme so that the employer can take some of the risks rather than leaving them all to be taken by the employees.

The basic definition of a new shared risk scheme

The essence of a shared risk scheme is that the pension would be based on the member's average pensionable earnings during the period of scheme membership rather than the member's pensionable earnings at retirement (as is the case in a final salary scheme).

The pension earned for each year of service would be revalued from that year to the date of retirement and increased when in payment.

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, however, 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.

Such schemes would be similar to existing average earnings schemes rather than to final salary or defined contribution schemes.

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.

Final salary schemes do not suit a risk sharing concept due to the potential for material cross-subsidies, for example, if significant salary increases are granted to members nearing retirement with long periods of past service.

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.

Delivery mechanism for new shared risk schemes

The Deregulatory Review – set up by the Government White Paper *Security in retirement: towards a new pensions system* dated May 2006 – will be recommending changes to legislation through the Pensions Act expected in the 2007/08 session of Parliament. It is vital that this legislation includes reforms that will allow shared risk schemes to prosper, alongside meaningful easements to assist existing defined benefit schemes, otherwise there is a real danger of extensive levelling-down in occupational provision.

The **appendix to this paper** describes the main features of new shared risk schemes.

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.

Equally, there is a real danger that, if the opportunity is lost to act in quick time, the decline in good occupational provision will accelerate to an alarming level, bringing with it a range of serious economic, social and political challenges.

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APPENDIX

Main features of new shared risk schemes

New shared risk schemes would be independent of the current regimes for defined benefit and defined contribution schemes.

The main features of a new shared risk scheme are as follows.

- The pension earned for each year of service would be related to the employee's earnings for that year and would be revalued to when pension commences and increased when in payment. Whilst this would be much like a defined benefit average earnings scheme, in that the accrual of each year's pension would be a defined benefit at that time, it would differ in that each year's revaluation and increase to pensions in payment would automatically become a defined benefit subject to the funding position of the scheme as described below.
- It is proposed that the targeted revaluation and pension increases would have to be at least at the current statutory level of Limited Price Indexation for increases to pensions in payment (increases in the RPI subject to a cap of 2½% in any year).
- The funding of the benefits would be subject to the new scheme specific funding regime but targeted future revaluation and pension increases would have to be valued using the same prudent assumptions as the defined benefits which had accrued.
- The employer would have the right to finance any past service funding shortfall by not granting the next year's revaluation and pension increase – but they would have to be reinstated as a first charge on any subsequent past service funding surplus. When a revaluation and pension increase is not granted, future actuarial valuations would have to be carried out annually until they were reinstated from future funding surplus. (As part of the scheme design, the employer could undertake to pay increased contributions up to a stated level to finance all or part of any such deficit.)
- At a valuation, the future service contribution rate would require to be calculated using the same prudent assumptions as used for the past service liabilities. Employer future service contributions would not be able to be abated by any past service surplus and could be reduced only if the future service contribution rate calculated at a valuation had reduced. The employer would be able to reduce future service benefits following a valuation. Thus an employer could maintain a level future service contribution rate by adjusting future service benefits.
- The employer would have the right to increase normal pension age (NPA) in respect of the past service benefits of active and deferred members who were more than 10 years short of NPA. This would have to be subject to a report from the Trustees' actuary, copied to The Pensions Regulator, providing evidence of increased life expectancy consistent with such a change. The Pensions Regulator would have the right to challenge any such increase to NPA and then disallow if the evidence was deemed insufficient to justify the change. This feature is quite different to changing NPA for existing schemes as

prospective members would have been advised from the outset that changes to NPA were part of the normal shared risk scheme design.

- On the winding up of the scheme, the employer debt would be based on the accrued defined benefits excluding the targeted future revaluation and pension increases (as well as excluding any past revaluation and pension increases not granted).
- The compensation available from the PPF would be 100% of the accrued defined benefits (as in the employer debt calculation) and the risk based levy would take this into account. The levies for new shared risk schemes would be calculated separately from existing defined benefit schemes and be held in a separate fund.
- New shared risk schemes would include those types of cash balance plan, where the retirement benefit is defined as a capital sum at NPA and then converted into pension at that time, provided they met the relevant criteria.
- Full disclosure of the risks being shared between the employer and members of the scheme would be required in member communications.
- Shared risk schemes would not be contracted out of the State Second Pension but could be used for exempting employers from participating in personal accounts.

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