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12 April 2007

Dear Gabrielle

Response to Deregulatory Review

Thank you for giving the Association of Consulting Actuaries (ACA) the opportunity to set out our comments on the Deregulatory Review.

Members of the ACA provide advice to thousands of pension schemes, including most of the country's largest schemes. Members of the ACA 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. ACA members include the scheme actuaries to schemes covering the majority of members of defined benefit pension arrangements. The ACA is the representative body for consulting actuaries, whilst the Faculty and Institute of Actuaries are the professional bodies.

We have set out our comments on the issues raised by the review in some detail in Appendix 1 to this letter. We have also included in Appendix 2 our detailed proposals in relation to a new type of pension arrangement, designed to provide a middle way between defined benefit schemes, under which the employer takes all financial risk, and defined contribution arrangements, under which the employee takes the risk.

Summary of our Response

The ACA has already made proposals for a new shared risk category of schemes between defined benefit and defined contribution that would revitalise occupational provision, which otherwise is in steep decline and particularly defined benefit arrangements.

The ACA does not believe that mild tinkering will reverse this trend – fundamental changes are needed to extend flexibility in scheme design.

Under the ACA's proposals:

- Shared risk schemes will be a defined category distinguished by the approach to indexation of pensions before and after retirement. Compared to defined benefit schemes, they have the potential to offer employers:
 - A more attractive accounting position
 - A lower level of employer debt on winding up
 - A lower level of PPF levies
 - Much more control over the level of future pension contributions.

For employees, they will offer a more stable platform for income in retirement than can be achieved by the same contributions paid to a defined contribution arrangement.

- In our view, employers should not be permitted to reduce in value the benefits that have been promised for past periods of service. This principle should apply to limited price indexation, deferred pensioner revaluation and normal pension age, subject to permitted changes in normal pension age to reflect increased life expectancy – see below.
- Employers should be permitted to make changes to benefits relating to future periods. If necessary, a legislative override of scheme rules should be permitted.
- Employers should also be permitted to make changes to accrued benefits that preserve the actuarial value of benefits, following the principles under section 67 of the Pensions Act 1995.
- An employer should be permitted to establish an arrangement with a normal pension age which increases in line with increases in pensioner life expectancy. This would be permitted retrospectively for benefits based on service after the date of establishment (but not for earlier benefits) provided this is clearly communicated to members. So, for example, if the scheme is amended in 2010 to permit changes in normal pension age, benefits earned before 2010 would not be able to be changed, and benefits earned after 2010 could be changed to a later normal pension age that reflects increases in pensioner longevity since 2010.
- Principles-based regulation is attractive if it results in a genuine reduction of legislative requirements. We do not regard the changes introduced by the Pensions Act 2004, which introduced extensive quasi-legislation in the form of codes of practice and guidance, as a reduction in the legislative burden. Indeed, all the evidence suggests quite the opposite.

If you have any queries, please do not hesitate to contact me on 020 7082 6228 or charles.young@hymans.co.uk

Yours sincerely

Charles Young
Chairman of the ACA Pension Schemes Committee



Appendix 1 – Detailed Comments on Deregulatory Review

Risk Sharing

The ACA has already submitted a paper on the importance of promoting shared risk schemes as a vital means of extending good pension provision to a wide range of employees into the future. The earlier ACA paper is attached as Appendix 2, supplemented by the Questions & Answers paper (Appendix 3) and the APL paper on ‘Shared risk schemes: Legal issues’ (forwarded separately). Together, these answers most of the questions posed by the reviewers on page 8 of the consultation paper. In summary, the ACA proposal for a new shared risk category of schemes between defined benefit and defined contribution would revitalise occupational provision, which otherwise is in steep decline and particularly defined benefit arrangements.

The ACA does not believe that mild tinkering will reverse this trend – fundamental changes are needed to extend flexibility in scheme design. Under the ACA’s proposals:

- Shared risk schemes will be a defined category distinguished by the approach to indexation of pensions before and after retirement. Compared to defined benefit schemes, they have the potential to offer employers:
 - A more attractive accounting position
 - A lower level of employer debt on winding up
 - A lower level of PPF levies
 - Much more control over the level of future pension contributions.

For employees, they will offer a more stable platform for income in retirement than can be achieved by the same contributions paid to a defined contribution arrangement.

Other types of risk sharing will continue to be possible by combining defined benefit and defined contribution as in the past.

- However, a new vision is needed to engender renewed interest and confidence in occupational arrangements. We believe that it is important to obtain the support of both employers and employees and indexation of benefits is probably an important element in this, but targeted and backed by prudent reserves rather than as a defined benefit.
- To avoid confusion with what has been meant by defined benefit in the past, a new name is required to accommodate ‘targeted indexation’ – shared risk schemes. Whilst initially this will be seen as a new third category of scheme, in practice it will facilitate an orderly transition from two categories (defined benefit and defined contribution) to two categories of shared risk and defined contribution. Defined

benefit with mandatory indexation of pensions before and after retirement will become a benefit enjoyed by a small minority of employees in the private sector within a very few years. This is what has happened in The Netherlands, where over 90 per cent of private sector occupational schemes are 'conditionally indexed' (interestingly, because of investment and longevity risks there are also very few defined contribution schemes).

- A new shared risk category will enable the accounting standards bodies to be engaged with a view to shared risk schemes being subject to accounting requirements which could be more attractive to finance directors than defined benefit schemes.

The ACA 2007 pension trends survey (to be published shortly), completed by 336 organisations of all sizes, found that 72 per cent of employers were in favour of the promotion of new risk sharing types of arrangement as an alternative to employees taking 100 per cent of risk. So it is clear there is interest amongst employers without any concrete proposals being widely publicised to date.

Limited Price Indexation

The ACA strongly supports the removal of mandatory indexation of pensions in payment in respect of future service within a defined benefit scheme. Employers should still be able to provide non-discretionary or discretionary increases to pensions in payment reflecting the financial condition of the scheme.

Revaluation

The 5 per cent per annum cap on the revaluation of early leaver defined benefits between the date of leaving and normal pension age should be reduced to 2.5 per cent per annum in respect of future leavers. This change would be consistent with the reduction for pensions in payment brought in by the *Pensions Act 2004*.

Normal Pension Age

New scheme designs should be allowed whereby normal pension age (NPA) can be increased to reflect increases in life expectancy, subject to certain safeguards for members, in respect of past service as well as future service benefits. We would also suggest protection of older members e.g. no change would be permissible for a member within 10 years of normal pension age. As regards existing pension schemes, it is recognised that introducing an ability to increase NPA in respect of past service benefits would be a difficult concept for many to accept (and indeed there may be human rights legislation that would render this difficult to enact) – even though there seems to be a general acceptance that State Pension Age can be increased retrospectively to reflect increased life expectancy. On balance, like the authors of the consultation paper, we do not believe that this is an appropriate change to make to legislation.

Reference Scheme Test

In passing, we note that for schemes that are contracted out on a reference scheme test basis, the value of reference scheme test benefits now significantly exceeds the value of SERPS/SSP benefits that the scheme is seeking to replace. Our view is that the reference scheme test should be revised downwards, particularly as schemes may seek to increase their normal pension age.

Legislative Override

In general, our view is that it should be permissible, within the normal constraints imposed by employee protection legislation, for benefits to be changed for future periods of service. We are also comfortable with the ability to make adjustments to benefits of past periods of service under the terms of s67 of the Pensions Act 1995. We recognise that there are some special circumstances, as described in the consultation paper, when a change may not be appropriate.

We would like to see a process introduced under which pension scheme trustees could, in specified circumstances, accept an employer's proposal to change scheme documentation. Alternatively, if the Government is unhappy to leave this to scheme trustees, we suggest introducing a process where, if an employer wished to make a change overriding the scheme's existing legal documentation, it would make an application to, say, the Pensions Regulator. The Regulator could decide whether such a change was appropriate in all the circumstances, possibly setting specific requirements.

Either of these approaches would be preferable to trustees having to obtain clearance from the Courts, as currently required.

Principles-based Regulation (including disclosure)

We are in favour of legislation that is principles-based provided that this results in a significant reduction in the amount of legislation or quasi-legislation. For example, although some parts of the Pensions Act 2004 have resulted in relatively little in the way of Parliamentary acts or regulations, the legislation has been supplemented by extensive codes of practice and other guidance. We would suggest only implementing changes in areas where significant parts of existing legislation are to be removed completely.

Pension disclosures are a case in point. While not entirely straightforward, the existing pension disclosure requirements are now generally well understood and have been implemented in pension administration systems. Any change, even if it is a change to reduce some aspects of disclosure, will incur implementation costs for pension schemes.

It does need to be recognised that moving to a principles-based approach will lead to occasions when two sets of trustees, facing the same issue in the same circumstances, may reach somewhat different conclusions.

Individual Trustees

We concur with the view in the consultation document that it is becoming more difficult to recruit individual trustees. This will become more problematic as schemes mature to the point that there are few, if any, employee members. All of the reasons given in the consultation document have some effect on reducing the number of people willing to become trustees.

In general, trustees are stepping up to the mark, and are doing their best to comply with requirements relating to their knowledge and training. In this connection, we find comments by some that suggest that Trustees should be experts, particularly in the investment field, to be unhelpful.

Return of Surplus

We have some sympathy with employers who are concerned that surplus assets may build up within pension schemes and not be recoverable by the employer. We note that the problem is likely to be far less pronounced in cases where schemes remain open to new joiners (or at least to future accrual of pension). We also note that the use of an escrow account can give the employer a mechanism, albeit a less tax-efficient one, for the employer to retain control over contributions that are not ultimately needed for pension provision.

We agree that there will be times when it is appropriate to allow employers to take a refund of surplus. The employer should have a right to a refund of the excess if a scheme has a solvency level of over 105 per cent calculated using an actuarial basis consistent with that used for s179 valuations, but valuing full rather than PPF benefits. In addition, sponsoring employers should be able to apply to trustees for a surplus refund if the funding level exceeds the statutory funding objective set by the trustees under the scheme funding regime.

In the latter case, given that the circumstances will vary from scheme to scheme, our view is that refunds would have to be overseen by, for example, the Pensions Regulator. The Regulator might, for example, take account of the investment strategy retained by the Scheme after a refund – schemes with more volatile investment portfolios would have to fund to a higher threshold. The Regulator might also want to take into account past and proposed practices in relation to payment of discretionary benefits.

Section 67

In our view, the general principles underlying Section 67 are appropriate i.e. changes to scheme benefits should only be permissible if the actuarial value of benefits is preserved under the change, unless each individual affected member consents to the change.

Having said this, the length of the current legislation seems over the top compared to its predecessor, and we believe there must be some possibility for streamlining.

Employer debt

The employer debt legislation as it affects multi employer schemes can create significant difficulties in a group's normal operations. We have seen cases where rational rearrangements of a company group are not possible, because they would trigger a significant additional payment to the Scheme.

In our view, it would be reasonable to add an alternative possible arrangement to the current ones of paying the full debt for the withdrawing employer or setting up a withdrawal arrangement. We suggest that it should also be possible for all of the remaining employers to take joint and several liability for the scheme funding, with no immediate requirement to make additional cash payments.

It is possible that the withdrawal of an employer might result in significant assets no longer being available to the trustees, if, for example, the business was sold by the group. In these circumstances, if the remaining companies are inadequately funded, we would expect it to be possible for the Regulator to issue a financial support direction (or in some circumstances a contribution notice) to safeguard the scheme funding.

FRS 17

As the consultation paper mentions, the International Accounting Standards Board has greater responsibility in setting pension accounting standards. The UK Accounting Standards Board is generally inclined to follow the IASB. As the IASB is beyond the Department for Work and Pensions' control, the DWP role will probably be restricted to lobbying the IASB. This is, no doubt, an issue which the DWP will wish to keep under review, given that the IASB is actively reviewing the pension Accounting Standard IAS19, and may well make significant changes in the coming years.

Given the proposals herein in respect of shared risk schemes, it will be important to engage with the accounting standards bodies to ensure that these schemes are subject to accounting requirements that are appropriate and which could be more attractive to financial directors and other stakeholders than for defined benefit arrangements.

Appendix 2

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.

**Ian A Farr
Chairman
Association of Consulting Actuaries**

26 March 2007

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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.

26 March 2007

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Appendix 3

SHARED RISK SCHEMES: QUESTIONS AND ANSWERS

We detail below a number of questions about *shared risk* schemes and answers, which we hope you will find helpful in understanding how they work and the context in which they would operate.

Question: The Government is improving the ‘defined benefit’ Basic State Pension for all. Isn’t this enough to ensure a good minimum pension for all?

Answer: Although the proposed improvement in the Basic State Pension (BSP) is welcome, the BSP and reformed State Second Pension will still only meet the very basic day to day essentials for most pensioners.

Question: The Government is also introducing auto-enrolment into personal accounts or company schemes. Won’t this bridge the gap?

Answer: The level of contributions into money purchase schemes remains a worry. The Government’s proposal for personal accounts is, effectively, an 8% total contribution on earnings between £5,000 and £33,500pa. Most company money purchase schemes also attract total contributions of around this figure. For many people, the emerging pension benefit from contributions at this level will be very modest indeed.

Question: So why not just encourage higher contributions to money purchase schemes?

Answer: The key snag with money purchase schemes is that the individual is exposed to investment risks on their own and generally does not have the benefit of, or protection from, being able to share these with the employer or other members of the pension plan.

This is a particular worry for low to modest earners: personal accounts and many existing company pension schemes place 100% of the investment risk with members and the pension depends on the amount of the fund at retirement built up by the investment of contributions for the individual and on the terms for annuity purchase from an insurance company at the time of retirement.

Typically the amount of an individual’s money purchase pension fund will be volatile, the contributions having been accumulated in equity-type investments. This can mean bad news for those retiring when equity markets are low, particularly if annuities are expensive because real interest rates are low. In fact, pension payouts have fallen by about three quarters over the last 10 years. Someone retiring now with a money purchase pension could be 75% worse off than someone paying the same contributions each month, but retiring 10 years ago (source: Watson Wyatt).

‘Lifestyle’ investment strategies can help dampen the volatility but only when retirement happens after pre-planning some years in advance. In reality, retirement can often arise without

much notice. Removing volatility can be achieved by investment in bonds but at the price of a lower expected investment return over the long term.

Question: So the new personal accounts are a bad idea?

Answer: Certainly not. For many employees of smaller firms, personal accounts offer the opportunity for the first time to build a modest pension on top of their State pensions. However, employees are taking all the investment and longevity risk, because personal accounts are a money purchase arrangement.

Question: Why should the Government encourage the development of shared risk schemes alongside personal accounts?

Answer: Employers offering shared risk schemes would be able to provide their employees with a much more stable platform for income in retirement than would be achieved by the same contributions paid to a money purchase arrangement – through the sharing of risks.

Shared risk schemes will offer larger employers, who cannot afford or are unwilling to take on the long-term risks associated with a balance of cost defined benefit scheme (eg the typical sixtieth final salary scheme), a new ‘third way’.

The recent Purple Book survey (December 2006) by the Pensions Regulator and the PPF found only 31% of defined benefit schemes are now ‘open’, which readily indicates the need for initiatives to promote good company provision that can be afforded into the future.

Question: But will employers accept the open-ended financial costs of shared risk schemes?

Answer: Not without new help and encouragement from government. Pension schemes thrived in the past when there were “safety valves” to control unexpected increases in costs. These need to be restored. **Importantly, shared risk schemes would offer employers the ability to control costs into the future by way of the ability to increase normal pension age or to hold back targeted indexation of benefits until the scheme could safely pay such benefits.**

The growth of shared risk schemes in the private sector would go some way to addressing the significant gap which has arisen between pension provision for private and public sector employees in recent years.

Question: It’s already possible to design risk sharing schemes under current legislation. Why is there a need to change the law?

Answer: 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 (money purchase), where all the risks are borne by the employees.

For example, current legislation does not permit a scheme to raise pension age retrospectively to reflect improving longevity (although the State can and is doing this for State pension age)

Those few 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. Alternatively, risk sharing has had to be provided by the employer establishing two schemes – one with defined benefits and one which is money purchase.

A new category of shared risk schemes, sitting between the existing categories of defined benefit and defined contribution schemes, would allow a radical extension of risk sharing and encourage new creative benefit designs.

Question: So why not just introduce new relaxations for defined benefit schemes?

Answer: This is easier said than done. It would be fair to allow defined benefit schemes to be more flexible, but the existing legislation which prevents retrospective changes to defined benefit schemes would be difficult to amend.

Having considered different ways of extending risk sharing, the ACA has 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 on the main legal changes to facilitate the introduction of shared risk schemes and they are surprisingly small in number.

Question: Are there really companies willing to introduce shared risk schemes in spite of the financial headaches they've had with defined benefit schemes in the last few years – haven't they had their fingers burnt once too often?

Answer: There have always been good employers willing to provide employees with good pensions, and they are still there. They now deserve support and encouragement.

A recent survey found financial directors at over half of companies offering their employees money purchase schemes said their schemes were not generous enough to provide their staff with an adequate pension in retirement (source: Fidelity International).

Many companies want to offer their employees the opportunity of a more stable platform of income in retirement than is possible through defined contribution/money purchase arrangements – but without the exposure to the full risks of defined benefit schemes. They continue to appreciate the recruitment and retention benefits that come from offering a good pension scheme, but cannot safely offer a defined benefit scheme given the potential forward financial risk involved.

Establishing a new shared risk scheme would enable an employer not only to create a benefit design with a level of risk it felt able to afford, but also to reduce the overall quantum of benefit if absolutely necessary. It is envisaged that such a need would only be required on an occasional basis.

Question: So the new shared risks scheme will not be as good as the traditional defined benefit schemes?

Answer: They are unlikely to match the traditional sixthly final salary schemes, but these new types of schemes will provide good benefits. The new improved State pension with a risk sharing benefit on top will provide a good standard of benefits. And there would be nothing to stop members themselves funding additional pension on top of this stable platform, on a money purchase basis, giving them their own choice between spending their earnings on consumption today or saving for tomorrow.

Question: So remind me, how do the new schemes differ from the traditional defined benefit schemes?

Answer: The main difference which new shared risk schemes offer employers from the requirements of defined benefit schemes is that only accrued benefits (including past revaluations and pension increases) are treated as defined benefits whilst future revaluation and pension increases are targeted.

Although the targeted future revaluations and pension increases would have to be backed by reserves assessed using prudent actuarial assumptions, the difference between them being treated as targeted rather than as defined benefits allows more freedom for investment strategy and a lower level of debt for the employer in the event of the scheme being wound up.

Question: If longevity improvements continue as in recent years, how would shared risk schemes protect employers from ever increasing costs to meet, on average, members enjoying longer periods in retirement?

Answer: An employer running a new shared risk schemes would be able to increase normal pension age under the scheme to reflect increasing life expectancy, provided there is objective evidence contained in a report from the scheme's actuary.

Question: So when a member reaches retirement age he finds he suddenly has to wait a couple more years for his pension?

Answer: No. An increase in normal pension age would not be allowed for members who were in receipt of pension or who were within 10 years of reaching normal pension age. The Pensions Regulator could also disallow the increase in normal pension age if the evidence to justify the change was deemed insufficient.

Question: Would members' pensions be protected if the sponsoring company collapsed behind a shared risk scheme that was not fully funded?

Answer: The ACA's proposal is that new shared risk schemes be covered by the Pension Protection Fund. The level of protection afforded we recommend should be 100% of accrued benefits, including past revaluations and pension increases, but not future revaluations or pension increases (as they are targeted not defined benefits). This is a higher proportion of accrued benefits than for defined benefit schemes where the protected benefit is 90% and is subject to a cap (but with future revaluations and pension increases generally being payable).

We propose that the PPF levy for new shared risk schemes is calculated separately from existing defined benefit schemes and be held in a separate fund. This is because the levies should be much lower than under defined benefit schemes, due to the nature of new shared risk schemes. There should be no cross-subsidy of existing defined benefit schemes from the levies paid in respect of new shared risk schemes.

Importantly, as the targeted future revaluations and future pension increases under new shared risk schemes have to be backed by reserves assessed using prudent actuarial assumptions, it would be most unlikely for such schemes, which had been in existence for some years, to be a call on the PPF. This is because the scheme's fund at the time of wind up should be sufficient to secure, through the purchase of non profit annuities from an insurance company, most of the potential future revaluations and future pension increases.

Question: What makes a shared risk scheme any better than a defined contribution scheme for members, particularly if contribution levels are much the same?

Answer: 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 should form a much more stable platform for income in retirement than would be achieved by the same contributions paid into a money purchase/defined contribution scheme.

Question: Isn't defined contribution better for a job market where individuals change jobs frequently?

Answer: No, because, like defined contribution schemes (and differently to defined benefit schemes), under new shared risk schemes there is no difference between the pension provided for each year of service for stayers or leavers.

Furthermore there is little evidence in most sectors of the economy to suggest that people do change employment more often than they used to.

Question: Defined contribution schemes are simple to understand with individuals able to identify their 'pot'. Aren't shared risk schemes likely to be complicated for members to understand?

Answer: New shared risk schemes should be capable of being explained clearly to members, and it will be important that they are.

The new schemes would have to comply with all the new requirements for keeping members fully informed of their benefits.

It is questionable how many members of money purchase/defined contribution schemes understand what their scheme pension may be. They may be aware of the amount of money in their 'pot', but how much is understood about the effect of future investment returns and the terms for converting the fund into pension at the time of retirement?

It is important to take up the challenge of good communication to members of all types of scheme.

Question: Final salary based defined benefit schemes have sometimes appeared to favour 'fat cats' and those with large pay increases towards the end of their career. Will shared risk schemes be any fairer?

Answer: The pension from a new shared risk scheme will reflect an employee's average earnings during the period of scheme membership up-rated by reference to price inflation (but subject to a 2.5% pa cap).

The benefits earned for each year of pensionable service are the same for a scheme member who remains until retirement or leaves service long before retirement, unlike in a final salary scheme.

Question: Final salary schemes have the benefit of being easy to understand and scheme deficits are reportedly falling rapidly. Won't companies re-open 'closed' schemes to new members, particularly if the Government agrees to ways to cut back on the costs of such schemes?

Answer: If deficits are removed, some employers may well think again about re-opening their final salary scheme. After all many of these schemes started because the previous money purchase schemes failed to deliver good or reliable benefits. However, given recent experiences many others will be unlikely to take that decision because of the long-term financial risk involved.

What the ACA is proposing is a new 'third way', where costs can be controlled, which will increase the likelihood of employers being prepared to offer a stable platform for the retirement income of their employees.

The ACA hopes the Government will introduce measures that meaningfully ease the costs and obligations placed on employers offering defined benefit schemes, but, even should this happen, it is judged many employers will remain unwilling to take on the forward risks associated with defined benefit schemes.

Question: Shared risk schemes would require regular actuarial advice to ensure that actions are taken by companies to adjust contributions or benefits. Aren't they just an innovation for actuaries to replace the loss of defined benefit schemes?

Answer: That would be a terribly cynical, and negative, view.

Actuaries advising a company must offer advice that is in the best interests of that client, reflecting the client's financial commitments, human resources strategy and other factors. On many occasions, the present advice will be to introduce a money purchase scheme to replace a defined benefit scheme.

The proposal for new shared risk schemes is meant to be non controversial and non party political. It is a well-intentioned attempt by the ACA to re-energise employer sponsored occupational pension schemes in the UK, learning from the lessons of the past, by allowing costs to be controlled whilst also looking to provide a good, stable pension for members.

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