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Ruth Saunders
Deregulatory Review
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Dear Ms Saunders

DEREGULATORY REVIEW – GOVERNMENT RESPONSE

I am writing on behalf of the Association of Consulting Actuaries (ACA) in relation to the Government response to the Deregulatory Review of Private Pensions.

Members of the ACA provide advice to thousands of pension schemes, including most of the country's largest schemes. Members of the Association are all qualified actuaries and are subject to the Code of Professional Conduct of the Faculty and the Institute of Actuaries. Advice given to clients is independent and impartial. The ACA includes the Scheme Actuaries to schemes covering the majority of members of defined benefit pension schemes.

The ACA is the representative body for consulting actuaries, whilst the Faculty and Institute of Actuaries are the professional bodies.

Private sector employers are continuing to decommission the defined benefit pension schemes which have historically provided comfort and security in retirement for millions of pensioners. The outcome, changing to provide defined contribution schemes, which transfer all risk to employees, is not in the best interests of the majority of UK employees. We are extremely concerned that Government appears to believe that there are no measures it can take that will materially change employers' behaviour. We are convinced that by lightening the bureaucratic burden under which defined benefit schemes operate and by changing the law to facilitate risk sharing schemes, the current decommissioning process can be halted and hopefully reversed.

We are therefore disappointed that the Government has not yet fully seen the merit in extending choice under the current pensions regime to remove the ban on employers offering **conditionally indexed pension schemes**.

However, we are encouraged that further views have been sought on how risk sharing schemes could be extended by way of the consultation within the 22 October paper. We have responded fully on this consultation in the appendix (**attached**). Separately we have asked the Association of Pension Lawyers (APL) to provide a second paper to DWP on the legal issues that inhibit the take up of risk sharing schemes other than conditionally indexed schemes, the latter being covered by the APL paper of 26 January 2007.

We support the other changes that the Government has proposed or is considering, namely:

- Reduction in the cap for revaluing deferred rights, as a means of returning the cap to a level which provides a level of protection to members equivalent to pensions in payment;
- Introduction of a statutory override for scheme rules;
- Agreement on some easing in the rules whereby employers can recover surplus
- A move to principles-based regulation; and
- A change to permit trivial commutation (although some greater vigour is needed to resolve the problems that have been raised by the industry and individuals in a timely manner).

We believe that these are all proportionate changes.

The reduction in the deferred pension revaluation cap will have some impact on costs and so will give some additional incentive to employers to retain existing defined benefit and shared risk schemes, or to establish new ones.

However, much more fundamental changes are needed to reverse the flow of closures. Virtually all actuarial consulting firms we have consulted say the deregulatory proposals to date are insufficient to encourage the continuing provision of high quality pensions. Virtually all say more freedom is needed in benefit design of occupational schemes than is possible under current legislation. Moving to principles-based regulation is a start, but the scope needs to be significantly wider than legislation affecting disclosures. Changes which merely transfer regulations to compulsory guidance are not helpful. A much more substantive move to simplify and cut back pensions legislation is required, coupled with the need to remove restrictions on employers to offer different types of schemes such as **conditionally indexed pension schemes**.

Yours sincerely

Ian Farr
Chairman

Enc: Appendix on risk sharing schemes

Appendix: ACA response to DWP consultation (22 October 2007):

New Pensions Bill needs to remove the ban on employers offering conditionally indexed pensions

Introduction

The big question that has to be asked, as the Government prepares its legislation, is whether the proposals in the DWP response to the Deregulatory Review of Private Pensions (22 October 2007) will be enough to maintain and extend good pension arrangements?

This ACA response to the consultation on 'risk sharing' argues that there is a danger that the Government is under-estimating the scale of the decline in occupational provision in the private sector.

Only about 900,000 private sector employees are now members of open defined benefit schemes – under a half of the number reported by the Pensions Commission just 2 years ago. Urgent and convincing reform measures beyond those intimated to date are needed in the forthcoming *Pensions Bill* to address the decline in occupational provision.

These measures need to be implemented ahead of the 2012 introduction of personal accounts, otherwise little good private sector provision will be left open, certainly to younger and mid-career employees.

The ACA, supported by a legal changes paper prepared by the APL (dated 26 January 2007), has provided Government with the blue-print of how it can extend good private sector occupational provision by allowing employers to offer **conditionally indexed pension schemes** – risk sharing schemes - that will help close the widening pensions gap between private and public sector provision.

This briefing summarises the rationale behind this recommendation and how such schemes would work.

Government strategy is well meaning, but that's not enough

Aside from the public sector, where more employees each year (presently over 5 million) are protected by defined benefit occupational pensions, Ministers will be aware that occupational pensions for private sector employees – particularly final salary defined benefit schemes – are covering fewer and fewer employees as each year goes by. That trend has been apparent for a number of years and, amongst other issues, led to the appointment of the Pensions Commission.

In 1995 there were 5 million employees of private sector firms in open defined benefit schemes. By 2004, the number was down to 2 million. **ACA latest figures – collected in November 2007 – show this figure is down to around 900,000.**

The Government has recognised that at the same time as promoting personal accounts aimed at low to middle income groups, it is important to protect and promote the occupational pension schemes offered by many private sector employers.

The Government recently announced its initial conclusions from the work of the Deregulatory Review, whilst at the same time asking for further input on issues like the best way to encourage more risk sharing schemes to be opened.

The scale of the problem...

The reality is that few private sector defined benefit occupational schemes are now open to new employees. ACA surveys conducted earlier this year and this month confirm **fewer than 20% of defined benefit schemes are now open to new entrants.**

Without urgent Government action, the next phase – closure of future pension accruals for existing members (which is already underway, **with now around 20% closed to future accrual**, up from 14% earlier this year) – will occur as employers look to close off the unacceptable costs and forward risks associated with defined benefit provision as it is presently organised under UK legislation.

Much of our occupational pension legislation is serving no better purpose than managing the orderly decline of a once widely applauded British success story. In short, defined benefit legislation is no longer 'fit for today's world'.

At present, employers wishing to cap their pension costs have in the main taken the simple decision – to move their employees into defined contribution schemes, where employees take on 100% of the longevity and investment risks.

Whilst a few employers have steered their way around current defined benefit legislation to design hybrid defined benefit / defined contribution schemes, most have taken the view that such arrangements are overly complex to communicate. Others have questioned whether these solutions will stand the legal test of time in terms of challenges by employees should benefits be revised.

What is also clear is that many employees do not want to take on 100% of the investment and longevity risks associated with their pension and, in truth, many are ill-equipped so to do. This is particularly the case for those in lower income groups, but by no means exclusively so, where the volatility associated with defined contribution arrangements is a particular concern.

Whilst the number of employees in defined contribution schemes has increased as defined benefit schemes are closed, the overall picture today is that **only 44% of**

employers now offer any kind of pension scheme, down an alarming 8% on the picture just 2 years before (source: DWP Employers' Pension Provision Survey).

There is also increasing evidence of closures of trust-based defined contribution schemes as employers opt for more lightly regulated contract-based arrangements.

So is there an alternative to this picture of decay and levelling-down?

A better way: conditionally indexed schemes

Finding ways around legislation that has become inappropriate to meet current circumstances is no way to proceed. To move ahead on this basis is likely to mean the schemes lost will greatly out-number those where 'manufactured' solutions are arrived at under today's restrictive defined benefit regime.

We also think that it is 'pie in the sky' to suggest that a move to principles based regulation would somehow allow a great new freedom to employers to offer a whole new raft of pension arrangements. Principles based regulation is certainly supported by the ACA, but we do not believe that Parliament or the wider public really is prepared to move to principles based legislation in the pensions area.

The ACA has put to Government earlier this year a blue-print to update the defined benefit legislation currently in place to allow employers to provide a new type of risk sharing scheme called a **conditionally indexed scheme**.

The required changes to defined benefit legislation are simple and do not require a new layer or regime, as some have suggested.

Conditionally indexed schemes are the prevalent type of scheme in The Netherlands, where defined benefit provision remains robust and the dominant form of pension provision, ensuring more stable pensions for millions of employees into the future.

For employers, **conditionally indexed schemes** enable costs to be capped reasonably into the future, despite changes in longevity and financial markets.

For employees, these schemes offer a pension linked to average career earnings, indexed in deferment and in payment, save on occasions in exceptional circumstances when this is against the long-term financial health of the scheme.

Thereby, unlike defined contribution schemes, where investment and longevity risks are placed squarely on the shoulders of employees, risk is shared instead between employer and employee.

So how do conditionally indexed schemes differ from final salary defined benefit schemes?

First, the similarities: if the legislative amendments were made to allow for **conditionally indexed schemes** to be offered by employers, **both types of schemes would fall under the same defined benefit regime we presently have.**

They would both be regulated by the Pensions Regulator, would both be required to support past and future benefits including indexation by prudent reserves under the new scheme funding rules and would both offer protections to members in terms of access to the Pension Protection Fund should the sponsoring employer fail. Importantly, such schemes offer the prospect of higher investment returns over the long term, and therefore lower costs, due to fewer constraints on investment strategy.

The principal differences from current final salary defined benefit schemes would be that under a **conditionally indexed scheme**:

- **the level of pension would generally be geared to average career earnings** (already possible under defined benefit legislation), not final salary, and
- **deferred pensions and pensions in payment would be indexed, but with annual increases conditional on the health of a scheme's finances.** Typically, the index chosen would reflect price inflation, capped as at present. These schemes – because they would fall under the existing defined benefit regime – would be required to follow the tough new scheme funding requirements. Future pension increases would be backed by prudent funding reserves.

As new schemes, **conditionally indexed schemes** would also be designed from the outset to adjust the normal pension age to reflect changes in longevity, in the same way the Government has with the State scheme, but subject to actuarial checks that the adjustment was justified.

These **conditionally indexed schemes** are likely prove particularly popular with employers who have come to the decision to close their final salary schemes to future accrual. At present, the only real alternative being considered is the move to defined contribution. This effectively transfers 100% of the investment and longevity risks from the employer so that these risks are 100% placed on scheme members, irrespective of their financial acumen.

Instead, a **conditionally indexed scheme** would offer a new option to employers, which in many cases might better suit the delicate balance between financial control and human resources policies designed to retain and recruit good employees.

Conditionally indexed schemes would also be attractive to the mounting number of employers who are concerned about the volatility in the pension outcome for lower paid employees from their defined contribution schemes.

The 2007 ACA *Pension trends* survey found **76% of firms employing over 250 employees support the wider promotion of these types of risk sharing schemes.** A recent *Pensions Week* survey found similar levels of support for such schemes, with 81% of firms saying changes in the law were needed to promote these schemes.

So what happens if the Government and Parliament doesn't allow the 'conditionally indexed' option?

Some might have us believe that the tweaks to defined benefit regulation so far proposed via the Deregulatory Review of Private Pensions are enough to turn the tide.

There is absolutely no evidence to support this view. Rather, there is a huge amount of evidence showing that the decline in occupational pension provision is ongoing and extremely serious.

Closure of defined benefit schemes is particularly affecting millions of private sector employees in their early or mid-career and virtually all new employees.

The evidence to date suggests defined contribution schemes that place 100% investment and longevity risks on members are unlikely to fill the gap.

What certainly will be unsustainable as the years go by will be if good defined benefit pension arrangements are almost solely confined to the public sector.

As taxpayers, private sector employees – already on lower average salaries – will react at some time, certainly if tax rates increase. The contrast between the Parliamentary scheme or civil service schemes, for example, and the average scheme now offered in the private sector does not really bear close examination.

A failure by Parliament to grant an option for private sector employers and employees to help bridge the pension gap with the public sector by sharing pension risks would be un-forgivable. It would represent a major failure in pension public policy-making.

Doing nothing or not enough will not preserve existing private sector final salary defined benefit schemes – the cost and forward liabilities involved with these schemes (even if the revaluation cap for deferred pensions is reduced) will mean decisions to close will continue, but with these schemes closed off to all but a small minority of older employees.

Yes, there may be some wider pension coverage of employees via defined contribution schemes at some time. But placing 100% of investment and longevity risks on a wider band of lower paid employees will only extend the numbers having to grapple with a greater uncertainty over their level of pension in retirement..

Certainly, at present, the swing to defined contribution is all too often associated with low participation rates, the widespread use of inappropriate default funds by individual members lacking access to financial advice and contribution rates that will generally

deliver inadequate pensions. For many on lower incomes, the volatility in such arrangements and the level of means-tested benefits in retirement remains a very relevant issue.

Then, at some time, there is the need to buy an annuity, with all of the uncertainties this presents depending on market conditions at the time of retirement.

These are areas Parliament will have to think very carefully about when agreeing the detail of personal accounts in the forthcoming Bill.

Time for Government and Parliament to act positively

In this period running up to the finalisation of the detail of the proposed *Pensions Bill* **the Government needs to do much more than tinker with current legislation through deregulatory measures that are unlikely to have anything more than a minor impact.**

Opening up the option for the future for employers to offer good occupational schemes – **conditionally indexed schemes** – that share risks between employers and employees must be of the highest priority.

Paper produced by:

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