



***ACA says the Pensions Commission and Government need to recognise the value of risk sharing in new pension reforms...***

## **ACTUARIES SAY LOWER-COST RISK SHARING SCHEMES SHOULD BE PROMOTED IN GOVERNMENT'S WHITE PAPER ON PENSIONS REFORM**

**30 January 2006: The Association of Consulting Actuaries (ACA), ahead of a House of Commons adjournment debate on pensions reform (31 January), has expressed considerable disquiet with one of the Pensions Commission's key recommendations - the *National Pension Savings Scheme* (NPSS). The ACA says that better incentives to encourage employers to offer good low-cost schemes that share risks between employers and employees should feature in the new reforms as an alternative to NPSS. The NPSS could undermine existing (and better) occupational arrangements and will throw investment risk - which represents a huge variable - 100% on employees.**

"We said that we wanted to chew over the *National Pension Savings Scheme* proposal when the Report was published in November and we have probably grown more alarmed as each day has passed. As Lord Turner himself said in 2003 (*see Note to Editors*) DC arrangements of this type, even with lower charges, usually do not work well for the lower-paid due to the considerable investment-risk involved, which falls entirely on the individual," said ACA Chairman, Adrian Waddingham.

"Moreover, restricted investment choice is inevitable, with the risks inherent in this of poor performance. We are sceptical that the projections in the Pensions Commission Report represent an accurate picture of the possible variability of returns. And still, in many cases, the returns may merely offset any remaining means-tested benefits that those on low-incomes might continue to receive - still 30% of pensioners are expected to be on means-tested benefits by 2050. The NPSS also suffers from the fact that individual advice is not costed into the proposals."

The ACA 2005 *Pension Trends* survey found 69% of employers favoured public policy seeking a better balance of risk, rather than risk transfer to the individual, with 63% supporting encouragement of lower-cost risk sharing schemes. The ACA says that it is perfectly possible to promote a lower cost risk-sharing model for workplace pensions that would better protect particularly those on lower incomes from investment risk. The aim would be to build these 'new' workplace pensions on top of the proposed improved State Pension, offering benefits based on career average earnings, with

contribution levels of around 10% of earnings from employers and 5% from employees (lower contributions in early years, but rising in later years).

"Unless the Government, supported by the Pensions Commission, takes some brave decisions, risk-sharing pension schemes shortly will be open to pretty well only public sector employees. We think that is both morally and politically unacceptable to taxpayers not in the employ of government - many of whom earn far less than public sector workers these days."

But, says the ACA, for risk sharing to work, the Government will need to remove some high costs enforced by law and reinstate some of the safety-valves that made risk sharing schemes so attractive to employers and employees. For instance, as in the Netherlands where such schemes still prosper, the ACA says schemes should be able to hold back on pension increases to help reduce deficits. Existing schemes too should be offered a new financial incentive to retain provision if they offer a better deal than the NPSS, and be given the ability - subject to regulatory approval - of gradually adjusting benefits to reflect improvements in longevity.

Adrian Waddingham also said, "the complete absence of help for employers in the Turner Report may have hastened the recent closure of more pension schemes. It is incredible that Turner offers to help the State trim pension costs by increasing pension ages retrospectively, but does not offer the same help to hard-pressed employers."

The ACA adds that the tightening of the regulatory 'knot' on the present generation of risk-sharing defined benefit schemes must stop as it is forcing wholesale closures of good schemes to the cost of millions of employees.

The ACA says pending proposals by The Pensions Regulator that schemes should remove deficits within 10 years will add some £15 billion to £27 billion to annual employer pension contributions - an increase of 50% to 90% in annual contributions since 2004. "Greater flexibility in an environment where deficits are being artificially inflated by historically low long-term gilt yields is essential. The role of regulation in driving schemes to buy gilts at these prices must also be squarely addressed," said Adrian Waddingham.

The funding of scheme deficit proposals come hard on the heels of the announcement of a 2006/2007 Pension Protection Fund levy of £575 million falling on defined benefit schemes - monies that now cannot go towards building scheme assets.

Further comment on **pensions reform** and **scheme funding to remove deficits** can be obtained by calling:

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**Note to Editors:**

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

**The following is an extract from Lord Turner's speech on 'The Macroeconomics of Pensions' made to the Actuarial Profession made on 2 September 2003**

"What are the implications of this for risk management and risk sharing in private DB and DC schemes?"

First, in relation to DC schemes, it is vital that we seek ways of minimising the crystallisation risk which people face when they sell corporate capital assets and invest in the government bonds that predominantly underlie annuities. And of course we already have a flexible right to delay annuity purchase until 75, creating a considerable period of flexibility. But my hunch is that the flexibility is primarily used by higher income individuals, who have a range of alternative financial and property resources, while low-income people who need immediately to replace predictable wage income with predictable pension income probably tend to crystallise value in one go at around the time of retirement. We don't yet have facts on that hypothesis, and more work is needed to explore these issues, but I want simply to flag that the management of the crystallisation risk is an important public policy issue on which some creative thinking would be useful – particularly if a larger role for funded DC saving is the way forward.

Second, what does irrational equity market volatility imply for the desirability of the shift from DB schemes to DC? That shift is certainly progressing very rapidly. Nobody has perfect figures, but the Commission's best assessment is that something like 50-60 per cent of DB schemes, weighted by number of employees, are now closed to new members, and perhaps 10 per cent in addition closed to new accruals, and that closure is continuing rapidly. And that means that whereas today we talk of DB schemes with over 9 million active members – half public and half private sector – unless something changes, the picture in say 2030, will be one in which DB membership is almost entirely public-sector based, and in which DB benefits are enjoyed by only a small minority of the population, even taking into account spouse/partner benefits. This is a huge shift in risk bearing within our economy, particularly when combined with the proposed shift of pension provision from 60 per cent public, 40 per cent private to vice versa. Risk is simultaneously being shifted from state to private from DB to DC, i.e. from business to individual.

Is that OK? And is it inevitable? Some commentators would say yes and yes. They would say its OK, and indeed desirable because DC is better suited to a more flexible workforce, and because it faces individuals with better labour market incentives and specifically with incentives to retire later. And they would say its inevitable because the risks involved in a DB scheme are simply too great for employers to accept. But I think we can't be so sanguine. For while above a certain level of income and wealth, it is perhaps reasonable and inevitable for people to be exposed to significant risk, I think there are real issues about increasing numbers of relatively low income people being exposed to high return volatility, as state provision becomes more basic and as private DB provision retreats. If a significant element of private DB provision can be preserved, I suggest that that would be highly desirable. But for it to be preserved I think we will need to think much more flexibly about risk sharing within DB schemes:

and if we do, we may be able to construct DB schemes with the same favourable labour market incentives as DC.

Let me illustrate this point. In the classic final salary, fixed retirement age DB scheme, an employer absorbs three types of risks, and the employee absorbs none. The employer absorbs investment return risk, the actuarial risk of unanticipated increases in life expectancy, and the uncertainties of individual and aggregate salary progression. And from that risk absorption pattern follow the labour market effects. Because benefits are final salary related, and salary progression for the individual unknown, the treatment of accrued rights for transfer purposes is complex, and typically to the disadvantage of early leavers. And because retirement ages are fixed there are no incentives for later retirement. And looking at this threefold package, employers are concluding that the risks are too high and are switching entirely to DC for new members.

But we do not need to take an either/or approach. The big problem with DC schemes is the irrational volatility of return. And it would be possible to construct part DB part DC contracts which remove that risk from the individual to the corporate but leave the other two risks with the individual. It would be possible to structure pension contracts which assure workers a proportion of average salary rather than final salary, and which promise it at a retirement age not precisely fixed in advance. We could write a formula which said "the retirement age in the scheme is currently X, but this will increase each five years by two thirds of any increase in forecast life expectancy at 65 calculated by GAD". And if we did create such contracts we would remove the inflexibility of DB schemes in the face of rising life expectancy, remove a significant element of risk, and make it easier to create incentives for later retirement.

And I suggest we should be encouraging employers, and actuaries should encourage employers, to think of these intermediate approaches, or of other varieties of intermediate or hybrid risk-sharing approach. Because if we do not think of these intermediate approaches, the alternative is almost bound to be a continuation of the shift to DC pure and simple. And that implies a challenge, for instance, for trade unions. Their instinctive reaction will be to oppose any such flexibility in retirement ages, whether these are formula based as I have suggested here, or based on occasional step changes as is being proposed by several companies today. But effective opposition to retirement age flexibility in DB schemes could kill DB schemes entirely: insistence that employers take actuarial as well as investment risk will lead to them rejecting both, handing both risks to the individual in the DC scheme. If we want to maintain an element of private provision which is defined benefit at least in the sense of not being exposed to equity price volatility, we are going to have to think flexibly and creatively about the precise risk-sharing balance between employers and the individual."