

LORDS' PENSIONS BILL BRIEFING

Produced by the Association of Consulting Actuaries

The UK is the only country in the world where certain types of pension scheme in the private sector are required by law to index both pensions in payment and deferred pensions...

Pensions Bill: if quality private sector workplace pension schemes are to thrive again, ending the ban on 'Conditionally Indexed' pension schemes is a vital first step in 'freeing up' design

26 June 2008: The *Pensions Bill* is currently being debated in the Lords at its Committee stage. One of the amendments being proposed to the Bill, which is likely to be debated in the next week or so would end the ban on employers being able to offer conditionally indexed pension schemes. At a time when many private sector workplace pension schemes have closed or are on the verge of closure, this is an important and urgent reform that will provide employers with greater freedom to offer a quality pension scheme for their employees that is presently banned under overly restrictive UK legislation.

What do conditionally indexed schemes offer?

For those many mid-sized and larger employers prepared to share risks with employees¹, conditionally indexed schemes offer a pension arrangement that not only will attract and retain employees, but that also caps employers' costs into the future.

Conditionally indexed schemes provide employees with a far less volatile pension benefit than defined contribution schemes. Key features are:

- Pensions are based on career average earnings and pensionable service.
- Future pension increases are pre-funded, but are conditional on the level of scheme funding.
- Save on occasions when the scheme funding falls below 100% (the 'condition'), pension benefits would be indexed in line with a scheme specific index, typically inflation up to a 2.5% cap per annum.
- Restoring indexation would be the first priority when the scheme funding level rises above 100%.
- Employer contribution rates would normally remain stable whether the scheme funding level is below or above 100%.
- Funding would be based, as with existing defined benefit schemes, on the new prudent funding standards set by the Pensions Regulator, who would regulate such schemes.
- The schemes would be subject to a PPF levy securing further protection for members (but with lower levies based on the lower risk profile of such schemes).
- These are trustee-run schemes offering the prospect of higher investment returns over the longer term due to fewer constraints on investment strategy.

A full description of how conditional indexation schemes work is contained in the ACA's Written Evidence to the Commons Bill Committee. Advice on the legal aspects has been given by the Association of Pension Lawyers.

¹ ACA surveys in 2006 and 2007 have found over 70% of employers support risk sharing being promoted by legislation.

Why is the 'Conditional Indexation' amendment to the *Pensions Bill* so important?

Unless the ban on conditionally indexed schemes is removed, private sector employers who decide to review their current pension arrangements – which most will have to do – in the run up to auto-enrolment and personal accounts in 2012 will have no credible option for the future other than to choose defined contribution types of pensions.

Whilst 5 million public sector employees continue to enjoy open defined benefit (DB) schemes backed by the taxpayer, **since 1995 the number of employee members of private sector defined benefit schemes, open to new entrants, has declined from 5 million to just 900,000 now – and this figure is going in one direction only.**

In the UK, existing private sector DB schemes are largely final salary based (although 80% are now closed to new entrants) and must offer mandatory indexation of benefits. Mandatory indexation of pensions both before and after retirement in defined benefit schemes is unique to the UK. No other Parliament in the World has placed such an onerous obligation on private sector firms to take on an open-ended commitment in terms of the costs and liabilities involved.

Pension Bill will not stimulate quality private sector pension provision

We know of no employers or pensions organisation that feel the *Pension Bill's* deregulatory measures as they stand are in any way sufficient to stimulate retention of quality existing or new private sector pensions. The CBI has given support to the conditional indexation amendment as a valuable addition to the Bill, endorsing the backing already given by pension bodies such as the NAPF.

Why employers and employees cannot wait for conditional indexation

Unfortunately, if this legislative opportunity is lost to remove the ban on conditional indexation schemes, it is expected that the decline in defined benefit arrangements will continue. The need for all employers to review their pension offerings in the light of auto-enrolment and the introduction of personal accounts could mean, in the absence of credible alternative pension designs permitted under UK legislation, the near wholesale switch to defined contribution schemes will be completed in a matter of a few years.

Despite this very real danger of further losses in good quality private provision – a danger that the Government has consistently under-estimated, in the Commons Committee, Mike O'Brien, the Pensions Minister, argued that more time is needed to study conditional indexation. He proposed a 12-week risk sharing consultation that is due to end on 28 August 2008. However, the consultation paper – which stretches to over 100 pages – gives no commitment to 'free up' pension designs and there was no mention in the draft Queen's Speech suggesting legislation could be expected next year. Given the amount of detail and questions which the DWP has chosen to include in the risk sharing consultation, there is a very real danger that there will be an elongated debate over second-order issues. Meantime the loss of quality schemes will go on.

In fact, over the last two years there has been a very substantial amount of consultation on risk sharing in general - as part of the *Deregulatory Review of Private Pensions* - and on conditional indexation in particular. Over the last nine months, there have been numerous meetings with DWP Officials and with the Pensions Regulator to discuss how conditionally indexed schemes would work – no substantive arguments has been advanced and sustained against this benefit design, which works so successfully in The Netherlands.

There are some who oppose the conditional indexation amendment on the basis that, in their view, if it is passed virtually all open final salary schemes will switch to conditional indexation for future service. In our view, only a few employers will be tempted down this route. Rather, very many more employers who are about to close their final salary schemes to switch to defined contribution will instead, if the amendment is passed, have the option to switch to a conditional indexation scheme for the future, ensuring a more stable benefit platform for their employees.

Why ‘freeing up’ pension design should not wait

The detail of how conditional indexation schemes would work is, in reality, far more advanced than the detail of some aspects of personal accounts where, for example, the administration of collecting contributions and the charging basis are still very uncertain. However, the implementation of personal accounts legislation is not being delayed even though consultations continue on key aspects of the Bill. The conditional indexation amendment should therefore find its way into the Bill before it is finalised.

Importantly, under the amendment to the Bill:

- Conditional indexation would not apply to the benefits offered by existing types of defined benefit (DB) schemes – for simplicity, the amendment only applies to new conditionally indexed arrangements set up after the Bill becomes an Act.
- The amendment in no way stands in the way of existing types of risk sharing arrangements (although the reality is that very few have been taken up by employers due to the complexity and limitations of current legislation and the communication issues involved).
- The amendment does not stand in the way of other possible types of risk sharing arrangements that might be identified in the future by the present consultation, but which are not ready for this Bill.

Conditionally indexed schemes are the first important step in re-invigorating quality UK pensions in the UK – the only new form of risk sharing pension design that is ready to implement now.

Removing the ban on employers offering conditionally indexed pension schemes is a key first-step reform that needs to be included in this year’s Pensions Bill – personal accounts and the minor deregulatory measures in the Bill to date are simply not nearly enough to encourage good quality private sector workplace pensions.

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