

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 pensions in payment and deferred pensions...

New clause 5: ending the ban on ‘Conditionally Indexed’ pension schemes is a vital first step in boosting quality occupational pension provision

18 February 2008: This week, the Pensions Bill Committee will debate ‘new clause 5’ which proposes an amendment to the *Pensions Bill* that would end the ban on employers being able to offer new conditionally indexed pension schemes.

Why is the ‘Conditional Indexation’ amendment so important?

Unless the ban on conditionally indexed schemes is removed, private sector employers who decide to close their current pension arrangements 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 (DC) types of pensions.

Whilst 5 million public sector employees enjoy open defined benefit (DB) schemes backed by the taxpayer, **since 1995 the number of employee members of open private sector defined benefit schemes has declined from 5 million to just 900,000 now – and this figure is going in one direction only.** Existing DB schemes are largely final salary based and must offer mandatory indexation of benefits. **Mandatory indexation of both deferred pensions and pensions in payment 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 such an open-ended commitment in terms of the costs and liabilities involved.**

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. Since giving Oral Evidence to the Committee, the CBI has reviewed its position and now supports the amendment (see: *CBI email to Bill Committee dated 6 February*), endorsing the backing already given by the pension bodies such as the NAPF, the Society of Pension Consultants and ABI.

If the ‘conditional indexation’ amendment is rejected by the Bill Committee – and we see no reason why a political consensus should not embrace this initiative across all parties – then the continued switch to DC that will follow means Parliament will be held responsible (by not allowing more freedom in pension design) for the situation where 100% of investment and longevity risks will fall on the vast majority of private sector employees. In such a case, Parliament will also be held responsible for exposing millions of private sector employees to the volatility in pension outcomes that are associated with DC; volatility that, inevitably, will follow at some time over the years ahead.

What do conditionally indexed schemes offer?

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

A full description of how conditional indexation schemes work is contained in the *ACA’s Written Evidence* to the 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.

Conditionally indexed schemes offer to employees a far less volatile pension benefit than DC. Pensions are based on career average earnings linked to service. Save on occasions when scheme funding falls into deficit (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 a scheme returns to surplus.

Funding would be based, as with existing DB schemes, on the new prudent funding standards set by the Pensions Regulator, who would regulate such schemes, with PPF levies securing further protection for members (but with lower levies based on the lower risk profile of such schemes).

Importantly, under new clause 5:

- 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, but which are not ready for this Bill.

Why employers and employees cannot wait for conditional indexation

Some will argue that more time is needed to study conditional indexation and to consider it alongside other possible risk sharing options before proposing possible legislation some time in the future.

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 six 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.

Unfortunately, if this legislative opportunity is lost to remove the ban, it is expected that the decline in DB types of arrangements, coupled with the need of employers to review their pension offerings in the light of auto-enrolment and personal accounts, will mean the near wholesale switch to DC will be completed in a matter of a few years. Once done, the switch back to any form of risk sharing may be slow and difficult – with generations of private sector employees paying the price of a missed opportunity in this Bill.

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 charging basis are still very uncertain. However, 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 Act before it is finalised.

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. Country-wide, consulting actuaries, who advise the vast majority of employers who would take up such schemes, are ready to promote the new design opportunity as employers plan the shape of their pension arrangements in the run up to 2012.

Remove the ban on employers offering conditionally indexed pension schemes – vote for new clause 5.