

Hardly a week goes by without more companies announcing the closure of their existing pension schemes, increasingly to existing employees as well as to new entrants. And survey after survey this year – including the ACA's – has flagged up 'UK pensions in decline', but surely it's time for fresh thinking and alternative approaches to be taken seriously...

Workplace pensions: a new hope?

It's a stark fact, but if you work in the private sector, a good pension is becoming a scarce commodity. But, what do we mean by a good pension? For many, a final salary defined benefit scheme remains the benchmark – and certainly this remains the case in the public sector, where upwards of 5 million employees enjoy such a benefit. In truth, 'good pensions' can take many forms and, legislation permitting, 'good' pension designs can be shaped to suit employer and employee aspirations alike. Designs can achieve the dual aims of controlling employers' costs and reducing the volatility in pension outcomes, so feared by those approaching retirement. There's just one problem, in the UK, pension legislation has become overly restrictive in the pursuit of 'safety first', frustrating innovation and, thereby, damaging the pension future for millions of employees. This issue of *Placard* examines what is a genuine crisis in pension provision in the private sector and explores a number of ways in which that crisis can be addressed providing new hope.

The articles that follow necessarily approach our pension crisis from a number of viewpoints. Some look to clear changes in pension legislation that are commended to the incoming Government to be implemented in quick time after the forthcoming General Election, early in 2010. It is to be hoped the main political parties pick up some of these ideas to include in their manifestos – *Placard* will be monitoring how the parties respond in our special General Election issue, in which we will analyse the parties' commitments on pensions and savings.

Fresh challenges

Another article in this issue considers how the inevitable reductions in public spending over the years ahead might impact on public sector pensions, where quiet changes in some areas of provision are already underway and where greater transparency in identifying the true cost of forward liabilities is likely to hasten reform, as is the pressure to out-source services to the private sector.

And we also look at the one growth area in current provision – defined contribution schemes, where legislative reforms are

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Welcome to this Winter edition of *Placard*, the discussion journal of the Association. In this issue, we examine the immense challenges experienced by employers in supporting ongoing workplace pensions and a range of our members' views on what needs to be done to re-energise provision.

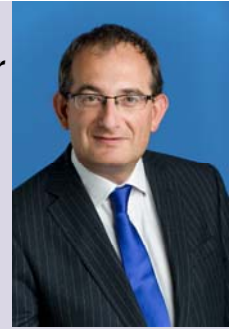
We continue to believe that auto-enrolment and the introduction of Personal Accounts from 2012 is not enough – indeed, there is evidence both are driving scheme reviews. This is why we are continuing to champion legislative changes that allow employers to offer a range of new 'middle-way' pension solutions, which would give a greater ability for employers to control costs whilst also allowing more employees to enjoy good pensions.

For more details about the Association's views, go to our website at www.aca.org.uk



Adam Gillespie, Editor

Until the late 19th century you worked until you dropped or your family looked after you. Could we now, in the early part of the 21st century be heading back to this rather unsavoury Victorian value?



The golden age of retirement provision has passed

By Jeremy Dell, Partner, Lane Clark & Peacock and ACA Main Committee

It has been more than a century since the advent of formal pension provision in the UK when the *Old Age Pensions Act 1908* was introduced, providing 70 year olds with 5 shillings (25p) a week. Over the ensuing 100 years the UK's pension system has, rather inadvertently, gone from being relatively straightforward to comprising a complex web of public and private provision.

Following on from the arrival of State provision, the end of the Second World War saw the widespread adoption of occupational pension schemes. Employers were motivated to set up retirement plans both through a sense of paternalism and – because people were starting to live longer – a desire to make room for younger employees.

However, rather than the initial recipients of occupational schemes being the greatest beneficiaries, it appears instead to be those individuals born during this period – the baby boomers – who look set to reap the rewards.

Many of those born during and immediately after the war are already in retirement and enjoying generous final salary pensions that provide incomes of which their parents would have been envious and their children incredulous. Today, the near death of defined benefit (DB) schemes, along with a shrinking formal State pension, has left the current workforce facing an uncertain financial future.

Retreat by the state

The State's commitment to securing retirement income has never been generous and for much of the last 30 years, its increasing parsimony, causing the basic and State second pension to become largely inadequate by themselves, has been justifiable only with the presence of good quality occupational pension schemes for those who have access to them, and complex means-testing for those that do not.

This trend was set to reverse, but only if you count Personal Accounts as within the State sector and only if you believe that it will succeed. Already the omens are not good. The current Government is again putting back the date of its full

implementation and has yet to address the fundamental weaknesses of the scheme. The official opposition will review the scheme entirely should it win next year's election.

Elsewhere within the State sector, pension provision is under attack. Whoever wins the election will have to face up to the fact that there is a huge deficit that needs tackling. Social security costs and public sector pensions will be far from immune to these pressures.

The shrinking role of the employer

And it's not just Government that has come to appreciate the true cost of providing people with an income in retirement. Employers, too, have recognised that keeping their pension promise under existing DB arrangements, with all the statutory restrictions on curbing cost and controlling risk, is no longer tenable. The promise is too expensive and too risky and employees often seem to undervalue it. Employers have therefore acted rationally.

According to the ACA's 2009 pensions trends survey, 87% of DB plans are closed to new members, while 18% are closed to all future accrual. And as the challenging economic environment persists and demands on company resources grow, the terminal decline in existing DB pensions can only continue. Not a week seems to go by without an announcement of further closures. Those in political circles who thought this time last year that the ACA were being Jeremiahs are regrettably being proved wrong.

Saver apathy

Retreat by the State and employers is a lethal combination. It is all very well extolling the virtues of individuals taking greater responsibility for funding their retirement but it just isn't going to happen.

Defined contribution provision is now the norm for workplace pensions; a situation which sees the transfer of all risk from employer to individual, placing a far greater responsibility on the employee.

However, there is widespread concern that many individuals are neither engaged in retirement savings nor furnished with the appropriate knowledge and support to make key investment decisions. While some employers are more than willing to offer robust DC schemes, with a wide range of choice to suit a diverse workforce supplemented by independent financial advice, for many companies the costs of such an arrangement are prohibitive.

And with the mind-numbing complexity of auto-enrolment and quality-assurance requirements on the horizon, which the Government is in a hurry to implement, there is a huge risk of levelling down or outright abandonment of good quality DC provision.

Consequently many individuals feel cut adrift and disconnected from retirement saving, leaving the UK suffering from a culture of 'spend today and save tomorrow'. Many people, in my experience, are so intimidated by the amount they need to save today to deliver a decent level of retirement income, and believe it would impact their lifestyle so significantly, they choose not to save at all. As such, many people could be facing a very difficult retirement.

Think hard or it's back to the future

With the Government averse to any loosening of the current system of regulation and no one willing to pick up the pensions tab, it is unsurprising the press describes the UK pensions system as 'in crisis'. It seems that the only way to meet this burden is for people to work for longer and postpone retirement until they really cannot continue to work or their families are prepared to support them. Chances are the UK's workforce will in future include a large proportion of those in their late 70s or even 80s who have been forced to continue in employment to make ends meet.

A society that requires its oldest citizens to work until such a late age because no one is prepared to foot the bill for their retirement is neither practical nor moral. And a return to the 1930s where older workers prevented younger generations from gaining jobs and progression is not commercially sound either. But this is where we are heading.

To avoid this, my view is that we need to re-engage employer interest. Any further pension provision should be applied in a way that works best for the employer and therefore should be free of most of the existing Department for Work and Pensions restrictions. We need to allow companies to apply their creativity to deliver a form of pension provision that is best for employer and employee, and in that way encourage companies to contribute more to their workers' personal savings.

What we really need from Government is vision; micro managing pensions and limiting the form of benefit provision cannot hope to improve the current position. We need incentives for individuals to save more and accumulate wealth while in work - ideally through tax incentives - and this should be supplemented with an insurance aspect that spreads risk across individuals so that benefit outcomes are not too widely spread, but are much more flexible than DB is today.

But is this just dreaming?

Re-invigorating UK private sector pensions

By Ian Farr, ACA Immediate Past Chairman



Final salary defined benefit pension plans have become unaffordable for most private sector employers in the UK whilst defined contribution (money purchase) plans have typically failed to provide the certainty of pension expected by their members. A pensions system which was once the envy of the world is now the subject of adverse criticism. The current Government's attempts at pension reform to encourage and protect good quality pension plans in the private sector have amounted to no more than tinkering around the edges. What is needed to re-invigorate private sector pensions in the UK is a change in mindset and a change in the law.

Change in mindset

It used to be that, if you worked for a major UK private sector employer, you could expect a pension, reflecting your period of service and your earnings near retirement, which would broadly maintain your standard of living in retirement. Such expectations cannot be sustained today. Given the significant increase in the cost of providing each £1 per annum of pension, an employee of a major private sector employer in the UK should nowadays expect a company pension which, along with the State pension, would meet the basic expenditures of life in retirement. The comforts and luxuries of retirement should be met from the individual's own resources – possibly funded in part by money purchase AVCs.

Consistent with such an approach is the pension funded by the employer being a lower proportion of the employee's earnings at retirement for those on higher earnings levels. The corollary is of course that the pension would be a higher proportion of the employee's earnings at retirement for those at lower earnings levels.

If the pension is to be capable of being reasonably predictable by the employee before retirement, a defined contribution (DC) arrangement is not the answer. Defined benefit (DB) plans, where the pension is based on the member's average earnings and service over the period of plan membership and up-rated to take into account price inflation, are coming back into fashion as a way of delivering a good basic level of pension. This 'career average' type of plan automatically produces a pension of a higher proportion of final earnings for employees whose earnings grow steadily throughout their employment compared to those whose earnings increase more rapidly. Capping pensionable earnings in real terms for high earners would be compatible with a philosophy of providing a good basic level of pension, and no more.

Changing the law

In the UK, the law divides company pension plans into either DB or DC. There is a different legal regime for each of these two broad categories of pension plan. That is one reason why the hybrid approach of a DB plan topped up by a DC arrangement is not attractive to employers – due to the expense and complexity of having to comply with two regimes rather than one.

Whilst the legislation applying to DB plans is more onerous currently than that applying to DC, the latter is catching up fast as the Government sees the amount of DC funds increasing dramatically and the Pensions Regulator becomes involved.

Private sector DB plans are in danger of being regulated out of existence. This is tragic given that this is the only type of plan which offers the member some predictability before retirement of the amount of pension likely to be paid at retirement. What is needed is changes to the law which allow employers greater freedom to design DB plans whilst keeping the security of members' benefits at an acceptable level.

There are two changes to the law which can be made in quick order and would create significant opportunities for private sector employers. They would allow the risks of adverse investment conditions and increasing longevity to be shared between employers and plan members in ways which the law currently prohibits.

Indexation of pension

The UK is the only country in the world which requires private sector DB plans to index pensions, both before and after retirement, in line with price inflation (subject to a cap). The first change to the law should be to remove this requirement for pensions in payment but only in respect of pension earned after the law is changed. If such a change is politically unacceptable, then conditional indexation should be allowed, whereby indexation is pre-funded but indexed increases can be withheld for a temporary period if the funding of the plan falls into deficit (and retrospectively made good when the funding returns to surplus).

Conditional indexation, particularly when applied to a 'career average' pension plan, would reduce significantly the risk of employer contributions having to be increased due to adverse investment conditions. This is because of the cushion

of the funding reserves held in respect of future pension increases. Members of the plan would enjoy a much more predictable pension than under a DC arrangement.

Importantly, the expected cost of each £1 per annum of pension could be significantly less than in a DC plan. This is due to the investment risks being pooled amongst all the members and investments only having to be sold when cashflow requires – unlike in a DC plan, where investments are earmarked to individuals and sold at retirement for an insured annuity.

Conditional indexation has for many years been the most common and successful form of pension provision in The Netherlands. And earlier this year, the OECD published a paper¹ which concluded that conditional indexation was the most cost-effective form of risk sharing for pension plans.

Changing normal pension age to reflect increases in longevity

Increasing the normal pension age, which is a key element in the design of a DB plan, to reflect increases in longevity should be non-controversial. It can be done as the law stands, but only in respect of pension earned during the period after the increase in normal pension age. Whilst this is a sensible protection for those where normal pension age is coming into sight (say in 15 years or less time), is it reasonable to require an employer to have to provide a 25 year old employee with a pension in respect of the next year's service payable from a fixed date 40 years hence? Employers are effectively being asked to underwrite the plan member's life expectancy from age 25. Given the uncertainties of the rate of increase in longevity, this is an entirely unreasonable proposition and one that the Government is not prepared to hold to in respect of State pensions. Therefore, the law should allow the normal pension age in a new DB plan to be changed retrospectively BUT NOT for those members in receipt of pension or with 15 years or less to go until the current normal pension age – in other words only for the young members who are very many years away from retirement. To

protect members, the law should require that any such increase in normal pension age would have to be justified actuarially by reference to actual increasing longevity.

The Government's consultation on conditional indexation

The changes to the law described above were considered by the current Government and a consultation paper was issued in 2008. In the end, the Government decided not to implement these changes for the reasons shown below. The ACA does not consider that the reasons given stand up to proper scrutiny and its comments are shown opposite each reason.

Government reasons against implementation- ACA's views:

- Significant additional regulation required - *but not according to leading pensions lawyers who worked with ACA.*
- Complexity would hamper member understanding – *surely could be managed and no more difficult than for either DB or DC plans.*
- Not sufficient demand from employers – *results of the very small Government survey highly questionable and not borne out by much larger surveys carried out by ACA.*
- Experience in The Netherlands rooted in Dutch industrial relations model – *but UK version based on the UK work and pensions environment.*
- No workable consensus apparent – *legislation is not always based on consensus; what is required here is leadership. Moreover, offering new choices – and conditional indexation need not be the only new option offered – does not require a consensus approach. The aim should be to offer a range of designs that employers can choose from suited to their business needs and the desires of their employees.*

¹Evaluating the Design of Private Pension Plans: Costs and Benefits of Risk-Sharing, OECD Working Paper on Insurance and Private Pensions No. 34, March 2009 www.oecd.org

Changes need to be made before 2012

Because of the impending auto-enrolment requirements and the dangers of levelling down associated with the Government's plans for new personal accounts, the changes to the law described in this article are needed before 2012. They can be made quickly and act as a stepping stone to further changes to free up benefit designs in due course. But urgency is of the essence. These are by far the most developed and thought through changes - which have been scrutinised extensively and no technical flaws found. They would help to save existing good quality pension plans in the private sector.

Also they would encourage those larger private sector employers, who can afford to take some risks but not all (as under final salary plans), to re-think the nature of the pension arrangements for their employees. Many of them may be attracted to a new way of providing a largely predictable pension at a level to fund just the basic needs of retirement. This could be an important step in the re-invigoration of pensions in the private sector in the UK.

Shake-up in pensions

By Raj Mody,
Partner and Chief Actuary,
PricewaterhouseCoopers LLP



Managing the costs and risks associated with what is frequently one of a company's largest creditors – the final salary pension scheme – is presenting challenges at every turn. With further tax and regulatory changes looming, the size of the challenge is set to increase and it is not surprising that news emerges on a weekly basis of household names making wholesale changes to their pension arrangements.

In particular, a growing proportion of employers are looking to change future benefits for current employees. This is being driven not only by the current economic climate and the need to reduce costs, but also by a desire to ensure value for money being spent on pensions is consistent with the employment package for the organisation overall.

Drivers for change

Companies are questioning how much their pension arrangements are costing and whether the organisation is getting good value for this expenditure. Drivers for change include:

- rapidly declining number of executives who still participate in defined benefit (DB) arrangements;
- desire to drive a culture of pay-for-performance;
- dealing with increasing 'pensions polarisation' between employees enjoying DB accruals and those who are not;
- increasingly diverse and flexible career paths;
- increasing need to flex how reward is provided to different individuals to reflect different wants and needs; and
- impact of the Finance Act 2009, proposed restrictions to tax relief from April 2011 and the introduction of auto-enrolment from 2012.

'Shake up' in pensions

PricewaterhouseCoopers LLP recently conducted a survey of UK employers, including 65 with over 5,000 UK employees and 33 of the FTSE100. The survey revealed that the cost and risk associated with pensions are still the main drivers for change but that the Finance Act 2009 is accelerating change in the UK pensions landscape.

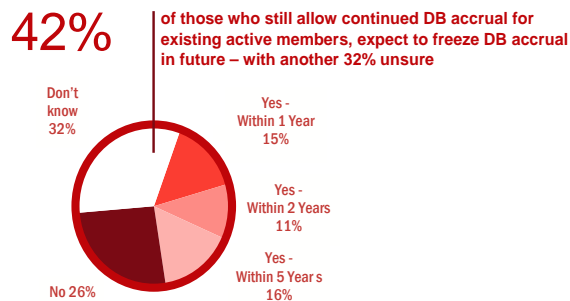
Survey findings revealed that some employers are losing motivation to offer workplace pensions beyond the minimum required under auto-enrolment, while others wish (in a relatively high-tax environment) to find ways in which they can help their employees build retirement savings for acceptable cost and risk. Companies will increasingly compete by offering employees understandable choice, ease of access and better value savings vehicles that they can obtain on their own.

Sustainability of defined benefit schemes

The survey found that 96% of respondents believed DB schemes are becoming increasingly unsustainable for UK employers and that fewer than one in twenty employers expect their DB schemes to be open to new members in five years' time. Further, only about one in five are saying they will not freeze future benefit accrual for existing members, potentially leaving UK businesses with a legacy of 'zombie' pension funds.

However, companies need to manage the closure or freezing of DB schemes carefully. While closure reduces future costs and risks, it can result in increased cash calls from trustees at a time when businesses are cash-strapped. That is why some companies are opting to keep their DB schemes open to future accrual while reducing benefit levels.

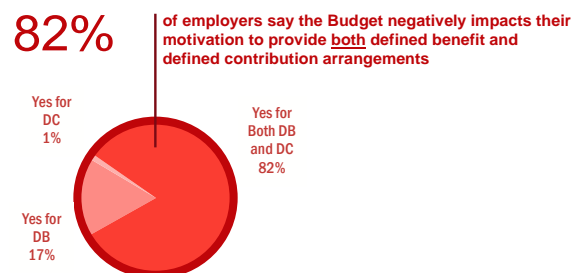
Scheme closures and changes



Budget 2009 - implications for pensions and reward PricewaterhouseCoopers LLP

The shake-up in pensions provision is now being extended to defined contribution (DC) offerings as companies re-evaluate the role that pensions play in overall employee reward and business strategy, primarily as a result of the Finance Act 2009 and subsequent proposed changes to higher earner tax relief.

Impacts both DB and DC arrangements



Budget 2009 - implications for pensions and reward PricewaterhouseCoopers LLP

The survey also provided interesting insight into other factors leading companies to make changes to their DB and DC company pension provision, as illustrated by the following chart:



What does the future hold?

With the demise of DB, we may see the UK catch up with the global trend for DC schemes, and eventually find itself finally on a par with the rest of the world. Countries like Australia and South Africa shifted away from DB to, in their case, pure DC some 25-30 years ago.

Larger employers may introduce a broader range of choice for people to receive the delivery of their reward, including for their retirement savings. The attractiveness of different delivery vehicles will depend on the employee's individual circumstances. This includes marginal rate of income tax and whether they are a 'higher-earner' caught by the proposed new restrictions on pensions tax relief that will essentially make pensions taxable as a 'benefit-in-kind'. Expect to see greater use of non-registered pension schemes (e.g. Employer Financed Retirement Benefit Schemes), share-based arrangements and a wide range of non-pension trust-based arrangements e.g. Employee Benefit Trusts.

Add in the auto-enrolment requirements from 2012 and we expect yet more changes in the overall nature of pensions reward. Some big name employers have recently launched SIPP (Self Invested Personal Pension) schemes to sit alongside their existing schemes, while others have adopted them as their mainstream vehicle. We may see SIPPs more widely become the choice of a 'top up' to the Personal Accounts Pension Scheme.

Conclusion

While this all sounds exciting, the reality is that the pace of enforced change is too much for most companies to bear. Action is needed to restore stability to the pensions savings system. Some employers have lost trust in the regulatory and fiscal framework governing pensions as they struggle to keep up with changes. And many employees have ceased to trust workplace pensions due to changes, coupled with a general lack of understanding of unavoidably complex arrangements.

As a result, less is being saved for employees' retirement, both by their employers and by themselves. While we have 'super protection' for defined benefit pension benefits earned to date, employers' motivations to provide quality retirement savings for the future continue to decline.

What will it take to resurrect employers' motivations to provide quality workplace pensions? For a start, pensions need to be depoliticised, and we suggest some kind of independent 'retirement savings panel' to become responsible for the pensions framework. It should have the authority to think the unthinkable and do the unprecedented – including overriding changes which give employers the option to alleviate legacy pension burdens imposed by previous legislative changes. However, as it would take some time to set up such a panel and for its influence to start having an effect, in the meantime some quick practical changes would be welcome.

Two ideas to get us started would include:

- Reduce the Annual Allowance instead of the new proposed restrictions on tax relief for higher earners from April 2011.
- For the Personal Accounts Pension Scheme, remove the cap of £3,600 a year on contributions and remove the ban on transfers from other pension arrangements.

Public sector pension schemes – the future landscape?



By Bart Huby, Partner, Lane Clark & Peacock LLP and Chairman, ACA Public Sector Outsourcing Committee

A recent Office of National Statistics survey showed that in 2008 there were 5.4 million active members of public sector defined benefit (DB) pension schemes, an increase from 5.1 million in 2006. Over the same period, active membership of private sector DB schemes fell from 3 million to 2.6 million, and this is undoubtedly significantly lower now a year later, following the recent wave of private sector schemes closing to future accrual.

So, where now for the public sector? Will it be able to justify continuing to offer DB pensions to its employees, once this becomes a genuine rarity in the private sector? If so, what will they look like, how will they be funded and how will their costs be assessed? And how will the pensions of employees be handled when the provision of public services is outsourced to the private sector?

These are very important questions for public sector employees and for the public finances – for both current and future generations of taxpayers. Yet their outcome is at present very uncertain, with public sector employees and unions typically keen to maintain something like the status quo, but a rapidly growing awareness amongst the general population of the potential future costs to taxpayers of providing for these pensions.

In his recent Pre-Budget Report, the Chancellor has proposed implementing "cap and share" reforms from 2012 to "limit the liability of the taxpayer as pensions become more valuable". However, there is very little detail on what this would mean in practice, and no indication that the growing divide between public and private sector pensions will be materially addressed under these proposals.

Rather than trying to use a crystal ball to predict the future, it may be more helpful to consider the main issues involved and what kind of solution may best address them.

Arguably there is nothing fundamentally wrong with providing public sector employees with DB pensions. Indeed they are likely to be a fairer and, in many ways more efficient, way of providing employees with a reasonable level of income in retirement, compared with the main alternative of defined contribution (DC) pensions. Furthermore, the public sector is much better placed than all but the very largest and most stable private sector companies to take a long view and meet the costs in a stable and structured way.

Unfunded issue

A significant issue, however, has been that, with the schemes' benefits generally being unfunded, their costs have not been transparently assessed or explicitly recognised in the public finances. Depending on how you measure them, the UK currently has unfunded public sector pension liabilities of in the order of £1 trillion – these are financial obligations which will have to be met by future taxpayers, in the same way as the interest and capital on gilts, but they do not form part of recognised public sector debt.

There have been significant reforms to the main public sector schemes in recent years to control increasing costs resulting from improved longevity expectations and falling interest rates. However, partly as a result of the lack of transparency, these reforms have been relatively slow and piecemeal. For example, while all the main public sector schemes have now moved to having a retirement age of 65 for new entrants, the large majority of current civil service and NHS employees, who joined before the changes, still retain a retirement age of 60.

So what are the key issues, and how can they best be addressed?

Appropriate, affordable and sustainable

The statistics point to an increasing proportion of older people in the population. The key to affordability and sustainability will be to provide an adequate, but not excessive, level of pension to employees from when they cease to be able to do their work, but no sooner. Employees wishing to retire early or to have a higher standard of living in retirement would need to save more themselves. The State, as employer, should aim to enable its employees to retire on a decent basic level of pension when they are no longer able to perform their duties.

What would such a pension scheme look like? Firstly, it should probably be DB, as this avoids the inefficiencies and perceived unfairness resulting from the "winners and losers" element of DC. Secondly, it should be career average rather than final salary, both to make the costs more predictable, and so that the employee's pension will more closely reflect their contributions throughout their career, compared with a final salary scheme. And thirdly, there should be a cap to DB pensionable pay, so that the DB risks being covered by the State relate to a basic level of income in retirement, with higher earners bearing the risks above that level.

Career average solution?

A possible example benefit structure might therefore be: a career average pension accruing at 1/60th per annum based on pensionable pay subject to a cap of £40,000 per annum in current terms; with DC provision for earnings in excess of this amount. Normal retirement age would be higher generally than now perhaps tying in with State Pension Age, which is currently set to increase to 68, but employees working in physically demanding jobs would be able to retire early on an unreduced pension – either as of right based on their job description, or subject to an occupational health assessment.

Such an arrangement, if achievable within a reasonable timeframe, and seen to be affordable and sustainable to the State, might perhaps even form the basis for a revival of DB pension provision amongst larger and more stable private sector employers. Particularly for the lower paid, DB pensions have considerable advantages in terms of practicality and fairness compared with DC. In recent years there has been a small but significant number of large private sector employers who have introduced redesigned lower-risk DB schemes which are open for new employees, recognising their value both in attracting new employees and in enabling them to retire long-serving employees at the end of their careers. If the State can set an example of an appropriate affordable DB arrangement for its employees, this might encourage many more private sector employers to go this way.

Proper recognition of the costs

Politicians generally find it difficult to view the costs of public sector pensions objectively. It is hard for Government to do so because of the impact on the perception of the state of the public finances, even though (or perhaps because) the cost is off balance sheet. This is also a very sensitive issue when cost control reforms of benefits and employee contributions are under consideration.

Might it therefore be better to place the assessment of the long-term cost of public sector pensions in independent hands, much in the way that inflation management was made the responsibility of the Bank of England rather than politicians in 1997? While there would still be a considerable element of judgement in assessing the costs, in particular regarding appropriate discount rates and longevity assumptions, an independent body (perhaps the Bank of England itself) could make these judgements without being directly concerned or influenced by political issues. Government would still be responsible for the benefits and contributions of the public sector schemes, and would be able to set policy based on independent objectively assessed cost benchmarks.

With such an arrangement, there may also be a window of opportunity to put the cost of accrued public sector pensions on balance sheet. With the country having taken on so much additional debt as a result of the global financial crisis, there will need to be a fundamental review of the public finances following the general election next year – this could be a “blame-free” opportunity to put public sector pension liabilities on balance sheet. They would then no longer be the ele-

phant in the corner, and the impact of future decision making in respect of benefits and contributions would be much more transparent.

Pensions in public sector outsourcing

The gap between DB public sector pensions and the position in the private sector, raises problems when public sector bodies look to outsource services (such as facilities management, IT support, waste management, catering, etc) to the private sector, in order to gain access to private sector expertise and operational management skills.

The Government's stance is that where employees transfer employment on such an outsourcing contract, the new private sector employer must provide the same kind of DB pensions as in the public sector – this is known as the “Fair Deal”. Unfortunately, however, the Fair Deal requirements deter many private sector companies from bidding for such contracts, and those that do bid often add significant extra margins to their bids to cover the pensions risks they have to take on - risks that most do not feel able to take for their mainstream employees. This inevitably means significant extra costs for the public sector, as a more competitive tender process and keener bid pricing would result if there were no material pensions funding issues for the bidders to deal with.

To improve the cost-effectiveness of the outsourcing process, and to create a level playing field between all bidders, the Government should recognise that the public sector is better placed to bear the long-term risks of DB pensions than private sector companies - and that if it does so it will in fact get better value for money on outsourcing contracts. This could be achieved by allowing transferred employees working on such contracts (particularly shorter-term contracts of up to say 10 years) to remain in the relevant public sector scheme with the funding risks being met by the State, except to the extent those risks that are directly under the influence of the employer (eg salary growth, early retirement, and augmentations).

Conclusions

There are major issues in public sector pensions which will need addressing soon, relating to the level of benefits offered to public sector employees, the way in which their costs are assessed and accounted for by the State, and how they are treated when employees transfer to private sector employment on outsourcing contracts. Many of these issues have started to be tackled in the Local Government Pension Scheme, for example, many authorities allow retention of some pension risks on outsourcing contracts, and cost sharing arrangements will be implemented in the next few years, but even here there are problems with implementation and overall costs.

Moving towards the kind of affordable and sustainable landscape outlined in this article will not be easy in light of the complexities and vested interests involved. However some form of major change is almost inevitable and, if it is not planned and managed carefully, could result in significantly less satisfactory outcomes for all parties.

DC: it's personal, isn't it!

By Mark Duke, Principal, Towers Perrin and ACA Main Committee



The occupational pensions landscape is increasingly dominated by defined contribution plans. The various governance structures may differ, but at heart they share the common challenge of trying to create a connection between the individual and their savings – a connection that was generally absent when a person's company pension could be described by way of a formula in a rule book.

Finding better ways of delivering pension saving in a DC world is a big topic. Literature is easy to find. Insurers, fund managers, actuaries, governments and academics contribute daily on the subject. In the UK those in charge of the embryonic Personal Accounts system are grappling with the issue.

My aim is not to compete with this cacophony but instead to make some entirely personal observations based on what I see. Consensus may be impossible and, I would argue that, if consensus is achieved, it probably just means everyone has got it wrong. There is room for disagreement!

For the actuary, our skills have generally been applied to the problems of institutions that are making long and short term decisions about reserving, funding and investment in the context of their objectives. Skills that are highly relevant to anyone concerned with the challenges of the DC world when the institution is the individual.

Whose money is it?

Company sponsored DC plans are long term savings vehicles through which employees defer their pay for later consumption. Whether it is a Government or employer making the decisions, this is the starting point. It raises the fundamental question of whether employees should be forced to save and, if so, how much saving should be required, into what type of savings plan should the money go and how much freedom should the individual have to manage their money along the way. For the employer, the choices made will be materially influenced by State pension provision and the regulatory backdrop.

As practical people, we do not always have time to reflect too deeply on these fundamental questions. But it's always worth remembering that when designing any form of pension provision we're making decisions about how people use **their** money.

We have reached a fascinating position where very different philosophical positions are emerging about the way DC pro-

vision is delivered. To hugely over-simplify these two positions can be summarised as follow. Perhaps the biggest distinction between them is the extent to which the individual is deemed able to make financial decisions.

Over to you then

In this world the individual is left to choose whether they save. The employer takes no position about whether pay should be deferred – other than to comply with whatever rules are imposed by the State such as auto-enrolment and minimum contributions. The personal circumstances and aspirations of the individual are assumed to be just that – personal.

Information will be made available that (if the individual chooses to pay attention) will encourage the employee to make informed decisions. The employer may use a third party to facilitate access to a range of savings products including pension and possibly advice.

The way the individual chooses to use these products and services will be up to the individual. It is likely that any employer subsidy or support will cease when employment ends. Even in this system there is a decision to be made about what happens if the employee makes no active decisions. Assuming the employer sees themselves as a source of remuneration, not pension, the answer is probably that the default position is cash in hand. Indeed the employer might argue that the employee could be taking the cash and arranging all their savings personally.

You can leave it to us

In this world the employer decides that there is some core level of pay that needs to be deferred. The need to save for retirement throughout a working lifetime is regarded as vital but most employees need to be nudged, compelled or incentivised to save.

There is likely to be a view that no matter how effective the information provided to employees, the majority may be reluctant to engage with topics such as investment risk. Consequently, assumptions have to be made about what a fit for purpose DC investment choice looks like for this silent, disengaged, majority. This does not mean absence of choice. But consistent with the desire to herd the right groups of people into the right choices, attempts will be made to help employees easily to assign themselves to a profile that will lead them to a suitable range of options.

As well as defining a core level of pension saving and the best default investment options, the employer (or trustees) will take an active role in monitoring the performance and efficiency of the underlying products made available through the pension plan.

Health warning

Such a black and white characterisation ignores the many shades of grey that lie between the two approaches. The danger of grey is that key elements of good implementation can get lost. For example, I may be an employer who instinctively favours the “over to you” approach. Unless I want to be completely silent and hands off, there remains the need to explain to employees how they are now responsible for their decisions and ensure that they have the means to plan their finances. Unsupported choice may well produce worse outcomes than no choice at all.

Similarly, taking some responsibility for the selection and monitoring of employees’ DC pension options requires diligence and persistence. Treating DC provision as something that can be governed on the cheap with little effort leads to what I would describe as “lazy default”. Here, a single off the shelf default is implemented, isn’t that well communicated, collects the bulk of the DC money and is infrequently, or only half heartedly, reviewed. As employers and trustees have struggled to deal with a defined benefit pension legacy, while DC has grown materially in importance, this situation may have crept up on some pension plans.

Fortunately there are signs of change as DC governance is taken more seriously as evidenced by the Pensions Regulator’s initiatives.

Next - a financial plan

So what might we expect to be involved in as the DC pension saving market develops?

The greater the responsibility passed to the individual, the greater the need for tools that help employees match their circumstances and preferences to a personal financial plan. This will have to embrace more than long term retirement planning. It has to start with the person’s immediate concerns which will often be as much to do with expenditure and housing as about the distant and highly uncertain issues around retirement (not least the uncertainty of the balance between working lifetime and length of retirement). These tools need to show outcomes in an intuitive way and ideally capture the risks that arise from using different types of investment. And very importantly, especially for the lower paid, the level of State pension provision needs to be illustrated since for many this is likely to remain the bedrock of their lifetime retirement income.

Any tool also has to be layered such that the employee can quickly get value from “light touch” use but enables a much more rigorous investigation of the wider range of savings options and investments. Potentially it offers a means of managing these savings and executing instructions as well

as a way of storing personal information that could be discussed on a one-to-one basis with an adviser.

Many of the building blocks already exist in the tools (and by this I mean all forms of communication) that are being used to support commercial savings products/portals, occupational DC plans and flexible benefits arrangements. Pulling it all together (and working out who pays for the tools and services) is the next step.

Better default

Even where employees are being directed, or defaulted, to a particular DC solution, the market shocks associated with the credit crunch have called into question some of the conventional life styling investment approaches to DC. In particular, there is evolution in the following two areas.

- Simplicity has its virtues but directing, as often happens, most DC money into equity funds may not be ideal. Personal investors generally don’t like volatility, no matter how long the long term, and there should be diversification opportunities that are being left unexploited. It is up to the pension plan or product provider to decide on implementation. For example, the outcome could be more use of funds that have a target rate of return (achieved across a broad spectrum of assets) or just greater diversification within the default portfolios and some discretion for the manager to move between asset classes. Whatever the solution, there is a governance issue. Who is taking the fiduciary responsibility for the chosen strategy? Trustees will be wary of “black box” products where they remain ultimately on the hook for setting strategy and selecting product.
- The default world need not be one where the personal dimension of savings decisions is completely ignored. Attempts can be made to create default solutions that recognise that there is probably a difference between the needs of a 25 year old earning £16,000 per annum and a 35 year old earning £100,000 per annum (not least that the tax system will soon remove high income individuals from normal DC plans). This suggests trying to do some segmentation based on what the employer does know about his employees and then direct people to asset mixes that may better reflect their circumstances. For example, there is no reason why the core plus approach cannot be applied to DC so that there is a core of lower risk savings accumulating in respect of a first tranche of earnings and greater risk or personal discretion encouraged in respect of higher income. Individuals could even be encouraged to set target fund levels that they want to achieve and the underlying asset mix is de-risked as the target is approached.

Nobody said it was easy

DC pensions and the personal responsibility that goes with it, gets us straight into the messy world of the individual. Actuaries have much to contribute to the analysis of the underlying financial problems and solutions. Equally we have much to learn about how best to connect with individuals in all their glorious diversity. It really is personal, isn’t it?

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less of a priority, but where immense challenges remain to engage employees meaningfully and in managing more reliable pension outcomes.

The articles are by no means exhaustive in covering the range of ideas that public policymakers and practitioners in the

sector should be considering. The ACA's *2010 Biennial Review*, as well as reporting on the *ACA's 2009 Pension trends survey* and the work of the Association, includes other ideas – including the ACA's Pensions Manifesto – and will be available shortly in printed form and at our website at www.aca.org.uk

Pensions - a divided nation: the challenge still remains to be addressed . . .



A famous TV sketch re-visited, what our characters might say today...

Cleese: 'I look down on them (Barker and Corbett) because I'll retire at 60 on two-thirds final salary thanks to my public sector index-linked pension.'

Barker: 'I look up to him (Cleese) because he's got a pension paid by tomorrow's taxpayers come what may, whilst my private sector employer struggles to meet the increasing cost of providing a funded pension. I will be lucky to retire at 65. But I look down on him (Corbett) because my pension is still better than his.'

Corbett: 'I look up to him (Cleese) 'cos he's obviously much more important than me. He's got what I'll never 'ave. I look up to him (Barker) less 'cos his pension is a bit like mine - uncertain, because of shocks and scares. I know my place - first a 'stake-burger' pension, now a work 'til you drop one!'

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