



SHARED RISK SCHEMES: QUESTIONS AND ANSWERS

We detail below a number of questions about *shared risk* schemes and answers, which we hope you will find helpful in understanding how they work and the context in which they would operate.

Question: The Government is improving the 'defined benefit' Basic State Pension for all. Isn't this enough to ensure a good minimum pension for all?

Answer: Although the proposed improvement in the Basic State Pension (BSP) is welcome, the BSP and reformed State Second Pension will still only meet the very basic day to day essentials for most pensioners.

Question: The Government is also introducing auto-enrolment into personal accounts or company schemes. Won't this bridge the gap?

Answer: The level of contributions into money purchase schemes remains a worry. The Government's proposal for personal accounts is, effectively, an 8% total contribution on earnings between £5,000 and £33,500pa. Most company money purchase schemes also attract total contributions of around this figure. For many people, the emerging pension benefit from contributions at this level will be very modest indeed.

Question: So why not just encourage higher contributions to money purchase schemes?

Answer: The key snag with money purchase schemes is that the individual is exposed to investment risks on their own and generally does not have the benefit of, or protection from, being able to share these with the employer or other members of the pension plan.

This is a particular worry for low to modest earners: personal accounts and many existing company pension schemes place 100% of the investment risk with members and the pension depends on the amount of the fund at retirement built up by the investment of contributions for the individual and on the terms for annuity purchase from an insurance company at the time of retirement.

Typically the amount of an individual's money purchase pension fund will be volatile, the contributions having been accumulated in equity-type investments. This can

mean bad news for those retiring when equity markets are low, particularly if annuities are expensive because real interest rates are low. In fact, pension payouts have fallen by about three quarters over the last 10 years. Someone retiring now with a money purchase pension could be 75% worse off than someone paying the same contributions each month, but retiring 10 years ago (source: Watson Wyatt).

'Lifestyle' investment strategies can help dampen the volatility but only when retirement happens after pre-planning some years in advance. In reality, retirement can often arise without much notice. Removing volatility can be achieved by investment in bonds but at the price of a lower expected investment return over the long term.

Question: So the new personal accounts are a bad idea?

Answer: Certainly not. For many employees of smaller firms, personal accounts offer the opportunity for the first time to build a modest pension on top of their State pensions. However, employees are taking all the investment and longevity risk, because personal accounts are a money purchase arrangement.

Question: Why should the Government encourage the development of shared risk schemes alongside personal accounts?

Answer: Employers offering shared risk schemes would be able to provide their employees with a much more stable platform for income in retirement than would be achieved by the same contributions paid to a money purchase arrangement – through the sharing of risks.

Shared risk schemes will offer larger employers, who cannot afford or are unwilling to take on the long-term risks associated with a balance of cost defined benefit scheme (eg the typical sixtieth final salary scheme), a new 'third way'.

The recent Purple Book survey (December 2006) by the Pensions Regulator and the PPF found only 31% of defined benefit schemes are now 'open', which readily indicates the need for initiatives to promote good company provision that can be afforded into the future.

Question: But will employers accept the open-ended financial costs of shared risk schemes?

Answer: Not without new help and encouragement from government. Pension schemes thrived in the past when there were "safety valves" to control unexpected increases in costs. These need to be restored. **Importantly, shared risk schemes would offer employers the ability to control costs into the future by way of the ability to increase normal pension age or to hold back targeted indexation of benefits until the scheme could safely pay such benefits.**

The growth of shared risk schemes in the private sector would go some way to addressing the significant gap which has arisen between pension provision for private and public sector employees in recent years.

Question: It's already possible to design risk sharing schemes under current legislation. Why is there a need to change the law?

Answer: Under current legislation, occupational pension schemes are classified either as defined benefit, under which normally all of the investment and longevity risks are taken by the employer, or as defined contribution (money purchase), where all the risks are borne by the employees.

For example, current legislation does not permit a scheme to raise pension age retrospectively to reflect improving longevity (although the State can and is doing this for State pension age)

Those few occupational pension schemes which have been designed to share risks between employer and employee have had their risk sharing ability restricted as they have been classified as defined benefit schemes. Alternatively, risk sharing has had to be provided by the employer establishing two schemes – one with defined benefits and one which is money purchase.

A new category of shared risk schemes, sitting between the existing categories of defined benefit and defined contribution schemes, would allow a radical extension of risk sharing and encourage new creative benefit designs.

Question: So why not just introduce new relaxations for defined benefit schemes?

Answer: This is easier said than done. It would be fair to allow defined benefit schemes to be more flexible, but the existing legislation which prevents retrospective changes to defined benefit schemes would be difficult to amend.

Having considered different ways of extending risk sharing, the ACA has concluded that the introduction of a new 'third way' is much more practical than changing the requirements for defined benefit schemes, as to do so would undermine and confuse what is, and has been, meant by a 'defined benefit'.

The Association of Pension Lawyers has provided input to the ACA on the main legal changes to facilitate the introduction of shared risk schemes and they are surprisingly small in number.

Question: Are there really companies willing to introduce shared risk schemes in spite of the financial headaches they've had with defined benefit schemes in the last few years – haven't they had their fingers burnt once too often?

Answer: There have always been good employers willing to provide employees with good pensions, and they are still there. They now deserve support and encouragement.

A recent survey found financial directors at over half of companies offering their employees money purchase schemes said their schemes were not generous enough to provide their staff with an adequate pension in retirement (source: Fidelity International).

Many companies want to offer their employees the opportunity of a more stable platform of income in retirement than is possible through defined contribution/money purchase arrangements – but without the exposure to the full risks of defined benefit schemes. They continue to appreciate the recruitment and retention benefits that come from offering a good pension scheme, but cannot safely offer a defined benefit scheme given the potential forward financial risk involved.

Establishing a new shared risk scheme would enable an employer not only to create a benefit design with a level of risk it felt able to afford, but also to reduce the overall quantum of benefit if absolutely necessary. It is envisaged that such a need would only be required on an occasional basis.

Question: So the new shared risks scheme will not be as good as the traditional defined benefit schemes?

Answer: They are unlikely to match the traditional sixtieth final salary schemes, but these new types of schemes will provide good benefits. The new improved State pension with a risk sharing benefit on top will provide a good standard of benefits. And there would be nothing to stop members themselves funding additional pension on top of this stable platform, on a money purchase basis, giving them their own choice between spending their earnings on consumption today or saving for tomorrow.

Question: So remind me, how do the new schemes differ from the traditional defined benefit schemes?

Answer: The main difference which new shared risk schemes offer employers from the requirements of defined benefit schemes is that only accrued benefits (including past revaluations and pension increases) are treated as defined benefits whilst future revaluation and pension increases are targeted.

Although the targeted future revaluations and pension increases would have to be backed by reserves assessed using prudent actuarial assumptions, the difference between them being treated as targeted rather than as defined benefits allows more

freedom for investment strategy and a lower level of debt for the employer in the event of the scheme being wound up.

Question: If longevity improvements continue as in recent years, how would shared risk schemes protect employers from ever increasing costs to meet, on average, members enjoying longer periods in retirement?

Answer: An employer running a new shared risk schemes would be able to increase normal pension age under the scheme to reflect increasing life expectancy, provided there is objective evidence contained in a report from the scheme's actuary.

Question: So when a member reaches retirement age he finds he suddenly has to wait a couple more years for his pension?

Answer: No. An increase in normal pension age would not be allowed for members who were in receipt of pension or who were within 10 years of reaching normal pension age. The Pensions Regulator could also disallow the increase in normal pension age if the evidence to justify the change was deemed insufficient.

Question: Would members' pensions be protected if the sponsoring company collapsed behind a shared risk scheme that was not fully funded?

Answer: The ACA's proposal is that new shared risk schemes be covered by the Pension Protection Fund. The level of protection afforded we recommend should be 100% of accrued benefits, including past revaluations and pension increases, but not future revaluations or pension increases (as they are targeted not defined benefits). This is a higher proportion of accrued benefits than for defined benefit schemes where the protected benefit is 90% and is subject to a cap (but with future revaluations and pension increases generally being payable).

We propose that the PPF levy for new shared risk schemes is calculated separately from existing defined benefit schemes and be held in a separate fund. This is because the levies should be much lower than under defined benefit schemes, due to the nature of new shared risk schemes. There should be no cross-subsidy of existing defined benefit schemes from the levies paid in respect of new shared risk schemes.

Importantly, as the targeted future revaluations and future pension increases under new shared risk schemes have to be backed by reserves assessed using prudent actuarial assumptions, it would be most unlikely for such schemes, which had been in existence for some years, to be a call on the PPF. This is because the scheme's fund at the time of wind up should be sufficient to secure, through the purchase of non profit annuities from an insurance company, most of the potential future revaluations and future pension increases.

Question: What makes a shared risk scheme any better than a defined contribution scheme for members, particularly if contribution levels are much the same?

Answer: Because of the mechanisms for the sharing of risks between the employer and scheme members and by way of the modest pooling of risks amongst scheme members, the benefits provided should form a much more stable platform for income in retirement than would be achieved by the same contributions paid into a money purchase/defined contribution scheme.

Question: Isn't defined contribution better for a job market where individuals change jobs frequently?

Answer: No, because, like defined contribution schemes (and differently to defined benefit schemes), under new shared risk schemes there is no difference between the pension provided for each year of service for stayers or leavers.

Furthermore there is little evidence in most sectors of the economy to suggest that people do change employment more often than they used to.

Question: Defined contribution schemes are simple to understand with individuals able to identify their 'pot'. Aren't shared risk schemes likely to be complicated for members to understand?

Answer: New shared risk schemes should be capable of being explained clearly to members, and it will be important that they are.

The new schemes would have to comply with all the new requirements for keeping members fully informed of their benefits.

It is questionable how many members of money purchase/defined contribution schemes understand what their scheme pension may be. They may be aware of the amount of money in their 'pot', but how much is understood about the effect of future investment returns and the terms for converting the fund into pension at the time of retirement?

It is important to take up the challenge of good communication to members of all types of scheme.

Question: Final salary based defined benefit schemes have sometimes appeared to favour 'fat cats' and those with large pay increases towards the end of their career. Will shared risk schemes be any fairer?

Answer: The pension from a new shared risk scheme will reflect an employee's average earnings during the period of scheme membership up-rated by reference to price inflation (but subject to a 2.5% pa cap).

The benefits earned for each year of pensionable service are the same for a scheme member who remains until retirement or leaves service long before retirement, unlike in a final salary scheme.

Question: Final salary schemes have the benefit of being easy to understand and scheme deficits are reportedly falling rapidly. Won't companies re-open 'closed' schemes to new members, particularly if the Government agrees to ways to cut back on the costs of such schemes?

Answer: If deficits are removed, some employers may well think again about re-opening their final salary scheme. After all many of these schemes started because the previous money purchase schemes failed to deliver good or reliable benefits. However, given recent experiences many others will be unlikely to take that decision because of the long-term financial risk involved.

What the ACA is proposing is a new 'third way', where costs can be controlled, which will increase the likelihood of employers being prepared to offer a stable platform for the retirement income of their employees.

The ACA hopes the Government will introduce measures that meaningfully ease the costs and obligations placed on employers offering defined benefit schemes, but, even should this happen, it is judged many employers will remain unwilling to take on the forward risks associated with defined benefit schemes.

Question: Shared risk schemes would require regular actuarial advice to ensure that actions are taken by companies to adjust contributions or benefits. Aren't they just an innovation for actuaries to replace the loss of defined benefit schemes?

Answer: That would be a terribly cynical, and negative, view.

Actuaries advising a company must offer advice that is in the best interests of that client, reflecting the client's financial commitments, human resources strategy and other factors. On many occasions, the present advice will be to introduce a money purchase scheme to replace a defined benefit scheme.

The proposal for new shared risk schemes is meant to be non controversial and non party political. It is a well-intentioned attempt by the ACA to re-energise employer sponsored occupational pension schemes in the UK, learning from the lessons of the

past, by allowing costs to be controlled whilst also looking to provide a good, stable pension for members.

26 March 2007

The Association of Consulting Actuaries
Warnford Court, 29 Throgmorton Street, London EC2N 2AT
Tel: 020 7382 4594 Fax: 020 7374 6220
Email: acahelp@aca.org.uk Web: www.aca.org.uk