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WORKSHOP SESSION B2: RISK SHARING SCHEME DESIGNS

MODERN PENSION SCHEME DESIGN
More predictable than DC: less costly than DB

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1. BACKGROUND

1.1 This short paper is written from a UK perspective, by an actuary who has seen, during his 45 years of professional life, the dramatic decline of an occupational pensions movement through which employers once proudly delivered predictable pensions on a defined benefit basis (DB) to grateful employees. Today in the private sector, for reasons that are well documented elsewhere, the vast majority of those employers still prepared to fund pension provision for their employees do so on a defined contribution basis (DC), resulting in highly unpredictable pensions being dependent in amount on investment conditions during the accumulation phase and on the financial conditions when the employee retires (at a possibly unpredicted date). The risks which employers have had to bear when providing DB pensions have grown significantly over this period, due to layer upon layer of legislation, from having been bearable by most to a level where few company boards are now prepared to countenance the risks. The corollary is of course that the risks are now taken primarily by the employees and are manifested in the unpredictability of the level of pension which will be available on retirement (or on earlier death).

1.2 The phenomenon described in **1.1** is not unique to the UK, but I doubt if any nation has had as severe a jolt to its private sector retirement provision as has been experienced here. Quite a few other countries have had similar experiences, but a lot more were never so immersed in DB provision and so the transference from DB to DC has not been experienced by such a material proportion of citizens. Nevertheless many of the reasons for the phenomenon are similar, and so I hope that this paper will be relevant and of interest to actuaries in countries around the world.

1.3 So should this worldwide phenomenon be of concern? Yes. Why? Because large numbers of private sector employees on modest incomes could have much more satisfactory arrangements for the provision of their pension. Such people find it very difficult to live with the uncertainty of the level of their future retirement income, particularly the volatility associated with equity investment as their DC account accumulates. But if volatility in the accumulation phase is dampened by investment in inflation-linked or fixed-interest government bonds, there is potentially a significant reduction in investment return and so an increase in the cost, and therefore a reduction in the resulting level, of pension. Typically the self-employed and employees of small companies will have no choice other than DC arrangements. Industry-wide schemes could have a useful role to play, but today in the UK there are few such arrangements. It is therefore in the national interest for governments to encourage medium to large private sector employers to provide more predictable pensions without having to take unacceptable risks. In my view, part of the answer would be to assist the provision of pensions where there is a greater and more equitable sharing of risks between employer and employees.

1.4 Such sharing of risks can be done to some extent currently in the UK, but not as much as is required to provide more useful forms of benefit design and therefore a much greater take-up by private sector employers. For this to be achieved in the UK there needs to be some changes to the law. But the changes required are not great and not complicated, and could be made relatively quickly. I do not request tax incentives for particular types of pension scheme design because that would inequitable and no doubt politically unacceptable.

2. PUBLIC SECTOR PENSIONS IN THE UK

2.1 In the UK, public sector pension schemes – which include civil servants, local authority employees, teachers, National Health Service employees and the armed forces - provide DB pensions based on final pensionable earnings. Many of these schemes are unfunded; those for local authority employees are funded. The public sector has not yet seen the phenomenon of the transfer from DB to DC experienced by the private sector. The strength of the argument that earnings in the public sector were generally lower than in the private sector and that 'gold plated' pensions went some way to redress the balance has weakened in recent times with surveys showing average earnings in parts of public and private sectors having now become similar and in some cases greater in the public sector. In any event, concern had been growing over many years at the escalating cost of public sector pensions. These factors lead the current Coalition Government to establish the Independent Public Service Pensions Commission under Lord Hutton of Furness, a former Secretary of State for Work and Pensions in the previous Labour Government, to consider and report on the case for reform and to make proposals.

2.2 The main proposals made by Hutton were that public sector schemes should remain DB but that future accrual of pension should be based on the average of a member's pensionable earnings over their career with past pensionable earnings being revalued in line with national average earnings; that higher earning members should contribute at a higher rate of pensionable earnings than at present; and that normal pension age should be increased in line with state pension age. The detail of the changes may vary in respect of individual schemes. Consultation thereon is taking place with the trade unions. Whilst the trade unions have expressed concerns about aspects of the proposals and considerable unrest amongst the membership of public sector schemes is reported in the media, the Government has indicated its intention to press ahead with changes in line with the Hutton proposals subject to the completion of the consultation process.

2.3 Should the Hutton proposals be implemented, although they will affect only the public sector they could potentially have a major influence on the nature of pension provision in the private sector. Even now, not all private sector employers closing their final salary schemes have replaced them with DC arrangements; some have switched to a DB career average scheme, but they are in a small minority. It is understandable that there could be differences between public and private sector pension provision in general; but surely not a major chasm. Rationally medium to large employers in the private sector should be able to provide their employees with pension schemes of similar design to public sector schemes without having to take on high levels of risk to do so.

3. HOW THE CHASM BETWEEN PUBLIC AND PRIVATE SECTOR PENSION PROVISION CAN BE ADDRESSED FOR THE BENEFIT OF THE NATION

3.1 I set out below a series of proposals. Some involve the greater sharing of risks between larger private sector employers and the members of their pension schemes. Others simply require a change of mindset by employers, employees and trade unions. None of these proposals is revolutionary, none should be taken as threatening to any party and none of these by themselves is likely to be sufficient to tip the balance back from the insanity of potentially all private sector pension provision in the UK being DC. Taken together, however, the proposals form a menu from which medium to large employers could choose to design schemes which provide pensions more predictable than DC and less costly than traditional DB. Such schemes would be of significantly greater benefit to those on modest incomes than the DC alternative, for the reasons given in **1.3** above.

3.2 CHANGING THE 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 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.

3.3 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.

3.4 If the pension is to be capable of being reasonably predictable by the employee before retirement, a DC arrangement is not the answer. The career average schemes proposed by Hutton for the public sector automatically produce a pension of a higher proportion of final earnings for employees whose earnings grow steadily throughout employment compared to those whose earnings increase more rapidly.

3.5 Capping pensionable earnings in real terms would be compatible with a philosophy of providing a good basic level of pension, and no more. Moreover, why would an employer want to force, or why would an employee want to be forced to have, further pension above the capped limit – provided the amount of earnings above the cap reflected that they were non-pensionable. Individual employees could top up their basic pension by making additional voluntary contributions on a money purchase basis.

3.6 INDEXATION OF PENSIONS: The UK is the only country in the world which requires private sector DB schemes to index pensions, both before and after retirement, in line with price inflation (subject to a cap). The law should be changed to remove this requirement for pensions in payment but only in respect of pension earned after the law is changed. Many employers would still voluntarily want to provide pensions which would increase in payment, by indexation or by discretionary increases or by a new concept of conditional indexation (which is explained below).

3.7 If such a change to the law is politically unacceptable, then the law should be changed to allow conditional indexation. This would enable career average DB schemes to have indexation of pensions which, although pre-funded and protected through the scheme funding regime overseen by The Pensions Regulator, was conditional on the scheme not having a funding deficit. If the scheme has a funding deficit, future increases, whether to pensions which are accruing or are in payment, would be withheld temporarily as part of the funding recovery plan, and be reinstated out of future funding surplus. Thus pensions in payment are never reduced, but the flexibility in the vesting of future increases should stabilise the employer contribution rate to the scheme.

3.8 Importantly, the expected cost of each £1 per annum of pension could be significantly less than in a DC arrangement. 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 arrangement, where investments are earmarked to individuals and sold at retirement for an insured annuity.

3.9 The Association of Consulting Actuaries has developed the concept of conditional indexation and researched in detail how it could fit into the current regulatory framework for pensions in the UK. This process involved consultation with regulatory bodies and the Department of Work and Pensions. The changes to the law required to allow conditional indexation were researched jointly with the Association of Pension Lawyers. The technical structure of conditional indexation and how it would fit into the regulatory framework has stood up to wide scrutiny.

3.10 INCREASING NORMAL PENSION AGE IN LINE WITH INCREASING LIFE EXPECTANCY: With the rapid increase in life expectancy and the uncertainty over future rates of increase, it must be right to allow the normal pension age in a DB scheme to be increased from time to time. Typically an increase in normal pension age only affects the pension accruing after the introduction of the new normal pension age. But why should an increase in normal pension age not be retrospective – subject of course to safeguards to protect the interests of the scheme members. The following two safeguards should be sufficient. First, the change in normal pension age could only be in respect of members who had more than 15 years to run to the existing normal pension age; i.e. were aged more than 15 years younger than the existing normal pension age. Second, an increase to normal pension age would only be allowed by reference to new longevity indices to be calculated and published regularly by an independent body such as the Continuous Mortality Investigation of the Actuarial Profession or by the Government Actuary's Department. Understandably the uncertainty of future life expectancy ranks high amongst employers' concerns with DB provision; that uncertainty needs to be managed effectively.

3.11 INCREASING MEMBER CONTRIBUTION RATES WITH AGE: Why are member contribution rates typically the same at all ages? To my mind the traditional reasons are outweighed today by the following two arguments. First, older members can generally afford to pay a higher rate than younger members. The younger members have mortgages to pay, children to bring up and so on, whilst in due course children leave home and outgoings reduce. Clearly different circumstances pertain to individual scheme members but there is a logic to a gradual increasing of the rate of member contribution with age. Second, in a career average DB scheme, the funding rate for each year's accrual of benefit increases at a slower rate than in a final salary scheme, thus making it normally possible to devise a member contribution rate which rises gently with age – say in five year age bands – and results in an employer contribution rate which is independent of the age distribution of the scheme membership. Many employers have felt uncomfortable that the cost of DB pension provision increases with the employee's age. Why is it, they ask, that more company resource should be spent on the provision of older employees' pensions than on those of younger employees? Well, with age-related member contributions to a career average scheme, the employer's resource spent on pension provision can be broadly the same percentage of earnings for employees of all ages.

3.12 PENSIONS PAYABLE TO DEPENDANTS ON THE DEATH OF SCHEME MEMBERS: The range of benefits, and their conditions of payment, in DB schemes has gradually increased over the years to become very comprehensive and complicated. As part of this process, the benefit paid when a married member, or one with financial dependants, dies can exceed materially that paid in respect of a member who is single, unmarried or widowed. That should not need to be the case in a modern scheme design.

3.13 Employers do not pay married employees more than those who are single. So, in a modern DB scheme the employer may well prefer to provide a pension at retirement which is payable only to the scheme member, but with the option for the member to exchange at retirement some of that pension for a pension payable on the member's death to the member's nominated dependant(s). Such options were once commonplace, and actuaries are well placed to advise on their terms and conditions.

4. MY VISION OF THE FUTURE FOR OCCUPATIONAL PENSIONS IN THE UK

4.1 Public sector pension provision will be changed to follow broadly the proposals of Hutton.

4.2 Having learnt from the issues raised by Hutton, Government will wake up to the potential nightmare of all private sector provision becoming DC and will make the modest changes to the law which will allow a greater sharing of risks between employers and members of private sector DB schemes .

4.3 There will be a read across from the public to the private sector and many medium to large employers will establish new career average DB schemes with conditional indexation linked to price inflation, with normal pension ages being able to be increased regularly in line with life expectancy, with member contribution rates typically increasing with age and with pensionable earnings for benefits and member contributions being capped in many cases.

4.4 This movement will act as a catalyst for an expansion in the different ways of risk sharing in private sector pension schemes, for example, hybrids where DC tops up traditional DB or risk sharing models above capped pensionable earnings, and cash balance schemes. Thus many more employees will enjoy pensions which are more predictable than DC. Many employers which reluctantly switched from DB to DC will be able to return to the provision of DB pensions to their employees but taking risks which they can manage.

4.5 Several million employees in the private sector will be able to plan for, and have much more confidence in, their future retirement. The consequences which flow therefrom for the nation are immense and positive both for the economy and for the good of society.

4.6 What is required now is the motivation of politicians to get on with the job. The changes to the law should not be party political. If this vision is to become reality, the voices of actuaries need to be heard, speaking with impartial and strong authority, given the expertise of so many members of our profession in these matters. I believe that it is our responsibility to do so.

Author's note: All the views which I express in this paper are my own and should not be taken as those of the Association of Consulting Actuaries or any other body.