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RESPONSE TO

RISK SHARING CONSULTATION

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Introduction

1. The **Association of Consulting Actuaries (ACA)** welcomes the opportunity to respond to the *Risk Sharing Consultation* paper issued by the Department for Work and Pensions on 5 June 2008. Members of the ACA provide advice to thousands of pension schemes, including most of the country's largest schemes. Members of the Association are all qualified actuaries and are subject to the code of professional conduct of the Faculty and the Institute of Actuaries. Advice given to clients is independent and impartial. ACA members include the scheme actuaries to schemes covering the majority of members of defined benefit pension schemes. The ACA is the representative body for consulting actuaries, whilst the Faculty and Institute of Actuaries are the professional bodies.
2. As Ministers and the Department will be aware, with workplace pensions in general decline in the private sector for well over a decade, the ACA has been calling for a change in approach by Government in the way it regulates and encourages quality pension provision. That change of approach includes a lighter regulatory touch, which is why we have actively supported the intent behind the deregulatory review. It also requires changes in legislation that would allow much greater pension design freedom for private sector employers wishing to offer workplace pensions. This overall approach was recently endorsed by Richard Lambert, CBI Director-General, who said, in a speech bemoaning the shortening lifespan of private sector defined benefit pensions:

“Give companies the freedom to design schemes that work and then leave them alone, so long as the funding and covenant is there to meet pensions, and scheme members understand what is on offer.”¹

¹ *Defined benefit pension costs*, speech by CBI Director-General, Richard Lambert, 30 July 2008.

To this, the ACA would add that greater freedom in design should also be subject to two important requirements – that all designs are effectively communicated to scheme members and that they are required to satisfy the appropriate regulators that they meet certain minimum standards of investor protection, giving scheme members access to appropriate compensation in the event of employer or provider failure.

The over-riding theme of our response to the consultation paper is that all forms of risk sharing and new scheme designs should be encouraged provided these are clearly and simply explained to scheme members and meet appropriate minimum regulatory standards, including appropriate compensation for individuals in the event of employer or provider failure.

3. As part of the change in approach, the ACA has sought actively to promote legal reforms by way of this year's *Pensions Bill* that would allow for greater design freedom to be enacted. In particular, the ACA has proposed that employers in the private sector, as a first step reform, be allowed to offer conditionally indexed schemes, one of the new risk sharing models described in Chapter 6 of the consultation paper. This model, that has been worked on for over two years (including the legislative changes needed to include it in current law), is therefore better developed than the other new model mentioned in the consultation paper, collective defined contribution, and could be implemented very quickly.

4. The ACA continues to believe that the present *Pensions Bill* should be amended so that private sector employers would have an early opportunity to offer such schemes. The ACA view is based on three key points:

- the speed of the decline of quality pension schemes in the private sector, as described in the consultation paper, has not slowed (as was being suggested by Ministers during the early debates on the current *Pensions Bill*). Indeed, there is now mounting evidence that, unless private sector employers are offered new design freedoms at a very early stage, the flight from any form of quality provision other than where this is available under defined contribution is accelerating². Within the past few days, the survey by Aon shows that more than one - third of private sector pension schemes which were open to new joiners just a year ago have now closed. This is supported by our own findings - our biennial survey of pension trends for smaller employers³ - covering employers with fewer than 250 employees - indicates that 91% of these employers which have defined benefit plans have closed them to new entrants and 48% have additionally closed them to future benefit accrual. Where DB schemes are closed, employees inevitably end up in defined contribution plans since there are currently no realistic risk sharing alternatives which employers are prepared to offer. Whilst defined contribution schemes can provide good pension benefits, particularly where employer and employee contributions equate to 15% of earnings or more over a lifetime, the lower paid may not be well placed to deal with the volatility often associated with such schemes. Certainly, there is no

² Most recently, see *Does the exodus signify genesis* published by PricewaterhouseCoopers, June 2008 and *Pension plan design survey*, published by Watson Wyatt, July 2008 and Aon 2008 Employer survey, August 2008.

³ ACA 2008 *Smaller Firms Pension Survey* to be published in September 2008.

superiority in terms of pension outcomes that can be assigned to defined contribution schemes that would suggest they should become the dominant design.

- the DWP's own research has found that over two-thirds of individuals feel that a private pension linked to the Stock Market is 'too much of a risk'. Exposing an increasing proportion of private sector employees to 100% of pension investment and longevity risks via defined contribution is therefore suspect, at best⁴. As each month goes by, this risk transfer to employees who are often ill-equipped to cope with the financial decisions involved is taking place, with private sector employers feeling they have little option but to move into DC as they feel they can no longer justify the forward liabilities associated with defined benefit provision.
 - the legislative amendments for one form of risk sharing – enabling sponsors to offer a conditional indexation scheme – have been worked on for over two years by both the ACA and the Association of Pension Lawyers, in discussion with officials at the DWP. These amendments are ready for introduction into the Bill in its final stages in October 2008 – the DWP has had ample time to make any amendments that they feel are needed to the proposal.
5. If the Government fails to include this 'first step' risk sharing measure in this year's *Pensions Bill*, then a Bill will need to be introduced in this year's Queen's Speech on 3 December 2008 to implement the outcome of this risk sharing consultation – any later timeframe would simply be too late. This Bill would need to properly address the deregulation and

⁴ *Attitudes to Pensions: The 2006 survey, published by DWP, pages 5-7*

encouragement of all forms of quality pension provision, before this is mostly lost from the private sector.

6. In that regard, the ACA believes that risk sharing schemes of all types, including those possible now but not widely used, offer the design flexibility that employers need in order to be able to continue to offer quality pensions. Such schemes can be designed to be affordable over the longer-term and will be appreciated by many private sector employers and employees by virtue of the more stable benefit platform they offer when compared to pure defined contribution schemes.

Moreover,

- the ACA believes that it is an unsustainable long-term position whereby public sector employees would continue to be offered quality defined benefit schemes, whilst private sector employees are deprived increasingly of membership of schemes offering anything like similar benefits or predictability of benefits. Risk sharing schemes offer the opportunity for more private sector employees to benefit from quality provision that is also affordable to their employers over the longer-term. Such schemes can therefore help to close the (currently widening) gap with public sector provision which, if it is not addressed, will become a growing source of political and social conflict.
- whilst the Government has protected some existing scheme members and is bringing in measures to combat under-saving, these reforms do not touch many employees. Indeed, an unintended consequence of the additional protection is that it has turned employers away from defined benefit provision and has therefore been harmful to literally millions of pension scheme members, who are now denied access or continued access to defined benefit schemes. Whilst other factors have

contributed to scheme closures, excessive regulation has clearly played a significant part.

- the measures to combat under-saving are not yet implemented and will help many employees not covered by quality pensions to achieve some minimum standard of pension. However, the legislation may also lead to extensive levelling-down of per capita employer pension contributions for those in existing schemes to meet the extra employer costs of higher scheme participation through auto-enrolment.

7. The ACA is of the view that the pension reforms over the last two years do not meet the needs of many private sector employers and employees, but agrees with the Government's conclusion in paragraph 1.12 of the consultation paper (to quote):

‘ The Government ... thinks it should be possible for employees and employers to jointly decide how to share risks.’

8. Therefore, answering **Question 1: Given that we have protected scheme members and are bringing in measures to combat under-saving, should we undertake a far-reaching deregulation on the way risks are shared in pension schemes?**, the ACA is in no doubt in answering ‘Yes’.
9. Where we do depart from the consultation paper in Chapter 1 is where, in paragraph 1.12, it says ‘issues relating to risk sharing are complex and could have far reaching consequences for schemes and their members’. This statement typifies the excessive micro-management of pension design exhibited by Government over too many years. It is this very micro-management that has done so much damage and which has contributed to the rapid demise of quality provision and, thereby, to ‘far reaching consequences for schemes and their members’.

10. **To repeat, provided new scheme designs meet certain minimum regulatory standards (ensuring, thereby, that members have access to appropriate compensation in the event of employer or provider failure), it is not the business of the DWP or other Government departments to become involved in the detailed relationships between employers and employees in respect of pension design.** There should be a rich breadth of pension designs from which employers can choose so these can be tailored to their pockets and to meet the varied business needs of employers and the different aspirations of employees.

Please find over page the ACA's responses to those other questions in the consultation paper where we believe that we have something relevant to contribute.

Chapter 2: The decline in defined benefit provision

Question 2: Are you aware of any additional evidence of the impact of pension outcomes of lower contributions into DC schemes when all these complicating factors are taken into account?

11. In our answer to Question 3 we comment on why defined benefit schemes will generally out-perform defined contribution schemes per pound of investment. Whilst we acknowledge that some of the points made on pages 18 and 19 of the consultation paper explain the contribution gap between defined contribution and defined benefit, it remains the case that the commitments made (which legislation has gradually transformed into guarantees) under the vast majority of defined benefit schemes mean that the pension outcome from such schemes is considerably better than under defined contribution. Whilst there is some evidence that some larger employers are making employer contributions to DC schemes in excess of 10% of salary, these are still few in number.
12. More important is the volatility and unpredictability in pension outcomes that is associated with defined contribution, which to a large degree is absent from defined benefit schemes. The following table graphically shows the degree of volatility in pension outcomes (an 80% reduction in the pension outcome over a ten year period for the same contributions) arising from defined contribution:

Based on a man contributing £200 per month for 20 years in an average with profits policy (the picture remains much the same if mixed (managed) funds are used instead of with-profits)

Maturity Date	Fund value at retirement	Annuity rate per £1,000	Pension annuity amount (pa)
January 1996	£287,413	£79.14	£22,706
January 1998	£263,716	£66.16	£17,407
January 2000	£242,842	£59.47	£14,402
January 2002	£206,501	£56.70	£11,669
January 2004	£148,725	£44.60	£6,593
January 2006	£121,452	£41.20	£4,964

Source: Watson Wyatt Worldwide and the annual survey of with-profit pensions published by *Money Management* magazine.

Chapter 3: An overview of risk in pension provision

Question 3: Is our characterisation of the allocation of risks in DB and DC schemes correct?

13. The modelling of pension outcomes described in paragraphs 3.2.1 to 3.2.6 is wrong in relation to the positioning of DB schemes to DC schemes. The results in figure 3.1, if the model had been more appropriate, would have shown the DB final salary scheme outcome well to the right of the median DC scheme i.e. an outcome equal to a percentile DC scheme much higher than 50th. This is because the proportion of the assets invested in equities in a typical continuing DB scheme in the UK, where there were no particular concerns over the employer's covenant, would be greater than the proportion of the technical provisions in respect of active members and deferred pensioners relative to the total technical provisions of the scheme in respect of all members. (The proportion of the assets invested in bonds would typically be less than the proportion of the technical provisions in respect of pensioners relative to the total technical provisions of the scheme.)
14. To incorporate in the stochastic model the asset allocation typical of most DB schemes in the UK misses the point that most DB schemes have a high proportion of their technical provisions in respect of pensioners – following closure to new entrants and the general ageing of the scheme membership. Hence the model used is comparing the outcomes for an active member in a DB scheme based on an asset allocation which reflects a very mature age profile including pensioner liabilities with the outcomes in DC schemes based on an asset allocation which excludes pensioner liabilities.

15. What should have been incorporated in the model for the DB scheme was the assumption that the asset allocation between equities and bonds would reflect the liability profile of the scheme (as represented by its technical provisions) on the basis that equities would support the technical provisions for active members and deferred pensioners and the technical provisions for pensioners would be supported partially by equities, but mainly by bonds.
16. In practice, the asset allocation in a typical DB scheme would include asset categories other than equities and bonds to provide diversification and enhanced returns, but for simplicity we have restricted this analysis to equities and bonds.
17. If the stochastic model which produced the results shown in figure 3.1 was run incorporating this assumption for the DB final salary scheme, the pension outcome would have been well above the 50th percentile DC scheme. This is important, as it is a well recognised actuarial principle that the expected long-term cost of each £1 per annum of pension should be materially less in a DB scheme than in a DC scheme – because assets do not have to be sold to purchase an annuity from an insurance company when a pensioner retires, due to there being a pool of investments supporting all the liabilities of the scheme. A DB scheme, because of this pooling of assets rather than requiring individual investment accounts to be maintained for each member as under a DC scheme, has inherently greater operating efficiency. This is in addition to the effect described above, that, for the same membership profile by age, the proportion of the fund invested in equities in a DB scheme will typically be higher than in a DC scheme.

18. It is therefore wrong to suppose, as some commentators do, that if contribution rates to DC schemes were at the same level as contributions to DB schemes then the amounts of pension would be the same. They would not. The pensions from the DC scheme would typically be less than from the DB scheme.
19. The DB approach is therefore a more financially efficient mechanism for funding pension than the DC approach.

Question 4: Which parties are best placed to bear each risk?

20. The thrust of our response is that placing close to 100% of risks with either employers or employees is unsatisfactory for different reasons. If 100% of investment and longevity risks are placed with employers and the majority of default risk (via the PPF levy) and most inflation risk (via compulsory indexation up to the cap) – as is the case with defined benefit – then it is increasingly clear very few employers are prepared to bear such risks. So, whether best placed or not to take such risks, most employers simply won't take them on these days.
21. However, it is equally clear, as evidenced by our answer to Question 2, that the volatility in outcomes when close to 100% of investment and longevity risks (and default risks – priced into premiums) are placed on employees, then individual employees are, we suggest, in most cases not best placed to deal with the volatility in pension outcomes that can occur.
22. This is why the ACA has been campaigning for a number of years that there should be a sharing of risk. This design provides the long-term affordability sought by employers, whilst also meeting the stability of benefit platform sought by employees/members.

Chapter 4: Risk Sharing: International Comparisons

Question 5: Are you aware of any further international examples, or details of the experiences outlined above, which would be relevant to the debate on risk sharing in this country?

23. We have nothing to add to the examples other than to add a comment.

Nowhere else in the world other than the UK does Government require by statute of its private sector defined benefit schemes that indexation of benefits should apply both pre and post retirement.

The UK is UNIQUE in this regard. We believe this is highly relevant in that the movement from defined benefit in many of these countries has been very much slower and in some cases has not occurred at all. This is all well documented by the OECD.

Chapter 5: Risk sharing within the current regulatory framework

Question 6: In general, do you believe greater flexibility in the way employers and employees can share pension risks would increase (or slow any decline in) the availability of high-quality workplace pension provision?

24. Yes, we cannot believe that any other rational conclusion could be drawn.

25. A number of surveys have shown employers would like greater flexibility or are concerned about the pension outcomes from pure defined contribution schemes. The ACA 2007 Pension Trends Survey⁵ found 72% of employers wanted public policy to 'promote a new pension regime that combines better cost control for employers and a more stable benefit platform for employees through risk sharing between employers and employees'.

Question 7: Would this greater flexibility encourage employers who are considering a move out of DB provision to continue to bear some risk rather moving fully to DC?

26. Yes. And, because so many employers are considering this move in the immediate period ahead, this is why urgency in taking action to allow more flexibility is needed.

⁵ *ACA 2007 Pension trends survey* published by the ACA in December 2007. The survey included 336 employers covering 2.1 million members and total scheme assets of £127 billion.

Question 8: Would employers currently offering DC consider a move to a risk sharing arrangement?

27. Yes. At present, despite the forms of risk sharing that are available as described in this chapter, few employers feel that 'getting round' the existing rigidities of the law is a sensible option when making plans for the future. We believe that the volatilities associated with DC, and the consequent impact on human resources policies, will cause larger employers at present operating DC to consider risk sharing provided this offers a genuine ability to cap employer costs into the future by way of sound legislative reforms.

Question 9: Do employers consider the existing risk sharing options (for example cash balance schemes, career average) when looking at alterations to DB pension arrangements?

28. Yes, almost all medium to large employers, in our experience, take detailed advice typically from members of the ACA. As such advice to sponsors is normally given on a confidential basis, it may well be that any trade unions involved will not be aware that the employer has asked for and received it.

Question 11: Have the existing options proved inadequate and if so how?

29. We do not see that existing risk sharing options really address the issues. Cash balance plans, ultimately, are not very dissimilar from DC plans in that the entire annuitisation risk is borne by the member. Although such plans do provide some guarantees in the period prior to retirement (typically by guaranteeing an inflation linked roll up), in practice the guarantee could be largely replicated in a conventional DC scheme by the use of index-linked investments.

30. The only risk that a career average scheme removes compared with a typical final salary plan is the risk of pay increases in excess of the revaluation index (typically price inflation). The major investment and longevity risks remain with the scheme sponsor. Neither of these designs represents a balanced sharing of risk.
31. Other options such as DC /DB hybrids, which combine a reduced DB scheme with a DC top-up do reduce risk in that the employer's exposure to DB is smaller – because the scheme provides smaller DB benefits than if the entire scheme were DB - and reduce the risk to the members in that there is predictability over the part of the benefit which is DB compared with a fully DC scheme. But significant risks remain with both parties under these designs and they perhaps suffer from being 'neither one thing nor the other'.

Question 12: What could be done to regulation, legislation to make risk sharing alternatives discussed in this chapter easier to achieve?

32. The various existing risk sharing options described in the chapter suffer from the general employer (and adviser) view that they are an attempt to 'get round' rigid and over complicated legislation and don't really address the fundamental issues of risk sharing. They are therefore relatively rarely taken up and, in our view, this will remain the position until Government ceases to micro-manage pension design through overly complex legislation and regulation governing in particular defined benefit provision and, thereby, existing risk sharing schemes, all of which have some element of design governed by defined benefit scheme legislation/regulation.

Question 13: What could be done in information or guidance to make risk sharing alternatives discussed in this chapter easier to achieve?

33. Very little as things stand. As indicated earlier, existing options do not allow risk sharing between members and employees to be achieved in a truly balanced way. Advisers to employers are fully aware of these options when advising sponsors on benefit design changes for the future. The NAPF has also published a paper⁶ outlining some of the options available.

34. Easier achievement requires, as we have said before, much greater deregulation than has been achieved to date in the *2007 Pensions Bill*.

Question 14: Is the DB legislative framework disproportionate for cash balance schemes? Should the legislative framework be changed to allow schemes more freedom to apply revaluation and to increase annuity options available to members?

35. Yes, the legislative framework should be changed so that cash balance schemes are able to have incorporated in their design whatever revaluation or indexation increases are felt to be appropriate without fear that they may fall foul of existing DB indexation and revaluation requirements.

⁶ *All Change! Case studies from the changing world of occupational pensions* published by the NAPF in May 2007

Chapter 6: Conditional indexation schemes

Question 16: Would the introduction of conditional indexation schemes add significantly to the risk sharing already available to DB schemes?

36. Yes, it would provide an affordable option, within one coherent scheme, for those many medium to large private sector employers who want to do better than defined contribution whilst retaining the important elements of defined benefit that they have run with for many years.

37. In particular, career average conditionally indexed schemes could offer the following attractive features in relation to contributions to both employer and employees;

- employers could contribute the same percentage of pensionable earnings for future service benefits in respect of all employees; whilst employees could have a percentage contribution rate which increases gradually with age
- the attraction to employers is that future service funding contributions do not depend on the age structure of the workforce, unlike the current position with DB schemes where the older the member the greater the contribution rate
- the attraction to employees is that low contribution rates when young should not interfere with mortgage and/ or student loan repayments or the cost of bringing up a family
- for example, the employer contribution rate might be 10%, and the member contribution rate 1% at young ages increasing gradually, say in five year age bands, to 6% at age 50 and 8% at age 60 – this would result in total future funding contributions of 11% at young ages rising to 16% at age 50 and 18% at age 60.

Question 17: Is sharing investment risk with pension scheme members through indexation and revaluation provisions a suitable response to the costs and risks facing DB scheme sponsors? Is it acceptable that this risk should be transferred to retirees?

38. Investment risks in pension schemes should be allowed to be shared between the sponsoring employer and the scheme members in whatever manner they jointly agree when establishing the scheme and free from legislative prescription. The ACA's view, however, is that any financial downside should be shared amongst all categories of member (i.e. actives, deferreds and pensioners) through the conditional indexation mechanism rather than to favour certain categories of members at the expense of others. It is recognised that, if a year's pension increase is withheld and then subsequently reinstated, there is no requirement for the actual 'passed' increase to be repaid to the pensioners. This is to avoid the trap of prescriptive legislation requiring detailed individual calculations. Rather, we would expect the typical employer sponsoring such a scheme to request the scheme trustees to make a 'catch up' payment, when surplus subsequently emerges, on a broad brush basis, avoiding the need for administratively cumbersome and costly individual calculations.

Question 18: Are there other approaches to conditional indexation which you consider to be better?

39. None of which we are aware. The main difference between the ACA model and that described in paragraphs 6.33 to 6.53 is that the recovery plan, when a funding deficit emerges in the ACA model, would be for a short period subject to the Pension Regulator's requirements, which is typically over no more than 10 years. Under the other model, deficits are addressed by making a long-term reduction in the target rate of pension increases.

40. Accordingly, the “recovery plan” will normally be for a much longer period than under the ACA model because the reduction in pension increases only applies to benefits when in payment (rather than including revaluation increases in the period up to retirement) and is only a partial (rather than a full) reduction.

41. Of course, if there was only a small deficit under a conditionally indexed scheme operating under the ACA model, in practice:

- the employer might choose to make a (modest) additional payment on a year-by-year basis so that a full pension increase could be awarded in the year in question
- the trustees and employer might agree to make a partial reduction in revaluation and pension increases over the recovery period (typically less than 10 years) rather than suspend increases completely for a very short period.

Question 19: To what extent would DB scheme sponsors adopt this option as a middle ground for continuing to provide some sort of DB provision? If so, in what circumstances? If not, what might be adopted instead?

42. In our view, many existing DB scheme sponsors would incorporate conditional indexation in respect of future service benefits, if the law was changed to allow it, rather than switch to a DC scheme. That some employers would do so and would probably have retained the DB scheme had the law not been changed is possible. To use this argument, as some have, in order to oppose changing the law to allow conditional indexation is, in our view, misguided. The reality is that far more will switch to DC in the absence of a coherent risk sharing option.

43. We are sceptical of the results of consultation with employers at the current time, given the present economic climate and the different views that may be held within any one company (e.g. HR director, financial director, pensions manager, managing director, chairman, non-executive directors). Very many will be unaware of how conditional indexation schemes could work to the mutual benefit of employers and employees. We believe that once the law has been changed to allow conditional indexation, and employers have been given detailed advice by 'trusted' advisers as to its possible application to their situation, then there could be a significant take-up.
44. Conditionally indexed future service benefits could be incorporated in a new scheme or as part of an existing scheme. In the latter case, the assets accumulated in relation to the conditionally indexed benefits would have to be legally separate from those supporting the benefits which have already accrued, where indexation is not conditional.
45. In his recent speech, the Director-General of the CBI drew attention to the 3 million active members currently in private sector DB schemes closed to new entrants. He indicated, based on his discussions with employers, that many of the employers sponsoring these schemes would very soon be closing the schemes to future accrual of DB pension and switching to DC unless new ways of risk sharing were allowed by changing the law – in which case many of these employers would be able to change to conditional indexation rather than switch to DC for future service benefits.

Question 20: To what extent would DC scheme sponsors be expected to adopt a conditional indexation option to protect their employees from the risks inherent in DC provision?

46. The success of DB schemes incorporating conditional indexation for future service benefits could lead to some existing DC schemes, run by larger employers, being upgraded to new style risk sharing schemes which could include conditional indexation. Competition for, and retention of, staff are likely to be drivers of such changes, given the expected reduction in the UK workforce.

Question 21: Are the risks of implementing conditional indexation identified in this chapter appropriate? If not, which other risks do you think apply? How likely is it that these risks would materialise?

47. We believe the chapter covers the risks arising from such schemes quite well.

Question 22: If risk sharing is adopted, what sort of protection for members is appropriate?

48. As this question falls under the 'conditional indexation' chapter, we assume the question relates to such schemes. The chapter covers the ACA's recommendation that such schemes are regulated by the Pensions Regulator but are subject to a (lower) separate levy from the PPF to cover compensation in the event of employer failure. We believe the level of PPF compensation should be 100% of accrued benefits (for the reasoning, see para. 58, below)

Question 23: Does the fact that the risk sharing available to sponsors depends on the rate of inflation reduce the potential value of conditional indexation to them?

49. No, we believe this is a workable basis which employers and members will find acceptable.

Chapter 7: Collective defined contribution schemes

Questions 24-30

50. Collective DC captures many of the same features of the ACA's conditional indexation proposals and we therefore support them as a possible way of achieving some of the same objectives. Accordingly, our comments in response to questions on conditional indexation are relevant. Some of the differences are set out below.
51. Under collective DC the employer has no residual liability - meaning that in extreme circumstances members' accrued benefits could be reduced. In particular, there will be a gearing effect if pensions in payment are insured through annuities, resulting in the actives and deferreds taking the full brunt of the reduction in accrued benefits. It represents a different form of risk sharing i.e. between scheme members, rather than between scheme members and the employer
52. There would be no PPF protection available under a collective DC scheme in the event of sponsor insolvency leading to a reduction in accrued benefits.
53. The proposals, at least to the extent described in the consultation document, do not appear to be as fully developed as the ACA conditional indexation proposals and they may require more work before they could be implemented.

Question 31: What else could be done to increase the certainty or predictability for members in DC schemes?

54. Certainty of benefit outgo can be improved through low risk investment choices – the ultimate position being investment in non-profit deferred annuities where a guaranteed pension is purchased by each contribution. Such schemes were historically common in the UK but were perceived as providing poor value and have disappeared.

**General comments concerning the section on
ACA model of conditional indexation**

Moral Hazard

55. We believe that there are sufficient safeguards in the conditional indexation proposals to guard against moral hazard. In particular,

- scheme funding assumptions will have to be prudent and agreed between the scheme trustees and the sponsoring employer
- there is no leakage of past service surplus as the employer has to pay full future service funding contributions, with past service surplus being carried forward
- a refund to the employer on winding up would only be possible if full accrued benefits, including all past revaluation and pension increases and all future revaluation and pension increases, were secured by non-profit insured annuities from an insurance company
- we think the concerns in paragraphs A24 and A25 are not warranted.

Pension Protection Fund

56. We answer below the concerns expressed in paragraphs A31 and A32.

57. Our proposal for PPF compensation being 100% of accrued benefits with no cap means that members would lose out on any future revaluation and pension increases on their accrued benefits. Bearing in mind that contributions would have been paid to fund all future revaluation and pension increases on accrued benefits and that there would have been a strong expectation that all future revaluation and future pension increases would have been paid, over the long term, from an ongoing scheme, members will receive compensation from the PPF well short of their legitimate expectations.

58. Paying compensation from the PPF of 100% of accrued benefits with no future revaluation and pension increases is a sensible change from the current PPF basis as:

- there is no “cliff edge” between deferreds and pensioners (i.e. 90% capped compared with 100% uncapped compensation)
- all members’ benefits paid from PPF are materially less than were funded for and expected due to there being no future revaluation or pension increases.

NB: As our proposal is that PPF levies for conditionally indexed schemes are paid to a separate section of the PPF, the existing compensation rules for DB schemes would remain unaltered. There would be no inconsistencies as DB schemes and conditionally indexed schemes are sufficiently different to justify different treatment by the PPF.

Employer duty in Pensions Bill 2008

59. We address below the concerns expressed in paragraph A43.

60. The probability of revaluation and indexation being paid must be sufficiently high, given the use of prudent assumptions in scheme-specific funding, that conditionally indexed schemes should be available for exempting employers from contributing to new style personal accounts on a broadly similar basis to that if revaluation and indexation in the scheme were mandatory. For example, a slightly higher rate of minimum accrual of pension could be required – perhaps 10% greater than the minimum allowed for a scheme with mandatory revaluation and indexation.

61. We understand that 1/120ths is the minimum rate of accrual for final salary schemes for this purpose and that there is no equivalent minimum rate as yet for career average schemes. We suggest therefore a minimum rate of accrual for career average schemes of 1/110ths where there is mandatory revaluation and indexation and of 1/100ths where the revaluation and indexation are conditional.

Transfer values

62. The effect of our proposal to value accrued benefits, excluding future revaluation and pension increases, using a discount rate based on gilt returns has been understated materially by the assumptions made in paragraph A34.
63. Firstly, on a best estimate basis the discount rate used in respect of pensions in payment referred to in sub-paragraph (i) would not typically be a gilt yield (other than in the very rare situation where the scheme followed a gilt matching policy). A discount rate which included an addition of 0.5 to 1 percent a year to the gilt yield would be common.
64. Secondly, the gilt discount rate, referred to in sub-paragraph (ii), would typically be expected to be more like 3 to 4 per cent a year less than the equity-oriented discount rate.
65. These changes would result in quite different conclusions to those in paragraph A35. Indeed the results would be shown to be broadly equitable between the approaches in sub-paragraphs (i) and (ii).

66. By way of example, we have tried to replicate your calculations in A35 but assuming:

- a post retirement discount rate of gilts +0.75% pa
- a pre retirement rate of gilts +3.5% pa

(i.e. well within the range of typical best estimate assumptions in a scheme which follows a mixed investment strategy)

Our calculations suggest that, rather than the 50 per cent reduction for a 35 year old suggested in paragraph A35, the transfer value available would in fact be slightly **higher** using a gilt approach without allowance for future conditional increases.

Thus paragraphs A36 and A37 would become irrelevant.

Adjustment of normal retirement age

67. There are three points we would like to make.

(i) **Applicability to schemes which are other than conditionally indexed career average schemes**

This facility was included in our specification for conditionally indexed career average schemes because it seemed appropriate to do so in a scheme designed to share risks between employer and members. Of course, adjusting normal pension age in respect of past service benefits is quite separate to the conditional indexing of accruing pension. Thus, it could be a matter of scheme design as to whether this facility was included in a particular scheme. Also, it could be applied to other types of schemes, not involving conditional indexation e.g. defined benefit final salary schemes. If implemented in an existing scheme, it should apply only in respect of benefits accruing after the date of implementation.

(ii) **Actuarial evidence in support of increasing normal pension age**

We would propose that the actuarial evidence to prove that life expectancy had increased, in schemes where the membership is not sufficiently large to rely on scheme-specific statistics, could be by reference to indices produced by the Actuarial Profession's Continuous Mortality Investigation of self-administered pension schemes. Such indices could be produced showing the average life expectancy (based on current rates of mortality with no allowance for any future reductions in mortality rates) at typical retirement ages in succeeding years. For example, if the life expectancy of lives aged 65 in 2009 was 20 years and in 2015 was 21 years, that might be evidence to support increasing in 2015 the normal pension age of 65 in a scheme which had commenced in 2009 to age 66 in 2015.

In practice, male and female life expectancies would be considered separately and the increase in normal pension age would have to be not more than the increase in life expectancy.

(iii) **Age discrimination**

We would agree with the justifications given in paragraph A17 in respect of raising normal pension age for members who have 10 years or more to go before reaching normal pension age. In our original draft specification submitted to DWP, we had incorporated 5 years but this was felt by DWP officials to be too short a period. We extended the period to 10 years on the grounds that a round number should be used (to indicate that there was no precise calculation involved) and that 15 or 20 years seemed too long a period.

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