Papers

Pension schemes for 21st century: Is there a third way?

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Abstract In the context of the defined benefit to defined contribution trend, this paper considers the possible consequences of transferring pension risks from employer to employee. It also questions whether the current trend is terminal or whether there might be a 'third way' for the future of pension provision in the UK. The paper does this by surveying the people that matter the most when it comes to scheme design — sponsoring employers. Finally, on the assumption that there may indeed be a third way for pensions, the paper looks at some of the options, including those just put forward in a government consultation paper.

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Executive summary

Changes in the defined benefit (DB) pension scheme landscape in the past decade and, in particular, the shift to defined contribution (DC), have been well documented. It is also well recorded that a shift to DC is often linked to a reduction in employer contribution rates.

Although DB scheme closures may have slowed in recent years, it is still widely accepted that future pension provision in the UK and beyond, at least in the private sector, will be predominantly DC.

Is this correct and, if so, what does it mean for pension scheme members and their employers?

With the help of the Pensions Management Institute, HSBC Actuaries and Consultants Limited have, through a survey of over 300 advisers, trustees, pension managers and employers,

sought to ascertain some of the wider implications of the DB to DC trend. The survey looks beyond just the impact on contribution levels, to address the burning question of whether it is terminal or if there is, in fact, another option — *a third way* — for employer pension provision in the 21st century.

The survey asked respondents about their own pension schemes and then obtained useful feedback on a wide variety of relevant issues. It investigated opinions on the possible consequences of current trends, including employee understanding of pension risks through to views on how employers should respond. Consideration was also given to the prospective implications of the introduction of personal accounts in 2012.

Key findings from the survey include the following:

- An overwhelming consensus that employees, in general, cannot manage the risks that are

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transferred to them when workplace pension provision is switched from DB to DC.

- An equally clear agreement that something needs to be done about this.
- A stark warning that personal accounts will lead to a leveling down of current workplace pension provision.

The survey also asked respondents about reforms that they would make to the existing pension environment. Given the ongoing government deregulatory review, the consultation on 'risk sharing' pension arrangements and proposals on accounting for pensions, this is, again, instructive feedback.

Many of the findings may not surprise readers. This, however, does not alter the fact that, notwithstanding the near unanimity in relation to responses on issues such as the risks associated with current pension trends, there is still little or no action on the part of stakeholders.

This report therefore concludes with some ideas on alternatives to conventional DB and DC, which, in the right environment, may offer employers some options in respect of that previously referred to and elusive 'third way' for employer pension provision in the 21st century.

When analysing the results, we were cognisant of the fact that the views that matter most are those of the people who choose to set up schemes. Therefore, to ensure that the opinions of schemes sponsors were consistent with the views of survey respondents generally, we separately surveyed employers (finance, managing and human resource directors) on our own database. Where differences in opinion arose, these are highlighted in the main text.

The survey

The *Pension Schemes for the 21st Century* survey received 338 responses, representing the views of advisers, trustees, pension managers and employers.

The breakdown of responses by reference to role is shown in Figure 1. For the purposes of the survey, we initially treated the views of those who are a pension manager for one employer, or for a group of employers, as being 'employer views'. As indicated above, however, to ensure that this has

Figure 1: The role of respondents

Figure 2: Pension arrangements of respondents

not skewed the results, we separately surveyed finance, managing and human resource directors on our own database. Where the employer-only views produced results materially different from those of the main survey, a separate figure is shown.

Over 90 per cent of responses in the main survey came from people employed in the private, as opposed to public, sector and the type of pension arrangement operated by respondents is shown in Figure 2.

Most DB schemes were final salary (85.4 per cent) and closed to new entrants (62.1 per cent). The rest were either career average revalued earnings (CARE — 6.6 per cent) or 'Other'. Surprisingly, no respondent was a member of or operated a cash balance scheme (see the next section).

Most DC arrangements were occupational pension schemes, with trustees, as opposed to contract-based personal or stakeholder pension plans, and average employer and employee contributions are set out in Figures 3 and 4.

Figure 3: Average company contributions to respondents' pension schemes

Figure 4: Average compulsory employee contributions to respondents' pension schemes

A switch from DB to DC is often associated with a significant reduction in employer contribution. For many this may indeed be the case, but our survey also confirms, in line with other recent studies, that DC contribution rates are on the increase; over 50 per cent of the schemes in our survey receive an average employer contribution of more than 10 per cent.

In any event, this report is more concerned with the 'risks' associated with different types of pension schemes (such as investment and longevity risk) and the fact that in a conventional DC scheme, regardless of the amounts being paid into it, those risks sit with people who may be ill-equipped to deal with them (ie ordinary employees), when there are others who are better placed to manage and diversify at least some of the risks.

When asked whether employees understand the risks associated with different types of pension schemes, the views of all respondents were clear ... they emphatically do not. Figure 5 represents

Figure 5: Employee understanding of pension risks

Figure 6: Employee understanding of pension risks (risk breakdown)

the opinions of the 297 respondents who completed the 'risks' part of our main survey.

Breaking risks down into investment, longevity and inflation components and then asking separately for each whether employees were in a position to manage the risk in question elicited almost identical responses.

Some subtle discrepancies can, however, be observed (see Figures 6 and 7). In particular, there is a depth of feeling about employees' inability to manage longevity risk, and respondents were slightly more confident about employees managing inflation risk than investment and longevity risks.

The above results are supported by a recent survey from the National Association of Pension Funds,¹ which found that, among finance directors, DC worries centred around the competence and ability of employees to understand the financial implications of a scheme, the management of an investment profile and the complexity of legislation.

Figure 7: Succession planning risk

It is also important to look at the issue of 'risk' from a wider perspective, and there are at least two issues affecting employers that spring to mind in the context of a DB to DC trend.

First, as we move into an era where, under anti-age discrimination legislation, employers will not be able to compulsorily retire employees (bearing in mind that the current default retirement age of 65 is possibly just a temporary measure), employees may reach their pension age but simply refuse to leave on the grounds that they cannot afford to retire. According to our main survey, around 80 per cent of respondents foresee problems with succession planning.

Secondly, staff unrest could arise between employees who joined their company's DB scheme before it closed to new entrants and workers who missed the cut off date and are only eligible for a DC scheme that might have an employer contribution rate of much less than the rate the company pays into the DB arrangement.

Our survey (see Figure 8) does indicate that staff relations is a potential problem in the context of two-tier pension provision, although it is not seen as being as big an issue as succession planning.

How should employers respond to these risks?

Nearly all respondents either agreed or strongly agreed that employers should take action to help employees manage their pension risks, so that their pension is more likely to meet their expectations (see also the Appendix, which sets out 'other' findings from the main survey).

When asked whether employers should be willing to share some pension risks with

Figure 8: Two-tier workforce risk

Figure 9: Employer's willingness to share pension risks

Figure 10: Employer's willingness to share pension risks (risk breakdown)

employees, most respondents agree that they should. As Figure 9 shows, however, only around 20 per cent strongly agreed with this contention and a significant minority of over 12 per cent disagreed.

Anticipating the above results, we, again, broke the pension risks down into investment, longevity and inflation risk, and the views of respondents from the main survey are set out in Figure 10.

It is at this juncture, however, that the results from our employer-only survey become relevant

Figure 11: Employer's willingness to share pension risks (risk breakdown)²

(up to this point, the views of employers have, on all issues, been similar to those of other respondents).

As shown under 'employer-only' (Figure 11), there is a consensus between scheme sponsors and others on the need for employers to take action in order to help employees manage pension risks. There is also agreement, albeit to a lesser extent, on the need for employers to be willing to share some of the risks.

Important discrepancies arise, however, between the main and employer-only surveys when employers are asked about specific risks. In the current environment, around 58 per cent do not accept that employers should share employees' pensions investment risk, and over 60 per cent do not want to share either longevity or inflation risks.

Given that pension scheme benefit structure is largely a matter for employers, and that, with just a few exceptions, companies closing their DB pension schemes are replacing them with pure DC, is there anything that can be done that might stem or even go some way towards reversing the current appetite for transferring pension risks from employer to employee?

We consider this question in the next section.

Before turning to this, however, we also asked respondents about their views on personal

Figure 12: Impact of personal accounts

accounts and the potential impact on existing provision. The results are shown in Figure 12.

Pension schemes for the 21st century

Some of the respondents to our survey felt that the solution to employees' inability to handle pension risks was better communication and education. As one particular respondent observed to the contrary, however

'Employees have only two questions about pensions, what will it cost and what will I get? Beyond this they don't want to know.'

If it is accepted then that communication and education are not a panacea to the weaknesses of DC, and if it is conceded that traditional final salary has had its day, is risk sharing a solution? If it is, what are the options?

CARE schemes have already been mentioned. For the few employers who have closed their final salary scheme while sticking with DB, CARE has proved to be very popular.

Nevertheless, investment and longevity risks typically remain with the employer, and without additional incentives and relaxations it seems highly unlikely that employers who have switched to DC, or are considering doing so, would be willing to choose CARE instead.

Conversely, and notwithstanding the overwhelming view of respondents that employees cannot manage longevity risk, cash balance is a proper risk-sharing vehicle and can have a high perceived value with employees.

As shown in Table 1, depending on the basis of the scheme, cash balance introduces a real spread of risk between employer and employee.

Further, there is considerable logic in this form of risk sharing with, broadly speaking, the employer carrying the risk pre-retirement, and the employee dealing with it post-retirement (probably by annuitisation). In addition to some certainty, cash balance also provides members with flexibility in terms of setting up a retirement income that will fit with their particular circumstances.

A more recent development in DB risk sharing is the 'living benefit structure', whereby employee contribution rates, retirement ages and/or even benefits are adjusted to reflect changes in longevity.

The design operates like a conventional final salary or CARE arrangement, except that an

additional element — the Change in Life Expectancy Factor (CLEF) — is written into the benefit formula. So, for instance, a typical living benefit structure formula would be as follows:

$$1.5\% \times \text{Final pensionable pay} \\ \times \text{Pensionable service} \times \text{'CLEF'}$$

CLEF is the longevity adjustment — the CLEF — which is a ratio such as

$$\frac{\text{Age} \times \text{Life expectancy at the date the living benefit structure is introduced}}{\text{Age} \times \text{Life expectancy at the date the member retires}}$$

And it works like this: on 1 January 2008, a scheme introduces the living benefit structure for future service. A member in service at that time retires 10 years later and his benefit entitlement is 15 per cent of $\text{FPS} \times \text{CLEF}$. If life expectancy has increased by 10 per cent between 2008 and 2018, the effect of CLEF is to reduce the amount of pension by 10 per cent.

The groundbreaking aspect of this is that the whole of the benefit attributable to post-2008 service is adjusted in 2018 to reflect increasing longevity in the interim. Once the pension is in payment, there is, of course, no suggestion of further longevity adjustment (so this part of scheme longevity risk stays with the employer and the member is just bearing the risk in respect of pre-retirement improvements in post-retirement mortality).

Finally, drawing on experiences from other countries, such as the Netherlands, bodies such as the Association of Consulting Actuaries are calling for legislative changes to facilitate 'conditional indexation', where revaluation of accrued pensions depends on levels of scheme funding. In the Netherlands, employers have switched from final salary to CARE and have also made the revaluation of pensions conditional on satisfactory funding of the scheme. This introduces risk sharing in relation to both salary progression (inflation) and investment.

The government has refused to introduce provisions into the current Pensions Bill to facilitate new risk-sharing schemes. They are,

Table 1: Scheme designs

<i>Design</i>	<i>Final salary</i>	<i>Cash benefit</i>	<i>Money purchase</i>
<i>Risk</i>			
Investment	Employer	Employer	Employee
Longevity	Employer	Employee	Employee
Earnings progression	Employer	Employer/employee	Employee

however, consulting on ways in which risks could be shared in pension schemes and are considering the issues associated with different approaches.² In relation to conditional indexation, the government consultation paper observes that such schemes could be implemented in a number of different ways. Two possible approaches are put forward.

The first approach would allow conditional indexation to be applied to career average schemes. The key elements are as follows:

- revaluation of salaries and indexation of pensions in payment would depend upon the financial health of the scheme;
- normal pension age within the scheme would be variable (within certain parameters) to take account of changes in life expectancy; and
- when a scheme has recovered after a period of underfunding, the reinstatement of revaluation and indexation rights would take priority.

The second approach would allow all DB schemes, including final salary schemes, to introduce conditional indexation arrangements in a similar way to that set out above, but it does not include any provisions for changes to normal pension age.

Of course, the problem with DB risk-sharing schemes, no matter how innovative, is that employers have already had a bad experience with final salary and it is likely that the old adage *once bitten twice shy* will be applied to all forms of DB.

Without further encouragement, the fact is that the future for DB looks bleak. Our survey, therefore, included a 'wish list' question; that is, if respondents could alter any aspects of the current pensions environment, what changes would they make. The results are shown in Figure 13.

In the context of the above, it is interesting to note the following:

1. the relative lack of support for a reduction in revaluation rates (a change that is provided for in the current Pensions Bill);
2. according to a recent OECD report,³ the UK is the only country that imposes both mandatory

revaluation and mandatory indexation on DB pension schemes; and

3. the importance attached to changes to pensions accounting (the inference being that respondents disagree with the current approach where, on an accounting basis — FRS 17 or IAS 19 — a scheme can be in surplus one week and deficit the next).

Even if the regulatory environment did become more conducive towards risk-sharing schemes, this might not be enough and, arguably, nothing less than a direct financial incentive will turn the DC tide.

For instance, should employers with DB schemes receive additional incentives (eg tax reliefs) to reflect the extra commitment they are demonstrating by sharing the risks, as well as the costs, of pension provision with their employees?

Whatever one's view is on this, there is no suggestion of it happening. This report, therefore, concludes with a consideration of risk sharing in a DC context.

From a DC perspective, the nature of risk sharing is very different and often it is only possible to achieve risk 'reduction'.

When DC members buy a conventional annuity, they are passing longevity risk to their chosen provider. There is no reason, however, why there should not, in principle, be risk sharing at the point of annuitisation.

Also, lifestyle funds are a familiar risk reduction medium for DC investment risk.

A more recent example of risk reduction initiatives in DC is target-driven investing. Drawing on lessons learned from liability-driven investment in DB schemes, some investment managers are offering funds that aim to generate positive returns regardless of what is happening in financial markets, while protecting accumulated capital. The objective is to give members more certainty in terms of their target level of income in retirement, but, of course, there is no guarantee of the final outcome.

As with DB risk sharing, lessons can also be learned from other countries. In Denmark, for instance, the country's largest pension fund, ATP,

Figure 13: Changes that should be made to the pensions landscape

is seeking parliamentary approval for a new DC product, which has a level of guaranteed return on contributions at no extra cost but also generates higher potential investment returns.

The government consultation paper mentioned above also includes a section on 'collective defined contribution schemes'. The key elements of this approach are as follows:

- it gives the employer complete certainty over costs, as the contribution rate is fixed;
- based on this contribution, benefits are calculated as in a DB scheme;
- if the scheme is underfunded, revaluation and indexation can be withheld;
- if funding levels drop too low to allow payment of basic benefits, the scheme can either increase normal pension age or reduce basic benefits; and
- risks are shared between scheme members
 - unlike in pure DC arrangements, there are no individual accounts.

It has been suggested, however, that these schemes would only really appeal to large employers or industry-wide schemes.

With the continuing growth in DC, and the introduction of personal accounts in 2012, further innovation in this market is inevitable. The question is, given everything stated in this paper, will it be enough?

A very recent Research Report⁴ from the Department for Work and Pensions suggests that there is a lack of enthusiasm in respect of risk sharing and pension provision, and scepticism about the risk-sharing approach. Key findings were as follows:

- Reasons for pension provision tend to focus around three key areas of paternalism, maintaining parity with competitors and the fact that the company has always provided a pension. Reasons tended to be broadly similar across the different types of organisations, regardless of the current form of pension provision.
- Overall, the employers in this study were not keen on a risk-sharing approach to pension provision and in general, awareness of these approaches was low. Furthermore, some employers found the concept of risk sharing quite difficult to comprehend.

- Employers were generally sceptical about the risk-sharing concept and very few employers perceived there to be any advantage in adopting such an approach because they were satisfied with their current pension provision, had concerns about the real costs of risk sharing and perceived risk sharing to be a complex concept that was difficult to communicate to employees.
- Employers were provided with examples of two approaches to pension scheme risk sharing and were asked to consider the pros and cons of each approach. These were collective defined contribution scheme and conditional indexation scheme. There was little enthusiasm for either aforementioned scheme.
- Employers in this study had no plans or intentions to introduce a risk-sharing approach to pension provision. Employers with existing DB schemes were committed to maintaining their existing approach because they viewed it as a key tool in attracting and retaining staff. Employers with DC schemes expressed no interest at all in taking on any risk in relation to their pension schemes because they were accustomed to a 'minimum risk' approach to pension provision.

It would, however, be dangerous to read too much into this small-scale piece of research that involved only 30 face-to-face interviews.

In summary, it appears likely that, in the short to medium-term, current pension trends will continue but, beyond that, the future is much more uncertain and will depend on, *inter alia*, the repercussions of an increasing number of DC arrangements moving from their current 'accumulation' stage to the decumulation phase.

Notes

- 1 See <http://www.napf.co.uk/DocumentArchive/Policy/Surveys/FD%20Survey%20July%202008.pdf>.
- 2 See <http://www.dwp.gov.uk/consultations/2008/risk-sharing.asp>.
- 3 OECD Working Papers on Insurance and Private Pensions No. 17..
- 4 See <http://www.dwp.gov.uk>.

Appendix: Other results from the survey

See Figures A1–A4.

Figure A1: Impact of DB to DC trend on employee expectations

Figure A2: Importance of pension schemes in attracting and retaining employees

Figure A3: Employer's role in management of pension risks

Figure A4: Impact of personal accounts on scheme design