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RISK SHARING – THE GOVERNMENT CONSULTS

1 INTRODUCTION

Private sector pension provision in the UK has traditionally been dominated by defined benefit (DB) schemes. However, since the DB heyday of the late 1960s when nearly 8 million people were contributing to DB pensions[1], private sector employers have moved in droves towards defined contribution (DC) alternatives.

Shared risk schemes are seen as potential alternatives to (or the middle ground between) the opposing models (in terms of risk) of DB and DC. Following a highly publicised campaign by the Association of Consulting Actuaries (ACA) (amongst others) in support of shared risk schemes, the Government has finally launched a consultation seeking views on their viability. The consultation closes on 28 August 2008.

2 KEY POINTS

- Three possible models of shared risk scheme are envisaged by the consultation (section 4).
- The idea underlying such schemes is that risks are shared more evenly between the employer and scheme members, or across the membership, depending on the model selected.
- Not surprisingly, the impact on existing legislation (including funding requirements) and effective communication with members are key considerations for the Government (section 5).

[1] DWP Risk Sharing Consultation, 5 June 2008 (p.1)

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3 BACKGROUND

Increased costs, adverse financial markets, improved life expectancy and the decrease in inflation during the 1980s/90s are all cited as reasons for the decline in traditional DB pensions.

Back in July 2007, the Deregulatory Review of Private Pensions[2] identified that there could be advantages for employers and employees in sharing the risk in DB schemes more evenly. The consultation (which flies under the banner of the Deregulatory Review) therefore looks in detail at how shared risk schemes could work in practice. Acknowledging that the issues relating to risk sharing are complex, the Government's objective is nonetheless "to encourage innovation and growth in the market", whilst striking "a balance between reducing costs for employers and protecting members' benefits".

4 THE THREE MODELS

The consultation describes three main models of shared risk schemes: conditionally indexed career average schemes; conditional indexation for all DB schemes; and collective DC schemes. (It also illustrates the ways in which some schemes have already achieved risk sharing within the current legislative framework.) Drawing on lessons from abroad, the consultation highlights in particular experience in the Netherlands, where over the last decade conditional indexation career average schemes and collective DC schemes have come to dominate the Dutch pensions market.

A theme common to all three models is that they would be contracted-in to the State Second Pension. In addition, to help manage longevity risk, the possibility of employers having greater flexibility to increase normal pension age (NPA) in respect of accrued benefits is discussed in terms of all three models. To protect those close to retirement, this option might only be available in respect of active and deferred members who are more than 10 years away from NPA. Actuarial evidence of increased life

[2] Lewin, C and Sweeney, Ed; July 2007 - Deregulatory Review of Private Pensions: An independent report to the Department for Work and Pensions

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expectancy would be required and “prescribed safeguards” would have to be complied with.

We set out below some of the other key features of the three proposed models.

4.1 Conditionally indexed career average schemes

In a conditionally indexed career average scheme, benefits would be based on earnings in each year rather than on final salary. Revaluation of benefits in the scheme pre-retirement, and the indexation (increase) of pensions in payment, would be targeted but not guaranteed. Such schemes would be subject to the scheme funding requirements of the Pensions Act 2004, and so the scheme’s trustees would need to adopt prudent actuarial assumptions which would take into account both targeted (but not guaranteed) revaluation and pension increases.

If the latest actuarial valuation showed the scheme to be fully funded, benefits would be increased in line with the scheme’s target. Any revaluation or increase granted in a particular year would then become a defined benefit.

However, if the scheme were in deficit, revaluation and pension increases would be withheld (hence the sharing of inflation risk between the employer and the members). As the scheme’s funding position recovered, any withheld revaluation / increases would be reinstated (annual actuarial valuations would be required until all withheld target benefits had been restored).

4.2 Conditional indexation for all DB schemes

The second possibility outlined in the consultation is to permit conditional indexation of pensions in payment in any DB scheme for future service, including a final salary scheme, provided the scheme rules specifically allow this. This could be achieved by the introduction of an entirely new scheme or via a new section of an existing scheme (keeping the finances of the old and new sections separate).

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Contributions in respect of active members would be calculated (again using prudent assumptions) on the basis that the pension accruing in a given year would be fully indexed by Limited Price Indexation (LPI)[3] once in payment.

Pensions in payment would be increased in this way provided the scheme's funding level remained sufficient to support this for all existing and future pensioners. Where funding levels fell below this threshold, full indexation would be suspended, although partial indexation could continue if affordable. (Increases already granted to existing pensioners would be unaffected.) Any suspension could be lifted if the employer "voluntarily agreed to make additional payments".

Full future indexation would be resumed once the scheme's financial position permitted. As with the previous model, a catch-up representing indexation lost during a period of suspension would also need to be provided.

4.3 Collective DC Schemes

Finally, the third model envisages the sharing of risks between members (as opposed to between the members and the employer).

The employer in a collective DC scheme pays fixed contributions (as a percentage of pensionable pay) into a collective fund. A targeted rate of pension is then calculated annually, as a percentage of pensionable pay on a career average basis. A target rate of revaluation will also apply in each year until retirement and to pensions in payment.

Investments would be pooled in one fund (sharing the investment risk across all members), allowing returns to be smoothed and avoiding significant negative effects on those retiring in a downturn. The benefits payable from the scheme would be conditional on the funding position and not guaranteed. If the scheme were underfunded, revaluation and indexation would be reduced in the first instance. Benefit levels could also be reduced if the scheme remained underfunded.

[3] The increase in the Retail Prices Index, capped at 2.5%

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5 SOME KEY CONSIDERATIONS

A number of legal and practical considerations relating to the possible introduction of shared risk schemes are flagged in the consultation. Areas of legislation thrown into the consultation mix include scheme funding, employer debt, transfer values, surpluses, preservation of deferred pensions and benefits on winding-up. Other significant points raised include:

5.1 Moral Hazard

In the context of conditionally indexed DB schemes, the consultation expresses concern that employers might have an incentive to resist agreeing sufficiently strong funding assumptions so as to meet the revaluation and indexation target (resulting in a reduction in overall funding costs). However, the statutory scheme funding requirements should be sufficient to avoid this risk materialising, particularly given the need to put in place a recovery plan for eliminating any deficit.

In any event, the Pensions Regulator could potentially intervene in cases of concern by, for example, giving directions in relation to the actuarial assumptions to be used or by imposing a schedule of contributions.

5.2 Interaction with the Pension Protection Fund (PPF)

As part of its proposals regarding conditionally indexed schemes, the ACA suggested that compensation available from the PPF should be pitched at 100% and be uncapped[4] (but exclude future revaluation and pension increases). The PPF levy for such schemes would reflect that level of benefits.

However, the Government clearly views the restrictions on PPF compensation as being "designed to ensure that trustees, high earners and others in positions of influence in

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[4] Under the PPF, members below normal pension age at the start of an assessment period receive 90% compensation, subject to a compensation cap. The PPF compensation cap is currently £27,770 per year

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a company or pension scheme have a clear incentive to ensure the proper management and funding of the scheme". The consultation therefore suggests that "these incentives would be seriously diminished if no one would lose out should a scheme be inadequately funded".

5.3 Adjustment of Normal Pension Age

As mentioned above, the proposals for shared risk schemes include a facility for increasing NPA. This could have age discrimination implications as younger workers may be able to argue that this indirectly discriminates against them on the basis of their age, when compared to workers within 10 years of retirement who are permitted to retain their NPA.

But the European Equal Treatment Directive[5] gives Member States some latitude to permit different treatment on grounds of age where such difference is objectively justifiable. Consequently, in light of the exemptions already set out in the Age Regulations[6], the Department for Work and Pensions will be giving this possibility further thought.

5.4 Communication with members

Viewed as "more complex than a pure DB scheme", communication with members regarding their benefits under shared risk schemes is a recurring theme in the consultation. If adopted, this would entail setting out which benefits are guaranteed, which are not, and what the various conditions are.

[5] Directive 2000/78 EC

[6] The Employment Equality (Age) Regulations 2006

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