SACKER & PARTNERS

RISK SHARING

RESPONSE TO CONSULTATION

Note: *for information purposes we have included an Appendix to this document summarising the three main models of shared risk scheme which are described in the Consultation Paper. This was not included with the response submitted to the DWP.*

The comments set out below form the formal response ("Response") of Sacker & Partners LLP ("Sackers") to the Risk Sharing Consultation ("the Consultation Paper") published by the Department for Work and Pensions ("DWP") on 5 June 2008.

Sackers is a firm of solicitors specialising in pensions law. The views expressed in this Response have been collated following discussions with a representative group of the firm's solicitors.

General Comments

1. We note that the aim of the Consultation Paper is to explore ways in which the DWP can encourage and support good pension provision, and to gather evidence and opinions on risk sharing in occupational pensions. We are supportive of such a policy which is designed to provide, through occupational pension provision, a good level of retirement income for pensioners.

2. While the Consultation Paper recognises the risks which are inherent in existing models for occupational pension provision, in discussing the benefits of shared risk schemes, the Consultation Paper emphasises the difference between pure defined benefit (DB) models and the proposed alternative arrangements. In doing so, in our view, the Consultation Paper understates the potential benefits of risk sharing. The extent of the decline in the traditional DB model to date means that a more pertinent comparison may be between pure DC and the proposed new risk sharing models.

3. As the Consultation Paper explains in Chapter 2, "since the 1970s, there has been a trend of private sector employers closing DB schemes and switching to defined

contribution (DC) schemes. This trend … accelerated in the early years of the current decade.” This transition is something which we have witnessed first hand.

4. Anecdotally, the most popular alternative to DB provision has been to offer trust-based DC schemes (particularly for new hires but also for future service generally). But contract based DC arrangements and career average revalued earnings (CARE) schemes have also proved popular. Clients who have not sought any alternative to the traditional DB model of benefit provision on closure of their existing schemes – either to new entrants or future service – are in the minority.

5. We support the recognition that there are viable alternative means of providing retirement benefits, not just through traditional DB and DC structures. We also support the recognition that changes need to be made to the legal framework to facilitate these risk sharing alternatives. The proposed changes to retirement provision to introduce risk sharing would bring increased flexibility and may help to bolster occupational pension provision, given the exodus which has already occurred from pure DB schemes.

6. However, we question the appetite at the current time for further change, particularly in the present economic climate. Employers who have already implemented significant changes to pension provision in their workplace may also be unlikely to wish to spend additional time (and cost) which would be associated with further change.

The three options

7. The Consultation Paper describes three main models of shared risk schemes:

- Option 1 – conditionally indexed career average schemes;
- Option 2 – conditional indexation for all DB schemes; and
- Option 3 – collective DC schemes.

8. 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.

Legal issues for Conditional Indexation

9. The following legal issues need to be addressed in providing a framework for risk sharing based on conditional indexation in career average schemes and in DB schemes generally. The comments below therefore apply to both Options 1 and 2.

Adjustment of Normal Pension Age (NPA)

10. The Consultation Paper appreciates the risk that younger workers may argue that the proposal for flexibility in NPA, for those members who are more than 10 years from NPA, is indirectly discriminatory. A possible solution is to make an amendment to the permitted exceptions contained in Schedule 2 to the Employment Equality (Age) Regulations 2006. We agree that, as noted in paragraph A.16 of the Consultation Paper, before attempting this, the Government would need to be certain that any proposed exemption would not constitute discrimination prohibited by the EC Equal Treatment Directive.

11. In addition, in circumstances where there has been a postponement of indexation over several years, there is a risk of indirect age discrimination on the basis that older, longer serving workers' catch-up payments represent a first call on the scheme's funds.

12. We also note that section 67 of the Pensions Act 1995 may need consideration. Section 67 is designed to protect members' subsisting rights in an occupational pension scheme. Conditionally indexed CARE schemes seeking to change NPA retrospectively are likely to fall foul of this protective provision. Thought therefore needs to be given to amending section 67 in order to accommodate this aspect of shared risk schemes.

Scheme Funding

13. We support, in principle, the recommendation that more regular funding valuations are undertaken in conditionally indexed schemes, so that progress against target benefits can be carefully monitored. However, the Government may wish to explore the scope for reduced compliance in the intervening years of the triennial actuarial cycle, given the fact that overregulation of pensions is often cited as one of the main reasons employers have ceased to offer DB benefits.

14. When setting up a conditionally indexed pension arrangement, establishing the balance of powers will be of paramount importance for employers. Given that all such schemes are likely to be established as new arrangements, guidance as to an appropriate balance of powers would be welcome, in particular in connection with responsibility for setting the contribution rate.

15. On the basis of the proposed models for conditionally indexed schemes, there is an increased risk for those closest to retirement who may not benefit from indexation if they retire during a period of postponement. This potential cliff-edge effect means that the position of the employer is even more important than in traditional DB schemes. This could have the consequential effect of increasing the (already onerous) duty on trustees to monitor closely the employer covenant, to ensure that any potential problems with scheme funding are identified quickly so that this risk is minimised. It may be appropriate for the Government to reconsider the methodology in order to address this issue (for example to provide a smoothing effect for those nearing retirement age, similar to that found in "life style" funds in DC schemes).

Transfers

16. Annex A of the Consultation Paper (at paragraphs A.33 – A.38) deals with the way in which transfer values would be dealt with. We agree with the proposal at A.37 that a sensible approach would be "to assimilate transfers from conditional indexation schemes within the existing rules on the calculation of transfer values", to give fair value on transfers. Thought would also need to be given as to whether the same principles would apply on bulk transfers and transfers-in. In addition, the potential

cliff-edge effect referred to in paragraph 15 above will also be a concern in respect of members who transfer during a period of postponement.

Contracting-out

17. We support the proposal that shared risk schemes should not be contracted-out. It is a sensible approach as such arrangements will have their own complexities in terms of administration and communication. It is also consistent with the Government's commitment to phase out contracting-out generally.

Personal Accounts

18. If provision is to be made in legislation to facilitate the existence of conditionally indexed schemes, it will be necessary to determine how these schemes would satisfy the eligibility requirement for the purpose of the Personal Accounts regime in 2012, (so that conditionally indexed schemes which are compliant with the new regime will be qualifying schemes for automatic enrolment purposes).

Pension Protection Fund (PPF) Compensation

19. With regard to the proposal that the PPF should provide 100% of target benefits in respect of any conditionally indexed schemes which it takes on, we consider that sponsors of other DB schemes may have views on this proposal if conditionally indexed schemes were to be provided with additional benefits for the same PPF levy payment.

Legal issues for Collective DC Schemes

20. In respect of the legal issues for collective DC schemes, the only point we would raise is the need ensure that any framework put in place to permit the operation of Collective DC Schemes is structured in such as way as to ensure that these schemes cannot inadvertently fall within the DB regime, with the consequence that employers become subject to stringent requirements on funding.

Disclosure and Communication

21. One area which the Consultation Paper does not address in detail is disclosure. The current disclosure requirements in respect of pensions are already complicated and set out in a number of different places. In addition, we note that any disclosure requirements relating to shared risk schemes will need to take into account the Deregulatory Review proposals on disclosure. Any solution for shared risk schemes (and for occupational pension provision generally) which draws all of the requirements on disclosure together would be helpful, given the inherent complexity of the area.

22. Disclosure will be particularly important at the points when members make decisions which crystallise their benefit, at a time when postponed increases have not been given (for example on transfers or at retirement).

23. In the context of conditionally indexed schemes it may not be necessary to create completely new communication packages, but those already used (e.g. benefit statements, statutory funding statements etc.) for DB schemes could be adapted for communication with members of conditionally indexed schemes.

24. We understand that in the Netherlands it is the Government which provides standard form member communication (for each of the six different types of conditional indexation) which employers must use without adaptation. Because of the complexity involved in communicating the premise of conditional indexation, these communications highlight in particular the risk that while indexation has been granted in one year, this is not a guarantee that indexation will be applied in future years. This can help prevent misunderstandings and the risk of claims.

Compliance and Monitoring

25. The inevitable complexities associated with shared risk schemes will lead to even greater responsibilities for trustees, particularly given the requirements to keep a very close watch on scheme funding levels (with annual actuarial valuations in cases of underfunding). Trustees will also need to consider how the interests of different

groups of members are balanced. By way of example, funding can affect different groups of members in different ways in terms of the benefits they receive, and whether NPA needs to be adjusted etc. (whilst bearing in mind the need for the employer to maintain its business). Therefore, we agree that the role of trustees will therefore be vital in the operation of shared risk schemes. Given this, specific guidance for trustees from the Pensions Regulator will be essential if legislation is introduced to facilitate such schemes.

Sacker & Partners LLP
28 August 2008

APPENDIX

Option 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.

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).

Option 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.

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)[1] 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

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

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.

Option 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.