

BUCK

# **Buck Consultants' response to DWP consultation on risk sharing**

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## **Executive summary**

We welcome the widespread discussion of these important social issues.

There are currently a number of issues that adversely impact an employer's ability to design and run an effective retirement arrangement.

There are aspects of current legislation that could be amended to ease unhelpful restrictions on employers.

Although it is not yet clear to what extent the two particular designs identified in the consultation paper would be taken up if made available, we would advocate the adoption of the proposed legislative changes, in order to widen the potential design options available, since employers are unlikely to consider particular changes in the abstract.

We recommend consideration of further legislative changes in future to give employers as much scheme design freedom as possible.

## Introduction

We are pleased to have the opportunity to participate in this consultation. The consultation document clearly charts the decline in workplace-enabled pension provision overall, and the part played by the decline in defined benefit arrangements. Both of these trends are of course already well-documented and widely recognised; however, it is essential to base any discussion on possible future amendments to legislation impacting scheme design on a thorough understanding of the causes of this decline.

The extent of the decline is a major concern; the prospect of a whole generation of pensioners with insufficient income presents serious social issues. Although there are a number of causes of this situation, there are probably four that stand out above others:

- Increases in average life expectancies, fuelling large increases in the costs of providing all pensions
- Increases in other costs, not least regulatory compliance costs, and the method of recording them in companies' accounts
- The restrictive influence of legislation and practice over the design options for workplace pension arrangements
- The lack of understanding by most employees of how pension arrangements work has engendered mistrust, giving many an easy excuse to opt out of meaningful participation, and severely hampers those who are engaging in the process from getting the best results from their efforts.

No developments in this area will be wholly successful unless all of these issues are addressed.

At the end of the day, it is the responsibility of individuals and/or their employers to make appropriate provision, but in the current negative environment for pensions, compounded by a large-scale transfer of responsibility to individuals, there is a heavy responsibility on government to ensure that legislation is no more restrictive than it needs to be. An effective pensions strategy must be wide enough to allow for the financial situations of both employers and employees. Although it will never be possible in practice to provide full flexibility to give every party a completely bespoke solution, as a point of principle it should not be “generic” legislation that drives the design of pension arrangements.

We accept that there should be some measures to protect the interests of individual members as consumers; most are not parties able to deal with employers and providers on equal terms, so an unfettered *caveat emptor* approach is not appropriate. In addition, if taxpayers are funding tax concessions to encourage pension provision for the greater good, it is entirely reasonable to have restrictions to control the amounts of tax forgone, and the circumstances in which those concessions are to apply.

Recent moves towards loosening the grip of legislation in the areas of tax concessions and regulatory activity have been welcome in principle, as has the easing of the required percentage increases that must be provided to pensions in payment. However, these steps have in practice had only very limited positive effect, and there remain many restrictions on scheme design that are stifling developments that could otherwise occur and which could drive a return to widespread meaningful provision. We therefore welcome any further consideration of what may be done to widen the possibilities of scheme design.

## Setting policy parameters: proportionate and focused legislation

There are of course always only finite resources available to both employers and employees to provide for retirement benefits, which can lead to tensions between them. At the same time, both parties crave certainty; employers seek certainty over costs, and employees seek certainty over the benefit amounts. Unfortunately, it is not possible to satisfy both of these desires through the same arrangement; consequently, one or other of the parties must compromise.

In order to maintain a balance between the conflicting desires of the parties, there must be flexibility in the system. Whilst it is entirely reasonable for legislation to protect the legitimate interests of weaker parties, such as in respect of accrued benefits, such legislation should be both *proportionate* and *focused*. It is not the place of legislation to dictate scheme design, particularly through placing new burdens on the sponsors of arrangements already in place.

The requirement to provide increases to pensions in payment is one example. When introduced, it constituted an additional, unplanned, cost for employers who had voluntarily agreed to provide pensions on an agreed defined benefit basis; it constituted, in effect, a state-imposed pay rise for those employees affected.

It may or may not be a good thing in principle for a pension to be increased during payment, but the determination should be made in respect of the circumstances applying to each individual case; however, if it is felt that there is a social case for requiring this in all cases, and that an overriding legal requirement to achieve this is required, it should not be done in a way that increases sponsors' costs, but by allowing a redistribution of resources to fund it. This of course does not preclude the affected parties themselves negotiating an increase in funding as a result, but this would be their decision, based upon knowledge of their particular circumstances.

This is just one example of the way in which legislation can inappropriately restrict the ability of consenting parties to make pension arrangements that best suit their particular circumstances, and shows a failure to recognise the financial effects of a particular policy; in short, the requirements of *proportionality* and *focus* have not been met.

If we are now pursuing a long-term policy of requiring individual employees to take widespread responsibility for their own financial situation, including pensions, we must support that by creating a widespread understanding of the costs of decisions, and ensure that it is possible to design arrangements that members will understand. Full understanding is undermined by giving the impression that legislation is able to introduce new benefits and somehow make them affordable at a stroke.

## Designing appropriate arrangements – employers' likely choices

Cost will always be a key factor in designing pension arrangements. When the wholesale move away from final salary schemes began, it was driven in many cases by the growth in costs and their unpredictability. At the time, there were very few alternatives apparently available other than straightforward money purchase designs. Thus, these employers moved their employees from one end of the benefits provision spectrum to the other, creating a number of problems that are only now slowly becoming apparent. Many employers are beginning to recognise the potential for such problems, and are beginning to consider whether there are alternative approaches that more equitably balance the positives and negatives and satisfy more of the objectives of each party. The growth in the number of CARE schemes is a result of this search for a “middle way”.

However, although as a matter of course benefit design issues are discussed from time to time with all clients, there is no point in discussing detailed options unless there is a genuine possibility that they are allowed by regulations; consequently, this should be borne in mind when reading surveys that purport to show employers' intentions if certain options were to be introduced – in most cases this will be nothing more than a general expression of interest in looking further at the particular option if it were to become available; there would be a long way to go before an employer would be in a position to consider adopting a new design feature.

At this stage therefore it is not possible to predict how many employers would adopt any variants of either of the two main designs – conditional indexation and collective defined contribution – proposed in the consultation document if legislation were amended to permit them; however, that should not be the determinant of whether the legislative easements are made. In principle we would strongly advocate making the legislative changes discussed, together with any others that would allow more freedom of design in future, so as to avoid any continuation of the situation where legislation effectively drives the design of arrangements.

There are other influences outside scheme sponsors' control that can drive scheme design. One such that has hastened the move away from defined benefit arrangements is the way in which the liability is treated in the employer's accounts. There are many views about whether the current accounting requirements accurately reflect the true value of the liabilities placed on the employer, but there is certainly a strong school of thought that says they do not; in addition, there is a perception that the accounting profession is not always sufficiently cognisant of the impact on an employer's continuing support for defined benefit provision of the way in which the liabilities are recorded in their accounts. Consequently, we would strongly advise the development of a closer relationship between the government and the accountancy profession, to ensure that the treatment of pension arrangements in the sponsor's accounts does not end up creating unforeseen difficulties for employers who choose to change the structure of their arrangements.

## Comments on the proposed design options

### Conditional indexation schemes

The concept should be attractive in principle to employers, because it should give greater control over funding costs, and particularly fluctuation in those costs and/or cashflow pressures in the employer. In addition, since the benefits that the scheme would have to pay on wind-up would probably be less than those already funded, the risk of an employer being hit with an unexpectedly large debt on wind-up should be considerably less than with current designs.

We believe that this should make employers' liabilities easier to quantify, which should open up the possibility of a more straightforward and universally-accepted approach to recording the liabilities in the employer's accounts.

From an employee perspective, this scheme design may be less immediately attractive, since it raises the possibility of the defined benefit not being provided to the fullest extent previously expected. However, if the availability of this design option persuades the employer to stay with a defined benefit design (albeit perhaps – but not necessarily – on the generally less generous CARE basis), the employee who values predictable outcomes will probably be more satisfied than if the employer had switched instead to pure money purchase.

There are two further negatives that we can see, however. The first is the complexity of the contribution change processes. The proposed circumstances under which an employer would be able to avoid – whether temporarily or permanently – liability for indexation and revaluation will be difficult for members to understand. Given the potential sensitivity of the issue, if members do not understand the circumstances in which their benefits may effectively be reduced (as they will see it) it will engender mistrust of the scheme and the possible motives of the parties connected with it. This will undermine the effectiveness of any such scheme.

However, this is not necessarily an insurmountable problem, and where it can be overcome (at a cost), the design may be a useful option to some employers.

The second is the funding implications. Moving to this design basis is unlikely by itself significantly to reduce the employer's funding requirement while the scheme is ongoing; instead, the advantages will be in respect of predictability of funding, and ultimate costs following wind-up.

In our opinion, it is less likely that this type of scheme will appeal to employers who have already moved to defined contribution arrangements, than to those who are still involved in defined benefit provision. Employers falling into the latter camp have resisted the move to defined contribution so far, despite the large number of other employers who have done so. This suggests that their commitment to predictability of benefits for their staff is high, and the threshold at which the pain they encounter in continuing defined benefit provision outweighs the desire to continue this benefit is higher than for those employers who have made the change. Nevertheless, in the face of continuing cost pressures, many will be looking for help

with managing their defined benefit exposures, and this type of scheme may have some attraction for them.

On the other hand, many of those employers who have already taken the pain of switching to defined contribution are likely to be most reluctant to move back to anything involving a defined benefit promise. Many of them regard government policies as having contributed significantly towards the problems that they have now managed to move away from, and are adamant that they will never again willingly put themselves back into a position where a government can arbitrarily impose new requirements and associated costs upon them through their pension arrangements. It will take a long period of benign government policies and consistency in policy for government to regain the trust of these employers that once they were able to take for granted.

That said, we believe there is a growing feeling amongst some employers that pure defined contribution does not best serve the interests of their employees. If it were not for their experiences outlined above that drove them from defined benefit provision in the first place, they might be tempted back into some "middle ground" involving some element of defined benefit promise. So, if this proposed reform were to be made, coupled with clear undertakings that employers taking it up would not be subjected once again in future to additional liabilities imposed unilaterally by government or a future regulator, they might be persuaded to move back in this direction.

There are certainly advantages to be gained in some circumstances, and even if it results in only a few more defined benefit schemes remaining in existence, albeit perhaps on a slightly less generous basis than at present, it would be worth making the legislative changes. Furthermore, in keeping with the comments above on allowing freedom to design schemes to suit individual circumstances, we would advocate making the legislative changes necessary to make this option available to those employers who wish to use it.

## Collective defined contribution arrangements

This design option might have wider appeal. In particular, for those employers who have already moved to defined contribution provision, we see it as a more attractive option than the conditional indexation proposal. It also has attractions for an employer who has employees working side by side, some of whom are still accruing benefits under a closed defined benefit scheme, and others (generally the newer recruits) on a defined contribution basis, because it offers the real option to move all the employees onto a single basis going forward.

However, as the consultation paper correctly identifies, schemes incorporating this design will generally be large, in order to gain the spread of members and overall size of funds that will be needed to gain meaningful smoothing of risks. The administration will also be more complicated, and that will again require a large scheme, in order to attain economies of scale to justify the costs. We agree that this suggests the use of industry-wide schemes, but as the consultation paper identifies, there is no widespread culture of such schemes in the UK and it would take a quantum leap for this to change.

Nevertheless, we believe that this general approach will find support from a number of employers, and so for that reason and again in the spirit of reducing arbitrary state influence over scheme design, we support the making of legislative changes to enable variants of this design possible.

It is worth mentioning that the process described here is not dissimilar in principle from that of “with-profits” funds. Although discredited of late, the principles behind these funds are basically sound, and could be used more today to achieve the same result, through the creation of one or more collective investment vehicles. Any new generation of fund would have to be far more transparent than many of their predecessors, but that apart, this may be a way forward, without the need for employers to replace their existing defined contribution schemes with new ones.

Once again, however, we have concerns over how the complexities of the arrangement can be effectively communicated to the members. Many will welcome the fact that someone else is looking after their investments for them, but the complexities of how monies are moved around to increase or decrease the final benefits for individual members will largely pass over their heads; this may be a problem where there is already distrust, and will be particularly difficult to explain in cases when the member’s benefit is lower than his or her expectation.