Deregulatory Review of Private Pensions

Risk Sharing Consultation: Government response

DWP Department for Work and Pensions

Executive summary

The Government is committed to encouraging good private pension provision and ensuring that employers have confidence in the regulatory environment. As part of its response to the independent deregulatory review[1], the Government undertook to explore the scope for risk sharing in occupational pensions.

On 5 June 2008, the Government therefore published a wide-ranging consultation document on risk sharing. The consultation closed on 28 August 2008. We received 87 responses to the consultation, the vast majority of which were from organisations linked to the pensions industry, companies or trades unions. The Government is very grateful to all those who took the time to respond.

Summary of responses

Opinion amongst respondents was divided. Stakeholders representing scheme members tended to take the view that far-reaching deregulation was not required, whereas industry and employer stakeholders thought that Government should take this opportunity to deregulate further. A wide range of suggestions on what should be done to change the current framework was put forward.

Some respondents were interested in risk sharing but found the approaches in the consultation document too complex. Instead they favoured simple, radical approaches such as abolishing the requirement to index pensions in payment.

On conditional indexation, those in favour put forward strong arguments for the need for a safety valve for employers who were trying to maintain their defined benefit (DB) provision, and defended the proposals against the perceived risks of moral hazard. Those against were particularly concerned by the complexity of the proposals, and doubted whether there was sufficient demand to justify such complexity. Many raised concerns about member understanding and the risks of undermining confidence in pensions in already difficult times.

It was clear from the consultation that the development of some form of collective defined contribution arrangement commanded significant support in principle, although many respondents raised particular questions about how such schemes would operate.

Government Response

The opposing views expressed by respondents to this consultation reinforce the need to be vigilant in striking the "balance between member protection and encouraging employer provision of pensions."[2]

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[1] Lewin, C and Sweeney, Ed; July 2007, *Deregulatory Review of Private Pensions: An independent report to the Department for Work and Pensions.*
[2] *Security in Retirement: towards a new pensions system – Summary of responses to the consultation*, Cm 6960, published in October 2006.

The consultation responses included a wide range of suggestions in response to questions about the range of options under **the current framework** and what could be done to make risk sharing easier to achieve. On the basis of these suggestions the Government will take forward the following areas of work:

- Consider, with the Pensions Regulator (TPR), what could be done to share information on current risk sharing practices more widely still.
- Work with practitioners and pension lawyers to develop proposals for regulations that will ensure schemes have more scope to introduce flexibility in the way pensions accrue for future service to reflect changing longevity with the aim of consulting by spring 2009 at the latest.
- Gather further evidence on whether the requirement to index pensions in payment is appropriate for cash balance schemes and subsequently consider the practical consequences of abolishing this requirement.
- Institute a general review of the burdens imposed by the arrangements for contracting out.
- Take forward other wider deregulatory review initiatives such as on employer debt.

Removing mandatory indexation would be a simple and radical deregulation, and although the Government rejected this proposal when it was raised by Chris Lewin in his report with Ed Sweeney, it has now seriously examined the case for reversing that decision in the light of responses to this consultation. However, in the absence of compelling evidence that such a move would reinvigorate DB provision, the Government still believes that the removal of this important protection for members would not strike the right balance between employer concerns and member protection.

The Government has carefully considered the arguments for and against **conditional indexation**. Significant additional regulation would be required to provide an appropriate framework for such an approach and the complexity would inevitably hamper member understanding and potentially undermine member confidence. The Government is also unconvinced that there is sufficient demand from employers to justify taking such measures. Finally, the consultation has demonstrated that there is, at present, no workable consensus on this proposal.

The Government's view is that the consultation has not provided the weight of evidence that this proposal is likely to make the significant impact on the level of DB provision that would have justified overriding the concerns of member representatives. It has therefore decided not to pursue conditional indexation at this time.

The Government has decided to undertake further work on the detail of how **collective Defined Contribution (DC) schemes** might operate in the UK. The Government intends to explore with stakeholders a number of questions around the legislative provision that might be needed, the concerns that were raised over the communications challenges involved in such schemes, and a range of detailed analytical and technical policy issues.

Contents

Executive summary ... 1
Foreword ... 5
Chapter 1: Introduction ... 7
Chapter 2: The decline in defined benefit provision ... 8
Chapter 3: An overview of risk in pension provision ... 9
Chapter 4: Risk sharing: international comparisons ... 12
Chapter 5: Risk sharing within the current regulatory framework ... 13
Chapter 6: Conditional indexation schemes ... 24
Chapter 7: Collective defined contribution schemes ... 35
Respondents to the consultation ... 42

Foreword

The Government is committed to encouraging good private pension provision and ensuring that employers have confidence in the regulatory environment. That is why we announced a rolling deregulatory review in May 2006.

In December 2006, we commissioned Chris Lewin and Ed Sweeney to undertake a deregulatory review to look at how the private pensions regulatory framework could be made simpler and less burdensome, thereby encouraging employers to continue to provide good pensions. As part of its response to their July 2007 report, the Government undertook to explore the scope for risk sharing in occupational pensions.

On 5 June 2008 the Government therefore published a wide-ranging consultation document on risk sharing. The consultation closed on 28 August 2008. We received 87 responses to the consultation, the vast majority of which were from organisations linked to the pensions industry, companies or trades unions. The remainder were from individual members of the public or interested pensions professionals speaking in a private capacity. A list of those who responded is at Annex A. In addition to the written consultation, the Government commissioned BMRB Social Research to undertake a small scale qualitative study into employer attitudes to risk sharing[3], which was supplemented by two small DWP-run workshops. The Government is very grateful to all those who took the time to respond.

The risk sharing consultation sought the views of stakeholders on 31 consultation questions. This document outlines the responses received and the decisions taken by the Government in the light of those responses. Given the large number of responses, this is not an exhaustive account of how each respondent answered each question, but rather gives an overview of reactions in each case. Quotes are included and views attributed as appropriate.

[3] *Employer attitudes to risk sharing in pension schemes: a qualitative study* Andrew Thomas and Anthony Allen (BRMB), DWP Research Report No 528, published 28 August 2008.

Chapter 1: Introduction

The opening chapter placed the current consultation in the context of the Government's pensions policy since 1997 and the ongoing programme of pensions reform. It also set out the objective of the consultation document, which was *'to explore ways in which we can encourage and support good pension provision and to gather evidence and opinions on risk sharing in occupational pensions.'*

Q 1. Given that we have protected scheme members and are bringing in measures to combat undersaving, should we be undertaking a far-reaching deregulation of the way risks are shared in pension schemes?

Opinion among respondents was divided.

Stakeholders representing scheme members tended to take the view that far-reaching deregulation was not required. The **TUC**, for example, stated that they were '*not convinced that there is a need for "far-reaching deregulation"*' and expressed the concern that such an initiative could be detrimental to pensioner incomes. **Unison** shared these concerns.

Unite expressed the view that action designed to mitigate the risks to members of DC schemes '*should be encouraged*' but also added that '*Before any measure of deregulation is adopted careful consideration should be given to why the particular regulation was introduced in the first place.*'

Industry and employer stakeholders took a different view. For example, the **NAPF** stated that *'The Government must take this opportunity to introduce far-reaching measures to ensure that going forward the risks inherent in pensions are shared more equally between scheme sponsors and scheme members.'* The **ACA**, **Hewitt** and other stakeholders in the industry generally agreed.

Government Response

The terms of reference for the Government's rolling deregulatory review, of which the consultation on risk sharing was part, make clear the need to take account of the "balance between member protection and encouraging employer provision of pensions." The comments made in response to this question, and indeed throughout the consultation, reinforce the need to be vigilant in striking that balance. It is vital that we continue to seek a broad consensus and ensure that the right regulatory regime is in place to give people confidence in the pension system, but without overburdening pension providers.

Chapter 2: The decline in defined benefit provision

Chapter 2 explained that, whilst occupational pension provision in the United Kingdom has traditionally been dominated by defined benefit schemes, there had been a trend since the 1970s for employers to close down these schemes in favour of defined contribution arrangements. The chapter examined the reasons behind this shift, including the downturn in financial markets of the early 2000s, increasing life expectancy, the decrease in inflation during the 1980s and 1990s, increased regulation to protect scheme members and changes in accounting standards. It also examined which factors might affect employer behaviour in the future.

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

No substantial additional evidence was presented in response to this question, though a number of interesting contributions were provided, and a number of respondents were keen to highlight particular factors from the list offered that they felt had had the most significant impact.

The **SPC** noted that whilst they did not have any additional evidence, we could expect further evidence to emerge '*from the USA, which is perhaps 10 or 20 years further along the path…in moving from defined benefit to defined contribution*.'

The **NAPF** suggested that in addition to those areas covered, the impact of different charging structures and governance arrangements of DC arrangements should be taken into account.

Unite stated that lower contribution rates to DC schemes are '*clearly one key reason for the much lower take-up of their membership relative to DB schemes.*'

Government Response

The Government notes and welcomes the broad agreement about the *breadth* of the inter-related factors at work behind the long term shift from defined benefit to defined contribution schemes, and believes that in such a complex environment there will inevitably be differing views about which were the most significant.

Chapter 3: An overview of risk in pension provision

This chapter explained that the value of the money set aside to pay somebody a pension in retirement can be affected by unexpected events, making risk an inherent feature of pension provision. The chapter identified a number of different types of risk including investment risk and longevity risk, and examined how these were distributed between different parties in different types of pension arrangements. It sought views on which parties were best placed to bear each type of risk. Finally, this chapter discussed the impact of the shift from defined benefit to defined contribution schemes by assessing the outcomes that scheme members could expect.

Q 3. Is our characterisation of the allocation of risk in DB and DC schemes correct?

Many responses expressed broad agreement with the document's characterisation of the relevant risks, although a number of stakeholders made suggestions for additional or different considerations.

For example, **Hewitt** suggested that the term 'Investment risk' could usefully be split into two categories:

a) asset risks; and
b) bond yield risks.

The first of these '*can be controlled through adopting an appropriate investment strategy*', whilst the second cannot be controlled by employers, employees or financial institutions.

The **TUC** made a number of suggestions, including one that an additional risk should be noted on the DB side – the risk that the employer will '*withdraw from pension provision altogether.*' The response went on to argue that this means that all of the risks attributed to the sponsor in table 3.1 should actually be attributed to the sponsor and members.

A number of responses, including those from **Chris Lewin**, the **ACA** and the **TUC**, questioned the validity of figure 3.1, which projected a range of potential DC scheme outcomes versus the benefit level expected from a DB scheme receiving an equivalent contribution. These responses all suggested that the figure should show the DB outcome as being higher than the mean DC outcome, rather than lower.

Q 4. Which parties are best placed to bear each risk?

There was broad consensus that some sharing of risk within a scheme seemed more desirable than placing all the risk with either employer or employee.

Indeed, the **ACA** suggested that '*placing close to 100% of risks with either employers or employees is unsatisfactory for different reasons.*' They went on to explain:

'*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.*

However, it is equally clear, … 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.'

The **TUC** argued that risk within DB schemes is already fairly widely spread, '*between scheme sponsors, members collectively and the state.*' They went on to state that, given the right of sponsors to withdraw provision, '*Members are unlikely to accept any additional risks without far more control in the form of negotiating rights…*'.

The **NAPF** suggested:

'*There are some risks which the member cannot bear, for example discontinuity risk. However, there are vehicles in place to address these risks including the PPF, FAS, FSCS and FOS. In terms of investment risk, it should be possible to share the risk (upside and downside) of investment between the sponsor and member as well as other risks identified including inflation and longevity risk.*'

Mercer concluded that:

'*…there is no straightforward answer. It will depend on the employer, the nature of the employer's business and the size of the scheme relative to the business; and also on the employee, the employee's financial capabilities and financial and personal circumstances, ability to access advice and attitude to risk.*'

Government Response

The Government has considered carefully the comments made on its categorisation of the risk distribution in DB and DC schemes. It notes in particular the general consensus on the desirability of sharing risks between the parties so that no one party should have to bear 100% of the risk. It is clear, however, that there is some disagreement on the extent to which members already bear some risks in DB schemes, as outlined above by the TUC, in particular with regard to the risk of future benefits being reduced.

In response to the point raised about figure 3.1, the comparison between potential outcomes from a DC scheme and that expected from a DB scheme, it was intended primarily to illustrate the variability of outcomes faced by members of DC schemes relative to the fixed outcome of a DB scheme. It was not intended to imply any

general conclusion about relative outcomes in DB and DC schemes; this is a complex issue well beyond the scope of the consultation. It was noted by several respondents that the figure reflected the particular assumptions made – alternative assumptions would generate different relativities – but would not alter the large variability of DC outcomes.

Chapter 4: Risk sharing: international comparisons

This chapter explained the risk sharing arrangements in place in a number of other countries, with a view to better understanding how different regimes could be applied to the UK situation. Whilst there are some strong parallels between the situation in the Netherlands and that in the UK, the chapter pointed out that the two countries operate very different industrial relations models, making direct comparison difficult.

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

Generally, respondents either recognised that the examples identified were the most relevant, or questioned the relevance of international examples, given the significant cultural differences that form the backdrop to pensions arrangements in other countries. Nevertheless, others drew attention to the different treatment of, for example, indexation between the UK and other countries.

The **NAPF** stated:

'*Whilst there are many international examples that can be drawn upon, we believe that the examples contained in the paper are the most relevant to the UK debate and provide a useful context to risk sharing approaches.*'

Unite noted that of the examples presented, the Netherlands was most relevant, though in this case arrangements are '*firmly rooted in collective bargaining and pension schemes are subject to real joint control with 50% member trustees. The model of risk-sharing they have adopted generates more support and confidence of members as it is inherently much less open to employer manipulation.*'

The **TUC** concluded that '*international comparisons are difficult as different schemes operate within a significantly different structure of negotiation and control.*'

Aegon agreed with this view, claiming that the different legislative requirements in the two countries mean *'there is a far greater risk of member misunderstanding in the UK introducing these schemes, compared to the Dutch.'*

Government Response

The Government welcomes the general consensus around the validity of the analysis in this chapter, and notes that many of the responses underline its own reservations about drawing comparisons between different regimes. In particular they noted the markedly different social and industrial relations context in which the Dutch system operates.

Chapter 5: Risk sharing within the current regulatory framework

This chapter noted that whilst many employers had chosen to move from defined benefit to defined contribution arrangements, others were considering ways of making their existing defined benefit schemes more affordable, or of sharing risks differently. The chapter went on to explore a number of options available under the current framework, such as raising normal pension age and adopting cash balance or hybrid arrangements.

Q 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?

This question generated a wide variety of responses, with the split of opinion drawn generally between those within the pensions industry, representing or advising employers or schemes, and those whose primary function is to represent the interests of scheme members.

The **Association of Pensions Lawyers**, for example, answered this question positively, believing that '…*this must be the likely consequence.*'

The **ACA** went further, stating that '…*we cannot believe that any other rational conclusion could be drawn.*'

The **CBI** stated that they '*would…welcome any move to enable employers to share risks more easily*', but also concluded that '*Risk-sharing will never be the answer to the pensions saving issue for more than a minority percentage of private sector workers, due to affordability and complexity concerns.*' Instead, the **CBI** considers that '*the crucial issue is to reduce unnecessary costs where employers take on risk.*'

However, the **CIPD** identified that the answer to this question:

'…*depends on what you mean by 'high-quality workplace pension'. A DC scheme could come under this definition depending on the level of employer contribution. In which case, greater flexibility wouldn't necessarily persuade employers to increase their contribution levels to their defined contribution schemes.*'

The **TUC** were '*unconvinced*' that greater flexibility would achieve the identified goals, as set out on page 24, question 16.

Help the Aged also disagreed with the proposition, stating '*we have seen no evidence to suggest that this would encourage more DB schemes to open or re-open to new members, or even to support the existing schemes to struggle on.*'

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

The majority of responses agreed that flexibility would provide a further option for employers considering moving from DB to DC arrangements, though differences of opinion arose as to the value of this option.

The **NAPF** referred to recent surveys of its members:

'*All respondents agreed that they thought it would help (to sustain DB arrangements), not just schemes that are open to new entrants but also schemes that are open to future accruals.*'

The **CIPD** and the **ACA** agreed with the broad thrust of this statement – the **CIPD** noting that '*It would depend on why an employer was considering a move out of DB in the first place*', concluding that where this was for cost reasons greater flexibility could encourage employers to continue to bear risk.

The **SPC** answered that, whilst greater flexibility could encourage employers to continue to bear risk in some cases, '*smaller employers will generally prefer the apparent greater simplicity, and in particular the apparent administrative simplicity, of pure DC.*'

Unite agreed that this option could be attractive for employers, but were concerned that greater flexibility might also encourage employers '*to run DB schemes on a DC basis by shifting all the risks on to members through the way they operate the scheme.*' They went on to voice the concern that '*At worst employees could be left with most of the downside risk while employers retain some of the up-side risk (benefit).*'

The **TUC** response (as referenced on page 24, question 16) offered the view that employers retaining risk under either a traditional DB arrangement or a conditional indexation arrangement would have to accept their contribution levels might fluctuate. Given this reality, they considered that employers were unlikely to be attracted by the more complex arrangement.

Q 8. Would employers currently offering DC consider a move to a risk sharing arrangement?

The majority view in response to this question was that employers currently providing defined contribution schemes would be unlikely to consider moving to a risk sharing arrangement.

While the **TUC** recognised that employers might be seeking alternatives to DC provision they did not see any *'immediate triggers which might encourage employers who only have DC arrangements to move from DC to risk sharing DB'*, however they

did add the caveat that if employers were faced with employees retiring on inadequate pensions or pensions become a more important tool in retaining employees then *'things may change'*.

This view was shared by the **CIPD** who argued that while their recent survey suggested *'that employers with DC schemes are more likely to raise their contribution levels rather than shift to a hybrid arrangement'*, it would depend on the circumstances of the employer. Some *'may be tempted to switch if they believed that such risk sharing arrangements could help them better attract their employees of choice and sustain a high performance working culture.'*

Deloitte summed up the pervading view when they stated that *'this seems unlikely in most cases over the short and medium term. If risk sharing became more popular, and there was a limited burden on sponsors, then companies (might) look to implement such a scheme in order to differentiate themselves from competitors.'*

These views were borne out by the research report, '*Employer attitudes to risk sharing in pension schemes: a qualitative study*'[4] carried out by **Andrew Thomas and Anthony Allen of BMRB Social Research** on behalf of the DWP. This report concluded:

'*Employers with DC schemes considered that they would generally be very unlikely to adopt a risk sharing approach to pension scheme provision, for three specific reasons:*

- *increased risk/liability;*
- *complex/administrative burden; and*
- *difficult to promote to employees.*'

On the other hand, the **ACA** considered that large employers currently operating DC arrangements may be willing to consider adopting risk sharing arrangements as a result of the *'volatilities associated with DC, and the consequent impact on human resources policies'*.

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

Most responses to this question expressed the view that employers considering alterations to their DB arrangements often consider risk sharing options, including those examples suggested. In addition, some responses identified scope for encouraging schemes to take advantage of risk sharing possibilities where they had previously been reluctant to do so.

[4] *Employer attitudes to risk sharing in pension schemes: a qualitative study* Andrew Thomas and Anthony Allen (BRMB), DWP Research Report No 528, published 28 August 2008.

The **TUC** suggested that:

'Some employers have considered options such as cash balance. However these debates have tended to be controlled by finance departments rather than HR departments. As soon as it becomes clear that such an option will place an FRS17 liability on a company balance sheet, the option is discounted.'

The **CIPD** who noted that changing its scheme to a career average scheme *'helped the organisation retain the defined benefit nature of its pension.'*

Chris Lewin shared this view, stating:

'*Employers who are looking at alternatives to final salary often consider career average because it can provide lower benefits and hence reduce costs*' though he also pointed out that career average schemes are '*not normally risk-sharing at present.*' He also suggested that other forms of risk sharing are often not much used, largely due to '*fears that the legislation (especially section 67)*[5] *may be interpreted by the Courts in future to prevent the risk-sharing provisions becoming operative to the members' disadvantage.*'

He recommended that the Government should take opportunities to reassure schemes that '*section 67 is not intended to apply in cases where the downward adjustment of benefits is either automatic under the scheme's rules or else does not infringe any guarantees given to the members about their benefits.*'

The **ACA** stated that many employers who come to them for guidance consider risk sharing options.

The **SPC** agreed that employers consider risk sharing options, but pointed out that '*this is less likely to be the case with smaller employers.*'

Q 10. Have you considered any options other than those outlined in this chapter?

Most respondents did not offer any additional options.

The **TUC** put forward the option of allowing members of a DC scheme to buy an annuity from the employer's existing DB scheme. They noted that this option would mean that the member would not be susceptible to the risk of buying an annuity from a third-party insurer.

The **NAPF** put forward the notion of "corridor indexation" in which schemes provide a lower level of indexation if its funding levels are within a 'corridor'. This is set out in more detail in answer to question 18.

[5] Sections 67 to 67I of the Pensions Act 1995 place restrictions on the power to modify pension schemes where the modification would have a detrimental effect on accrued rights or pensions in payment.

Q 11. Have the existing options proved inadequate and if so how?

Opinion was divided on this question. Some responses offered the view that there is flexibility within the current system that is not being used to its full potential, whilst a number of others thought that existing options do not provide enough risk sharing flexibility for employers who wish to retain their DB schemes.

The **TUC** fell into the former camp, stating that *‘options for risk-sharing are sufficient’* but that, in their experience, employers are *‘unwilling to consider the full range of options available to them under current legislation’.*

However, the **NAPF** argued that *‘it would be wrong to think that there is enough flexibility within the current framework,’* pointing to the continued decline of DB provision.

They were supported by the **ACA** who stated that they *‘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.’*

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

We received a number of considered responses to this question, and a number of areas for further consideration were identified.

As well as providing a number of comments specific to the ACA proposal for conditional indexation schemes, **The Association of Pension Lawyers** suggested three more general areas for review:

1. *‘Revaluation: it would be helpful to have greater certainty on the revaluation requirements for cash balance and career average arrangements.’*

2. *‘Pension increases: it is difficult to see why it should be a legal requirement for cash balance schemes to have to provide pension increases under section 51 of the Pensions Act 1995. At the benefit provision stage, the cash balance plan is effectively a money purchase plan, so it would seem more logical to allow a pension to be secured without increases if that were more beneficial to individuals.’*

3. *‘Flexibility for longevity risk sharing: … It would be helpful to have certainty on the issue of section 67 of the Pensions Act 1995 and mechanisms to share longevity risk as the pension builds up.’*

The **CBI** agreed that legislation needed to be altered, commenting that *‘the section 75 debt regulations, the value of the contracted-out rebate, and the need for overriding legislation to set schemes free from restrictive scheme rules are all areas where the government could take a stand and begin to rebuild employer confidence.’*

Hewitt also thought that restrictive rules were probably at the heart of any employer reluctance to consider risk sharing stating that *'current legislation applies DB rules to all schemes other than DC schemes.'*

Deloitte shared this opinion answering that: *'Should legislation permit changes to be made to accrued benefits if the funding demands were to become too great, then employers may become more inclined to provide risk sharing arrangements.'*

Derek Benstead suggested that the Reference Scheme Test, which must be met to enable a scheme to contract out of the State Second Pension '*is an obstacle to innovative scheme design, it restricts schemes to a particular form of defined benefits and a relatively high value of minimum provision.*'

However **Unite** stated that *'It is not clear that the alternatives considered are inhibited by current regulation, apart from cash balance schemes for the reasons noted in the consultation document.'*

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

Most employers and representatives from the pensions industry agreed that provision of additional information would be valuable. This view received some support from the **TUC**, though they also considered that consultation on risk sharing alternatives was important. Other organisations also raised the importance of employer consultation, whilst a minority expressed the view that additional information would have little impact, as employers were already aware of the available options.

The **CBI** commented: '*We could have clarity about sharing the risk of longevity through changes to the normal retirement age with new guidance'*.

CIPD also thought that '*Practical guidance from the regulator for employers and trustees considering amending their existing arrangements would be useful indicating what the various options are, the implications and the costs*.'

The **TUC** agreed that guidance from the Pensions Regulator would be helpful '*to impress upon employers that if a move away from DB is being considered, the consultation should include meaningful consideration being given to risk sharing alternatives.*'

Meanwhile, the **Open University** thought that the burden lay on employers *'to effectively communicate any proposed changes so it would make sense to require employers to carry out a full consultation'.*

Unite, on the other hand, were sceptical that information could have any impact: *'It is unlikely that such measures would have any significant effect as employers already have a general awareness of the possibilities.'*

Q 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?

Whilst the unions considered the advantages of the legislative framework in protecting members, pensions industry representatives tended to consider this too onerous, giving rise to some disagreement in response to this question.

The **TUC** did not think the legislative framework could be characterised as *'disproportionate'*, instead schemes '*include the full range of members' protections'* and this was '*a major advantage*'.

The **ACA** disagreed. They thought that cash balance should be *'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.'*

The **NAPF** broadly agreed, stating that '*regulation should be amended to give such schemes greater flexibility recognising the balance between DB and DC provision.'*

Q 15. Are you aware of any issues related to age discrimination in cash balance schemes in the UK today? Is this an issue which is stopping employers from setting up cash balance schemes?

There was some disagreement in this area.

Unite felt that *'it is not clear that it is fear of age discrimination claims which inhibit the adoption of cash balance'* arguing instead that there was *'a perception that it may have little attraction for either employer or employees relative to a DC scheme*'.

Slaughter and May thought that cash balance schemes can be fitted within the existing framework saying *'Depending on how the cash balance scheme is established, we consider that such an arrangement would be capable of being fitted within the scope of the exemptions in Schedule 2 to the Employment Equality (Age) Regulations 2006, as amended.'*

The **APL** by contrast, emphasised that *'there is some uncertainty in this area, which will only be eradicated by statutory provisions or a court decision'.*

Government Response

The Government is grateful for the wide range of comment and suggestions put forward by respondents. In the light of the responses, it concludes, in line with the comment of the external reviewers in their report[6] (*'We were surprised at the extent of flexibility for risk-sharing schemes which currently exists'*), that the current framework does offer significant opportunities for employers to share risks or indeed to control costs if they are so minded. The following sections therefore seek to address the question of whether these opportunities sufficient, and if they are, why do relatively few employers take them up?

Information on current risk sharing approaches

It is clear from Chapter 5, and the response to it, that some schemes have been able to find a manageable path between DB and DC within the current framework, and by utilising the flexibilities already available reach a cost-risk position that is manageable for the sponsor and acceptable to the member. Others have clearly decided that that approach is too complicated, or does not provide the magnitude of change that they were seeking. Still others may not even have considered or been aware of alternatives to moving direct to DC. In an attempt to address this last group, the Government is already committed, through its response to the Reviewers' report[7], to explore the scope for sharing information about the various forms of existing risk sharing schemes that are available (this work informed the production of Chapter 5 of the consultation document[8]). One possible solution may be the publication of an information note by the Pensions Regulator. Government and the Pensions Regulator will give further thought to this or other possible options for sharing information on risk sharing more widely.

Career Average Revaluation

One issue which might be included in such information is the extent to which, as raised by some respondents, current legislation already allows discretionary revaluation for active and deferred members in career average schemes. The Government's position is that Part IV of the Pension Schemes Act does indeed permit such an approach, provided that the scheme does not contain any rule which could result in deferred members being treated less favourably than members with long service. Indexation must be paid to pensioners in accordance with section 76 of the Pension Schemes Act 1993 and section 51 of the Pensions Act 1995. The Government is aware of a number of schemes that operate in this way.

[6] *Deregulatory Review of Private Pensions: An Independent report to the Department for Work and Pensions*, Chris Lewin and Ed Sweeney, July 2007.
[7] http://www.dwp.gov.uk/pensionsreform/pdfs/government-response.pdf .
[8] http://www.dwp.gov.uk/pensionsreform/pdfs/pensionrisksharing-consultation-june2008.pdf .

Section 67

There is clearly some uncertainty about the extent to which sections 67 to 67I of the Pensions Act 1995[9] restrict changes to Normal Pension Age for future accruals. As stated in its response to the Deregulatory Review, the Government and the Pensions Regulator both believe it should be possible for schemes to devise rules that provide a contingent normal pension age for future accruals under the current legislation.

The Government also accepts, however, that there is considerable uncertainty about the practical application of the legislation, and that this has led to some schemes not making changes to Normal Pension Age which might otherwise help them share longevity risk for future accruals.

Sections 67 to 67I of the Pensions Act 1995 arose from the view of the Pensions Law Review Committee[10] that *'certain limits should be set to freedom of trust, in order to preserve the reality of the pension promise'*. The Government recognises that there is general agreement that the pension promise should be protected, but also believes that schemes should be able to introduce some flexibility in the way pensions accrue for future service to reflect changing longevity.

The Government will work closely with practitioners and pension lawyers to develop proposals for regulations, that will ensure schemes have more scope to introduce this kind of flexibility, with the aim of consulting by spring 2009 at the latest.

Cash Balance schemes

The Government has also considered the arguments put to it on behalf of cash balance schemes, and in particular in relation to the imposition of the requirement to purchase an indexed annuity from such schemes, when this was abolished for pure DC schemes in the Pensions Act 2004. The Government is keen to explore this further, but will need to gather further evidence from those affected and will then consider the practical consequences of abolishing this requirement.

The Government agrees that a cash balance scheme may be structured so that it falls within the scope of the exemptions in Schedule 2 to the Employment (Equality) Age Regulations 2006. Furthermore, the United States courts, in decisions related to similar anti-discrimination provisions, have found that differences in benefit levels which are the result of the passage of time and the application of compound interest do not constitute age discrimination (in particular the decision of the Second US Circuit Court of Appeals in *Hirt v the Equitable Retirement Plan for Employees* (9 July 2008).

[9] Sections 67 to 67I of the Pensions Act 1995 place restrictions on the power to modify pension schemes where the modification would have a detrimental effect on accrued rights or pensions in payment.
[10] Pension Law Reform: The Report of the Pension Law Review Committee – CM 2342, September 1993.

Pension Protection Fund levy and risk sharing schemes

The Government has also been pursuing the independent Deregulatory Reviewers' recommendation that it explore the scope for a better match between Pension Protection Fund protection and the structure of risk sharing schemes. This recommendation stemmed from a perception that certain risk sharing schemes (in particular those structured as cash-balance schemes) are charged a disproportionately high Pension Protection Levy because their benefit structures are less generous than the benefit structure that underpins Schedule 7 of the Pensions Act, which sets out the compensation paid by the PPF. The PPF levy is directly related to this compensation structure.

The Government has concentrated its examination of the issue raised by the Deregulatory Review around cash-balance schemes as it is those schemes that the Reviewers considered were particularly hard-hit by the perceived disconnect between the benefits those types of schemes guarantee and the calculation of PPF compensation and the Pension Protection Levy.

Not all schemes are required to provide revaluation (see section on Career Average Revaluation above). However, under Schedule 7 to the Pensions Act 2004, revaluation is part of the compensation provided by the PPF. Under those rules, former active and deferred members' compensation is revalued up to their normal pension age, whether or not a scheme would have provided revaluation. The mismatch between schemes that do not provide revaluation and PPF compensation that provides revaluation means these schemes are in effect paying for compensation for something they do not provide.

The Government intends to change this through regulations that will amend Schedule 7 so that where a scheme did not provide for revaluation then PPF compensation will not be revalued. This will remove the mismatch between compensation and scheme benefits for those schemes that do not provide revaluation. These regulations will be laid before Parliament shortly and will come into force soon after.

Contracting Out

Some respondents also raised the question of whether the Reference Scheme Test for contracting out might inhibit sponsors from pursuing imaginative solutions to risk sharing with scheme members with a view to maintaining DB provision. The comments made, however, did not identify particular proposals and consequently the Government intends to institute a more general review of the burdens imposed by the arrangements for contracting out. The scope and timetable for this review will be determined by early spring 2009 and communicated to relevant stakeholders.

Other Deregulatory Review Initiatives

A number of respondents raised wider deregulatory issues within the current framework. In particular, the CBI noted that *'The section 75 debt regulations, the value of the contracted-out rebate, and the need for overriding legislation to set schemes free from restrictive scheme rules are all areas where the government could take a stand and begin to rebuild employer confidence.'*

The Government is pleased to report that informal consultations have been launched this autumn on both surplus and employer debt, with a view to easing burdens upon employers and thereby encouraging continuing good occupational pension provision. We have received a wide range of responses to the informal consultation on the surplus rules, and we are considering these carefully. We are discussing the views put forward with stakeholders, and have requested more information from some of them. We are aiming to reach conclusions on the way forward early in the New Year. On employer debt, once we have considered the informal responses, we aim to hold a formal consultation early next year and introduce any changes in October 2009.

In addition, the Pensions Act 2008 provides for the reduction of the cap on revaluation of deferred pensions from 5% to 2.5% providing a re-balancing of the risk between members and scheme sponsors, and opening up potential savings to employers of up to £250m per year, on average and in the longer term. In order to help schemes with restrictive rules to take advantage of this change (and the earlier similar change in the 2004 Act to the cap on indexation of pensions in payment) the Government has also published draft regulations to enable a statutory override of such rules, where trustees agree. These regulations are intended to be in force by April 2009, alongside the coming into force date of the provisions on the revaluation cap.

Chapter 6: Conditional indexation schemes

This chapter examined in some depth proposals made by the Association of Consulting Actuaries and by Chris Lewin (one of the two independent authors of the Deregulatory Review of Private Pensions). The former proposed introducing a new regime which would allow new career average schemes to operate on a conditional indexation basis, whilst the latter suggested an approach which would allow conditional indexation in all defined benefit schemes.

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

Whilst a number of responses from employers and the pensions industry suggested that risk sharing options would be improved by allowing conditional indexation, a number of others were sceptical, raising questions regarding the complexity and true quality of this provision.

For the **CBI**, '*One of the major cost drivers for historic DB schemes is the application of retrospective limited price indexation for early leavers and similar indexation in retirement.*'

Hewitt *'fully supports the Conditional Indexation proposals made by the Association of Consulting Actuaries.'*

*'The **NAPF** strongly supports regulatory flexibility that encourages and enables risk sharing including conditional indexation (CI) and other changes to indexation rules.'*

The **CIPD** too thought that it would be another option for employers to explore, rather than simply opting for a defined contribution plan. However, it would depend on why the firm was thinking of changing its existing arrangements in the first place.

However, the **Open University** sounded a note of caution, arguing that Conditional Indexation might undermine efforts to regulate existing DB schemes, and asking *'how does the Regulator expect to enforce a recovery plan if alongside, it is allowing schemes to switch to Conditional Indexation with a potentially greater uncertainty over the value of the pensions in payment?'*

Similarly, the **ABI** raised the issue of complexity on two levels. They suggested that:

'*the cost and complexity of introducing a new layer of legislation to support conditional indexation will be disproportionate when compared to the number of schemes likely to adopt such a measure.*'

Secondly, they were concerned:

'*that scheme member understanding of something as complicated as conditional indexation could be very limited. Employers and trustees will have to do much more*

than issuing details of the new type of schemes, to make sure that employees fully understand the risks involved.'

Connect agreed that such schemes would be '*Administratively complex and difficult to understand.*'

Unite were also sceptical, stating that:

'It would open the door to a major shift of risk from employers to employees. While this is being described as 'risk-sharing', that does not really fairly describe the effect as employees will be vulnerable to suffer a major reduction in their benefits before the employer becomes liable to pay any more money into the scheme in respect of their benefits.'

The **GMB** response stated that the introduction of this flexibility would:

'add to the quantity of risk sharing but not to the quality. There is no shortage of options available within the current legislative framework.'

This view was supported by the **TUC**, who were '*unconvinced*' that greater flexibility would achieve the identified goals. In their response, they set out, by way of example, three choices for an employer looking to cut costs, which could be broadly characterised as follows:

a) close the DB scheme and open a DC scheme;
b) continue with the final salary DB scheme but reduce the rate of future accruals; or
c) open a scheme which has conditional indexation (under new flexible arrangements).

They consider that if an employer is inclined to remain in DB, '*it is difficult to see which employers might opt for option (c)*', which '*could probably at best be described as borderline high quality*' in any case.

Q 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?

This question, in two parts, gave rise to a range of responses. The majority of respondents suggested that sharing investment risk with scheme members could constitute a suitable response to the costs and risks facing DB scheme sponsors, although a significant minority took the opposing view. In response to the second part of the question, the majority considered it undesirable for pensioner members to shoulder more of the risk, although some thought that this could be acceptable.

The **ACA** suggested that *'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.'

This view was supported by the **APL**, who stated that *'sponsors and members ought to be able to reach their own "deal" on risk sharing and have the full menu available to them in order to do so.'*

On the other hand, the **TUC** took the view that *'conditional indexation is neither desirable for scheme members nor attractive to scheme sponsors.'* Their response went on to express the concern that *'sponsors would not bear any risk at all until member benefits had been cut substantially.'*

Help the Aged made it clear that they do not think this is a suitable response, stating:

'introducing 'reforms' which effectively water down the pension promise to the employee at a time when we are trying to encourage the growth of pension saving and to promote the message that it always 'pays to save', is simply counter-intuitive. Presenting this, as a strategy designed to encourage more saving (or sustain more saving), would be a disaster.'

Deloitte's view was that the risk could be transferred to retired members, to some extent. They state: *'we think that it is acceptable for retirees to share in the risk, so long as it is clearly communicated, particularly for career average schemes where the risk is only partially taken by retirees.'*

However, many responses sounded a note of caution.

The **Open University** asserted that if *'there is uncertainty about the level of pension once these benefits have been crystallised then many employees might be put off by pensions and may prefer DC since they know that once their pension is bought it is more secure.'*

Unite argued that '*the effect of conditional indexation is to put retirees at the front of the queue of those who will suffer when a scheme gets into deficit. It is much easier to withhold an increase to a pensioner than to address the benefits of current employees.'*

The **ACA**, who offered the conditional indexation proposal, took the view 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'.

They recognised that the proposal would not require schemes to make good indexation not paid to pensioner members, but argued that this was to avoid *'the trap of prescriptive legislation'.* Instead, they said they:

'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.'

Q 18. Are there other approaches to conditional indexation which you consider to be better?

Whilst a significant number of respondents stated their support for the proposal, as presented in the consultation document, we also received a number of responses offering suggestions for alternatives. In particular a number of respondents suggested that simplification of existing rules might be more desirable than creating a new regulatory regime specifically for conditional indexation schemes.

The Trades Unions were generally unconvinced that conditional indexation would work, with the **TUC** answering *'we do not believe a conditional indexation approach would be widely taken up by employers.'*

Despite general scepticism **Unite** did suggest that '*one way of increasing the acceptability of conditional indexation would be for schemes adopting it to be obliged to target a rate of indexation higher than the current statutory minimum e.g. to target 5% rather than 2.5% LPI.'*

The **NAPF** referred to its proposals for "corridor" indexation. Under the proposed arrangement:

''if a scheme is less than 95% funded it would not have to provide indexation but, if it is funded between 95% and 100% of the SFO ("the corridor"), it would provide indexation at a figure somewhere between zero and the current statutory level of 2.5% LPI for both pensions in payment and pensions in deferment.'

They also floated the idea of optional indexation whereby the statutory requirement for indexation would be removed and *'therefore, schemes would simply aim to target the funding level necessary to provide a pension which is not indexed to inflation.'*

Amongst others, **Mercer** also took the view that, rather than developing a new risk sharing regime, '*it would be better if the legislation that imposed mandatory indexation were repealed, or at least amended.'*

The **Higher Education Employers' Pension Forum** response also argued that:

'*"deregulation" should be understood to mean precisely that – the removal of existing regulation – rather than the introduction of more regulations to the already over-regulated world of occupational pension provision in the UK.*'

PWC responded along similar lines, stating that:

'We are not generally supportive of introducing a new layer of legislation as this goes against the spirit of deregulation.'

Q 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?

As with other questions in this chapter, this was met with a mixed response. Whilst the majority agreed that some sponsoring employers would take advantage of this option, opinions were divided as to whether this would be a good thing (i.e. saving some DB schemes) or not (sponsors committed to DB rather than DC may level down given this option). A significant minority were sceptical as to whether employers would be keen to use this option.

Deloitte answered that *'where sponsors are currently providing DB benefits for future service and aim to continue to do so, they may consider changing future service to be based on conditional indexation in an effort to reduce risk and increase the flexibility in cash funding.'*

Unite, on the other hand, were concerned that *'for each employer who was persuaded to hold back from a more radical attack on their pension scheme there might be another encouraged to go further than they might otherwise have.'*

However the **ACA** thought that this shouldn't be used as an argument against conditional indexation. In fact, '*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.'*

Travers Smith took the view that '*employers are unlikely to favour this option*' on the basis that '*scheme funding discussions would become even more difficult than they are at present.*'

Mercer considered that, whilst employers would be likely to consider this option, current accounting standards *'could deter some employers from providing conditional indexation schemes, as defined in consultation document.'* They went on to reiterate their previous point that:

'If the government genuinely seeks to reduce the regulatory burden on employers providing defined benefit arrangements, it should remove the requirement to provide indexed benefits.'

Feedback received by DWP at its employer events of 23rd and 29th July, 2008, also suggested that employers would be concerned by the complexity of conditional indexation. Generally, feedback suggested that employers would be more likely to de-risk their schemes in other, simpler ways.

Q 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?

Many respondents expressed doubts that employers with DC schemes would choose to offer conditional indexation but others felt that, for example, competition, staff retention and the adequacy of DC scheme might lead employers with DC schemes to consider conditional indexation.

The **Open University** asked 'w*hat is the incentive for employers already with DC schemes since Conditional Indexation would presumably be more costly and involve the regulator…?'*

Unite were similarly doubtful that conditional indexation would be successful enough to facilitate a move from DC pensions saying *'this is unlikely unless conditional indexation is permitted on such a wide (ACA type) basis as would render them akin to collective DC schemes subject to employer influence'.*

The research undertaken by **BMRB Social Research** bears out this view that employers with DC schemes are unlikely to move to such arrangements (see question 8).

In contrast the **ACA** thought that the needs of staff would attract employers to conditional indexation saying 'C*ompetition for, and retention of, staff are likely to be drivers of such changes, given the expected reduction in the UK workforce'.*

To some extent this was echoed by **Mercer**, who pointed out that *'many employers with DC schemes are already considering the adequacy of their provision'*. Whilst they might be prepared to consider a conditional indexation approach, *'they might prefer to maintain the certainty of a DC structure – that is, a design similar to the one discussed in Chapter 7* [Collective DC]*.'*

Q 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?

The majority of responses broadly agreed that the risks identified are appropriate, although there were some additional suggestions.

The **ACA** agreed that *'the chapter covers the risks arising from such schemes quite well.'*

The **SPC** stated that, in their view:

'the greatest risks likely to materialise are that, (a) over time, conditional indexation will be legislated back into some form of mandatory indexation; (b) that on occasions schemes will pursue risky and unsuccessful investment strategies, which they would

not have pursued had there not been provision for conditional indexation; and (c) extra administrative costs reduce its attractiveness to employers.'

The **NAPF** thought that the risks of conditional indexation could be mitigated through communication with scheme members, arguing '*there are a number of risks inherent in all different types of pension arrangements. How these risks are managed and communicated to scheme members is very important. The risks identified in the paper are manageable risks.'*

The **TUC** expressed greater concern, arguing that pensioners may be forced onto means-tested benefits. They also raised concerns that the temptation would be there for employers to "create" a deficit. More generally they were concerned that '*additional costs associated with the proposed solutions outweigh the benefits'.*

The **GMB** expressed broad concern about the risks associated with this proposal:

'The extent and likely repercussions of implementing conditional indexation are not fully explored in this consultation. The implications of these proposals are fundamental and affect not just employer sponsors of current defined benefit schemes but employees, future pensioners, taxpayers, public bodies and the economy as a whole. The risks are inherent in the proposal, the significance of their impact will depend on how many schemes leap on this bandwagon and implement this option themselves. The more that do so, the worse the consequences.'

Q 22. If risk sharing is adopted, what sort of protection for members is appropriate?

The **ACA** presented their views on how the member protection regime should look under their proposal, stating 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.'

Other responses were broadly divided between those within the industry who considered that the current arrangements would be appropriate and those representing scheme members who advocated more rigorous protection.

The **NAPF** were content that the current system of member protection was adequate, stating *'we do not believe new forms of protection are required and the current reporting and funding regime can be adopted to ensure that a new system is not abused.'*

Similarly to the **ACA**, **Deloitte** stated that *'where members' benefits are potentially at risk from employer insolvency, the schemes should be eligible for protection from the PPF'*, although they did not offer a view as to how the levy should be calculated or what level of protection would be appropriate.

The **TUC** suggested that 50% of trustees should be member nominated, and that a *'…conditional indexation scheme would need to operate within a context where pensions form part of the collective bargaining agenda'.*

The **GMB** broadly agreed with the **TUC**, and added:

'Fundamentally, if the conditional indexation approach is pursued, some major member protections will be destroyed overnight. Any limited protections incorporated subsequently are not going to disguise this fact.'

Q 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?

Whilst many recognised that the rate of inflation would affect the value of conditional indexation to employers, the majority of respondents agreed that this would not be a barrier to employers adopting conditional indexation.

The **ACA** thought that conditional indexation *'is a workable basis which employers and members will find acceptable.'*

The **SPC** considered that dependence on the rate of inflation would reduce the potential value of conditional indexation, but not *'to the extent that it would be a factor which would lead them to choose not to adopt conditional indexation when they would otherwise have adopted it.'*

The **NAPF** agreed noting *'the greater smoothing of funding'* under conditional indexation.

The **TUC** agreed that, although the effect would be limited in a time of low inflation, the long-term nature of pension fund liabilities they *'would not see this as a significant deciding factor for employers.'*

However **Unite** were less convinced of this arguing that that: *'What is at stake in terms of conditional indexation may only be 2.5% unless conditional indexation schemes are obliged to target a higher degree of indexation than the statutory minimum. Perversely the prospect of higher inflation would reduce the attractions of these schemes as companies would be expecting to see scheme costs reduced by inflation eroding the value of member's benefits'.*

Government Response

The Government is grateful for the very many carefully considered responses, from all sides of the argument, received on the prospects for risk sharing through varying the provisions on indexation of pensions in payment. It is also grateful to those organisations and individuals who have taken the time to develop, test and promote the various propositions, and in particular the Association of Consulting Actuaries, whose tireless advocacy of conditionally indexed schemes has been a significant factor in lifting risk sharing up the agenda.

The responses to the consultation centred around the two main propositions outlined in the paper (conditional indexation restricted to new career average schemes and conditional indexation for all existing DB schemes), and a counter-proposal, put forward by some respondents, to abolish the mandatory indexation of pensions in payment.

All three propositions had their advocates amongst respondents, but they all also had their critics.

Removing mandatory indexation would indeed be a simple and radical deregulation, with the capacity to free up a wide variety of risk sharing practices and to offer very substantial cost savings to employers (the independent reviewers suggested in the their report that if only around a quarter of employers took advantage, the savings could still be as much as £1billion a year[11]). These savings, it was argued, might even be substantial enough to slow or reverse the trend away from defined benefit schemes. However, as others raised issues of fairness, pointing out that those savings would come direct from reduced future benefits for members, and in particular from those scheme members – pensioners – who had the least capacity to compensate for those losses in other ways. They also argued that there was no firm evidence that such a change would significantly alter employer behaviour.

The Government rejected this proposal when it was raised by Chris Lewin in his report with Ed Sweeney. It has seriously examined the case for reversing that decision in the light of responses to this consultation. In particular, the Government has weighed very carefully the pressures that the current economic climate is bringing to bear upon employers, as well as the arguments raised around the complexity of other options being considered. However, in the absence of compelling evidence that such a move would reinvigorate DB provision, the Government still believes that the removal of such an important protection for members would not strike the right balance between employer concerns and member protection.

On conditional indexation, those in favour put forward strong arguments for the need for a safety valve for hard-pressed employers who were trying to maintain their DB

[11] Paragraph 65, pg 18, *Deregulatory Review of Private Pensions, An Independent Report to the Department of Work And Pensions, Chris Lewin and Ed Sweeney, July 2007.*

provision, and defended the proposals against the perceived risks of moral hazard. Those against were particularly concerned by the complexity of the proposals, and doubted whether there was sufficient demand to justify such complexity. Many raised concerns about member understanding, and the risks of undermining confidence in pensions in already difficult times.

The Government has carefully considered the arguments for and against. The consultation has not uncovered any new issues relating to the proposals, but a number of concerns have been underlined. In particular, the Government remains concerned about the complexity of the proposals. Significant additional regulation would be required to provide an appropriate framework for such an approach, and a number of respondents have questioned whether this would not act as a disincentive to employers. Secondly, this complexity would inevitably hamper member understanding and potentially undermine member confidence.

The Government is also unconvinced that there is sufficient demand from employers to justify taking such measures. In the time available, the research commissioned by the Government into employer attitudes was necessarily small scale, but it nonetheless drew clear conclusions that most of the employers surveyed saw few attractions in these proposals. The consultation itself did not elicit a significant number of responses suggesting that there would be a substantial take up of this option, although some respondents thought that was a possibility in the longer term.

The Government has also noted with interest the comments on the Dutch experience, where conditional indexation is the norm within their system. It remains convinced that that arrangement is firmly rooted in the particular circumstances of the Dutch industrial relations model. In particular, there is much greater emphasis, within large industry-wide schemes, on member involvement in scheme affairs, engendering greater trust in the outcomes, which would be difficult to replicate in the UK's more heterogeneous, individual employer-driven system.

Finally, the consultation has demonstrated that there is, at present, no workable consensus on this proposal. It is, of course, unsurprising that employer and employee groups should disagree over the merits of a proposal that may result in reduced costs/risks for employers but increased risks/uncertainty for employees. The terms of reference of the Deregulatory Review[12] specifically refer to the need to strike a balance between encouraging employers and ensuring adequate employee protection, and striking such a balance when the two sides so clearly disagree is not straightforward. The Government's view, however, is that the consultation has not provided the weight of evidence that this proposal is in practice likely to make a significant impact on the level of DB provision that would have justified overriding the concerns of member representatives. It has therefore decided not to pursue conditional indexation at this time. The Government recognises that this will be very disappointing for those advocates who have promoted this scheme so strongly over

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[12] *Security in Retirement: towards a new pensions system – Summary of responses to the consultation*, Cm 6960, published in October 2006.

the past two years. It will of course continue to listen to representations on the matter and, as outlined in the previous section, will pursue a number of avenues on improving the flexibility of the existing framework.

Chapter 7: Collective defined contribution schemes

This chapter explored the potential of collective defined contribution schemes similar to those existing in the Netherlands and which were advocated by Hewitt Associates. The key difference between these schemes and the conditional indexation proposals in chapter 6 is that in this case the risks would be shared between scheme members, rather than between each member and the sponsoring employer.

Q 24. Would the introduction of collective DC schemes add significantly to the risk sharing already available to DB schemes?

Hewitt were very confident that collective DC schemes would add to the risk sharing options available to DB sponsors, on the basis that the main risk sharing options available under the current framework (identified as changing normal pension age, using hybrid schemes and cash balance arrangements) do not altogether eliminate DB risks which employers find unattractive.

The Open University agreed that there would be a shift since members and not employers would take responsibility for all the risk: '*There would therefore not be any risk sharing with the employer but instead be between members'.*

Unite shared this view commenting that *'companies only incur risk from Collective DC schemes if they allow their DB scheme to assume the risks of being an annuity provider to the schemes.'*

In line with comments reported earlier, the **TUC** expressed the view that there are already *'…plenty of routes to risk sharing within DB schemes which are often not adequately explored by employers.'* They went on to express a fear that *'Collective DC schemes are more likely to be used as a way of employers passing risk over to employees.'*

Q 25. Is sharing investment risk between pension scheme members through indexation and revaluation provisions a suitable response to the costs and risks facing DB scheme sponsors?

The majority view was that collective DC would produce a better outcome for employers and employees than current DC schemes. However, some respondents raised questions about whether collective DC would be the most suitable option for DB scheme sponsors.

The **CIPD** said:

'This would be something that members would need to decide, however they may value the smaller volatility that such a scheme could provide in comparison with a work-based DC scheme.'

The **APL** agreed:

'It is one response which could be attractive to employers and members and so might be made available as a suitable response option.'

Slaughter & May also answered in the affirmative, stating, *'in our view, the answer is clearly yes, if the comparison is against no defined benefit employer sponsored occupational pension scheme.'*

Similarly, **Help the Aged** considered that *'The concept of a collective sharing of risk in a very big pool-sharing arrangement is an attractive principle.'*

GMB, however, responded that:

*'**GMB** does not see the need for more legislation of this type surrounding occupational pension provision. The best response to secure continued good quality pension provision is increased involvement of employees and their representatives. As stated above, there are already many options available to defined benefit scheme sponsors who want to reallocate (or) rebalance the cost and risks of scheme provision.'*

In addition, the **PMI** expressed the view that, whilst this response would be suitable, *'there are other ways that already exist such as reducing future benefits or increasing member contributions which are easier to communicate.'*

Hymans Robertson were similarly cautious:

'The potential for inter-generational inequity seems high as does the potential for substantial underfunding (based on the targeted rates of pension and indexation) if the assumptions underlying the funding assessments turn out, in the long-term, to have been inadequate. Such arrangements would also surely be difficult for scheme members to understand.'

Q 26. 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?

Whilst this option was generally considered to be attractive to DB scheme sponsors, the idea that this would equate to 'some sort of DB provision' was questioned by some. In addition, a number of respondents thought that the question of whether collective DC schemes would work as a "middle option" would depend on the scale of the pension scheme.

Hewitt suggested that this option would be attractive to those employers with open DB schemes, increasing numbers of whom they suggest will *'enter the process of switching to DC'*, as well as those with partially open DB schemes combined with DC arrangements for future accruals or new joiners.

Unite were keen to point out that:

'Collective DC is a variant of DC and debate should not be focussed on its comparability with DB. This only distorts a valid discussion about whether Collective DC has any advantage to members as compared to conventional DC.'

The **CBI** believed *'that risk sharing between members may work well. However it will only work for very large employers or across industry-wide schemes that are not currently a natural feature in the UK pensions landscape.'*

CIPD agreed stating that *'We cannot envisage many employers opting for such schemes other than possibly those who are covered by industry-wide arrangements.'*

However, **Slaughter and May** suggested that, though collective DC would be limited to large employers, '*such schemes could cover a relatively large number of employees, even though the actual number of such schemes could be relatively small (because of the associated costs).*'

Q 27. To what extent would DC scheme sponsors be expected to adopt a collective DC option to protect their employees from the risks inherent in DC provision?

Whilst many thought that this could be an attractive option, we received a lot of feedback suggesting that there are a number of issues that need to be considered before collective DC schemes could be introduced.

Hewitt suggested that they would expect a significant shift from DC to collective DC partly, but not solely, because *'discussions with DC scheme sponsors indicate that a key attraction of Target Pensions[13] is members getting progressively more predictable pensions as they approach retirement.'*

GMB considered that:

'The practical issues thrown up by the Hewitt model of collective defined contribution would need to be overcome before widespread introduction of the approach could be considered. In due course therefore this question should be raised but at the current time such an expectation would be premature.'

Feedback received by DWP at its employer events of 23rd and 29th July, 2008, suggested that many employers would be concerned by adopting such an approach because of significant perceived communication difficulties.

The Open University thought that alternatives would soon be available, stating *'this would be up to individual employers to decide but presumably they will prefer the existing DC scheme or Personal Accounts in many cases if cheaper.'*

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[13] This is the term used by **Hewitt** to describe their proposed collective DC schemes.

Q 28. Do you think members would accept this way of sharing risk?

Some respondents thought that members would readily accept this way of sharing risk. The **Society of Pension Consultants** stated *'We would expect that many members would accept this way of sharing risk'.*

Hewitt agreed stating:

'If sponsors are willing to allow members to share in the greater efficiency of Target Pensions, our view is that members will also find Target Pensions attractive.'

However, there was some concern expressed that the risks may not be comprehensible to members. **Mercer** were worried that though members may accept the risk *'this is not necessarily to say that they would understand the risk they were accepting, or accept it if they did understand it.'*

Likewise **Deloitte** cautioned that *'It would be a difficult message for individuals to understand, and if it is not fully understood and appreciated by individuals, then there is no value to the sponsor who gains nothing from the change.'*

The **NAPF** agreed that, '*Member understanding is a key issue which needs to be addressed*'.

Q 29. Are the principles for the regulation of collective DC schemes appropriate? If not, which other principles would be appropriate? Would these schemes be able to operate under these principles?

Hewitt suggested that the eight principles originally proposed for the regulation of collective DC schemes should *'be reviewed in the context of the Government's five tests of pension reform'* (paragraph 1.13 of the risk sharing consultation document). They suggested ways in which their eight principles would be consistent with these tests.

The **NAPF** thought that the principles were appropriate.

However, **Deloitte** were slightly more cautious and were of the opinion that *'the principles seem sensible, but they could be difficult to apply in practise due to the cross subsidy over generations.'*

Unite and the **GMB** both emphasised that the differences between collective DC schemes and DB schemes would have to be made clear to members.

Q 30. Is the attraction of collective DC great enough to justify the creation of new regulatory regime for them? Are the other ways in which they would be permitted?

Hewitt responded to this question to state that '*employers – who have spent time understanding these matters – have formed the view that the answer to Question 30 is yes.'*

The large majority of responses to this question came from employers who responded to the consultation solely to corroborate this view in the following terms: *‘(we….) confirm the attraction of Collective DC is great enough to justify the creation of a new regulatory regime for Collective DC Pension Plans.’*

On the other hand, there were some responses that suggested a new regulatory regime might not be appropriate.

The **APL** thought that the current regime would be adequate, *‘It seems to us that it ought to be possible to build the legislation for collective DC schemes off the existing legislation rather than needing to create a completely new regulatory regime.’*

While the **TUC** noted that *‘it is difficult to argue that a new regulatory regime just for them is appropriate.’*

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

Deloitte suggested that a system of deferred annuities could be workable: *‘Members could purchase deferred annuities each year with an insurance company. While this is currently prohibitively expensive, if the insurance companies could make use of conditional indexation policies, the cost could become competitive.’*

The **ACA** agreed that investment choice, including annuities was a possibility: *‘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.’*

The **NAPF** emphasised once again the importance of member understanding.

Government Response

The Government is grateful for the support of Hewitt who have been central to the promotion and development of the concept of collective defined contribution schemes.

Although many respondents raised particular questions about how such schemes would operate, it was clear from the consultation that the development of some form of collective defined contribution arrangement commanded significant support in principle across a wide range of respondents. As the current economic climate has shown, individual DC choices can be difficult at times of significant stock market volatility, and so it is not surprising that many were interested in exploring the scope for smoothing or risk sharing across members. Others were interested in the proposal as a means to encourage employers to improve existing DC arrangements to which many employees had been transferred in recent years.

In the light of this broad consensus, the Government has decided to undertake further work on the detail of how collective DC schemes might operate in the UK.

Amongst the issues that the Government intends to explore with stakeholders are a series of questions around the legislative provision that might be needed, including:

- the extent to which such designs can already be accommodated within the existing regulatory framework;
- the need or otherwise to prescribe in legislation a model scheme;
- how these schemes might interact with the UK interpretation of EU legislation (in particular the Occupational Pensions Directive); and
- the interaction with the ruling in Aon Trust Corporation v KPMG [2005] WECA Civ 1004 and Section 67 of the Pensions Act 1995.

The Government will also wish to explore in some detail concerns that were raised over the communications challenges involved in such schemes. As it mentioned in its response above on conditional indexation, it is important that risk sharing should not undermine confidence in occupational pensions. Some respondents were concerned about the scope for misunderstanding amongst members, and in particular for significant disappointment of expectation in the event of a substantial variation from year to year of the “target pension” offered.

Thirdly, there is a range of detailed analytical and technical policy issues that would need to be further developed before the Government was able to make a decision on whether to permit the establishment of such schemes. These include:

- what size of scheme would be needed to make such a design viable (and what the scope for such schemes is in the UK context);
- more analysis on how outcomes for collective DC compare with conventional DC schemes;

- how the scheme would in practice make adjustments to pensions in the light of variations in the assets and liabilities match (how much would happen automatically, how much would be left to trustee discretion);
- what safeguards would be needed to ensure that the cross-subsidy between younger and older members of the schemes worked fairly; and
- how each member's share of the common fund would be determined – since each member would "own" a particular share of the joint pot at all times, subject to adjustment – and how that would operate in transfer or wind-up situations.

Respondents to the consultation

ABP-Netspar Hoogleraar Economie Collectieve Pensioencontracten

The Actuarial Profession

AEGON

Aon Consulting

Archer Daniels Midland (UK) Limited

ASDA Stores Ltd

Association of British Insurers

Association of Chartered Certified Accountants (ACCA)

Association of Consulting Actuaries (ACA)

Association of Pension Lawyers (APL)

Astra Zeneca PLC

AT&T

Atkins Limited

Barnett Waddingham LLP

Benstead, Derek

Bentley Motors

BMW (UK) Pensions Services Limited

Brighton Rock Group

British Chambers of Commerce

BT Group

Buck Consultants Limited

Cardano

Chartered Institute of Personnel and Development (CIPD)

Confederation of British Industry

Connect

Co-operative Group Ltd

Deloitte Total Reward and Benefits Limited

EDF Energy

Eversheds LLP

Fleet, Richard

Foster Wheeler Energy Limited

Fujifilm Imaging Colorants Limited

Galiform PLC
GMB
Goldman Sachs
Headley, Tom
Hewitt Associates Limited
Hewlett-Packard Ltd
Higher Education Employers' Forum
Hospira UK Limited
Hymans Robertson LLP
Institute of Chartered Accountants in England and Wales (ICAEW)
Jeyes
The Law Society of Scotland
Chris Lewin
LSF Pensions
Mercer
Messier-Dowty Limited
National Association of Pension Schemes (NAPF)
National Institute of Economic and Social Research
Open University
The Pensions Institute
The Pensions Management Institute
Pensions Policy Institute (PPI)
The Pensions Regulator (tPR)
Pfizer Ltd
The Pilkington Group Ltd
The Port of London Authority
PPG Industries (UK) Ltd
PricewaterhouseCoopers (PwC)
Punter Southall
Rentokil Initial PLC
RSA
Sacker & Partners LLP
Slaughter and May
The Society of Pension Consultants (SPC)
Sonoco Products Company

Standard Life
Steria
Syngenta
Tesco
Toshiba Electronics Europe (UK Branch)
Trades Union Congress (TUC)
Travers Smith LLP
The Union of Shop, Distributive and Allied Workers (USDAW)
UNISON
Unite
Universities Superannuation Scheme Limited
University of Cambridge
Vertu Motors PLC
Watson Wyatt Limited
Wesleyan Assurance Society
YIG Consulting