Pension schemes for the 21st century

*is there a third way?*

HSBC Actuaries and Consultants Limited
A survey in association with The Pensions Management Institute
Foreword

The pensions industry has undergone major seismic changes over the past decade. The cosy certainties (for the employee at least) of Final Salary/ Defined Benefit (DB) occupational pensions have been swept out by the cold winds of change brought in by Money Purchase/Defined Contribution (DC) pensions where employers have sought to terminate the open ended risk associated with DB provision.

However, merely closing DB schemes will not make the problems go away. Neither will passing the risk from the employer to the employee which is one of the major criticisms of companies moving from DB to DC. There are fundamental problems of dealing with employees who, as they approach retirement, suddenly discover that they do not have sufficient income on which to embrace and enjoy their retirement. Age discrimination laws will make it impossible to force them out of their jobs if they don’t want (or can’t afford) to go. Employers must also face up to the massive reputational risk of dissatisfied employees with many years’ service being pushed towards the exit and the negative media (and repercussions on staff morale and shareholder esteem) they will face as a result.

Yet equally employers will often point out that their pension schemes have been radically affected by Government and regulatory intervention over the years and now bear little resemblance to the pensions promises that were originally made by the company to its employees. Companies that have tried to meet all their Final Salary promises find that they are commercially handicapped by coming up against newer companies who don’t have this financial baggage to hamper them.

Somehow - and this is easier said than done - there has got to be a middle ground; a way for companies and employees to share some of the risk whilst keeping the benefits. That is the basis behind this survey which the PMI has helped HSBC Actuaries and Consultants to conduct. Entitled “Pension Schemes for the 21st century”, both organisations feel that it is an important step forward in evaluating the “risk tolerance” for both sides and then to look at ways of shaping future pensions design so that, to quote the title of the PMI Spring Conference, we may make “pensions fit for purpose” - again!

Vince Linnane, Chief Executive
The Pensions Management Institute
Executive summary

Changes in the defined benefit (DB) pension scheme landscape in the past decade and, in particular, the shift to defined contribution (DC), have been well documented. It is also well recorded that future pension provision in the UK and beyond, at least in the private sector, will be predominantly DC.

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

With the help of the PMI, HSBC Actuaries and Consultants Limited have, through a survey of over 300 advisers, trustees and employers, sought to ascertain some of the wider implications of the DB to DC trend. The survey looks beyond just the impact on contribution levels, to address the burning question of whether it is terminal or if there is, in fact, another option – a third way – for employer pension provision in the 21st century.

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

Key findings from the survey include:

- An overwhelming consensus that employees, in general, cannot manage the risks that are transferred to them when workplace pension provision is switched from DB to DC.
- An equally clear agreement that something needs to be done about this.
- A stark warning that personal accounts will lead to a leveling down of current workplace pension provision.

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

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

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

The survey

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

The breakdown of responses by reference to role is shown in the following graph. For the purposes of the survey, we have treated the views of those who are a pension manager to one employer, or to a group of employers, as being ‘employer views’. However, to ensure this has not skewed the results, we separately surveyed finance, managing and human resource directors on our own database (see Appendix II – employer-only survey).

Over 90% of responses came from people employed in the private, as opposed to public, sector and the type of pension arrangement operated by respondents is shown below.

Most DB schemes were final salary (85.4%) and closed to new entrants (62.1%). The rest were either career average revalued earnings (CARE – 6.6%) or ‘Other’. Surprisingly, no respondent was a member of or operated a cash balance scheme.

Most DC arrangements were occupational pension schemes, with trustees, as opposed to contract based personal or stakeholder pension plans, and average employer and employee contributions are set out in the next two graphs.

Key findings from the survey include:

- An overwhelming consensus that employees, in general, cannot manage the risks that are transferred to them when workplace pension provision is switched from DB to DC.
- An equally clear agreement that something needs to be done about this.
- A stark warning that personal accounts will lead to a leveling down of current workplace pension provision.

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

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

This report therefore concludes with some ideas on alternatives to conventional DB and DC which, in the right environment, may offer employers some options in respect of that previously referred to and elusive ‘third way’ for employer pension provision in the 21st century.
A switch from DB to DC is often associated with a significant reduction in employer contribution. For many this may indeed be the case, but our survey also confirms, in line with other recent studies, that DC contribution rates are on the increase; over 50% of the schemes in our survey receive an average employer contribution of more than 10%.

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

When asked whether employees understand the risks associated with different types of pension scheme, the views of the 297 respondents to the ‘risks’ part of our survey (see below) are clear — they emphatically do not.

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

Some subtle discrepancies can, however, be observed (see the graphs, below). In particular, there is a depth of feeling about employees’ inability to manage longevity risk, and the fact that respondents were slightly more confident about employees managing inflation risk than they were investment and longevity risks.

### Risk Breakdown

<table>
<thead>
<tr>
<th>Risk Component</th>
<th>Strongly Agree</th>
<th>Agree</th>
<th>Disagree</th>
<th>Strongly Disagree</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Longevity</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inflation</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

It is also important to look at the issue of ‘risk’ from a wider perspective and at least two employer-issues spring to mind in the context of a DB to DC trend.

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

### Succession planning will be a problem in an environment in which there could be no compulsory retirement ages and employees perceiving they have inadequate pension provision

![Succession planning graph](chart1)

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

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

### There will be staff relations problems where DB pensions are still provided to longer serving and/or senior employees but most new employees are offered a DC scheme

![Staff relations graph](chart2)

How should employers respond to these risks?

Nearly everyone in the survey either agreed or strongly agreed that employers should take action to help employees manage their pension risks, so that their pension is more likely to meet their expectations (see Appendix I, which sets out “other” findings from the survey).

When asked whether employers should be willing to share some pension risks with employees, most people agree that they should. However, as the following graph shows, only around 20% strongly agreed with this contention and a significant minority of over 12% disagreed.

### Employers should be willing to share some pension risks with employees

![Employers share risks graph](chart3)

Anticipating the above results, we, again, broke the pension risks down into investment, longevity and inflation risk, and the views of respondents are set out overleaf.
A. Employers should carry some or all of employees’ pensions investment risk
B. Employers should carry some or all of employees’ pensions longevity risk
C. Employers should carry some or all of employees’ pensions inflation risk

Of course, the above results do not reflect reality. With just a few exceptions (such as the employers that have replaced their final salary arrangements with CARE schemes), companies closing their DB pension schemes are replacing them with pure DC.

Is there anything that can be done which might stem or even go some way towards reversing the current appetite for transferring pension risks from employer to employee?

We consider this question in the next section.

Before turning to this, however, we also asked respondents about their views on personal accounts and the potential impact on existing provision. The results are shown below.

**Personal accounts will result in a levelling down of existing employer pension provision**

Of course, the above results do not reflect reality. With just a few exceptions (such as the employers that have replaced their final salary arrangements with CARE schemes), companies closing their DB pension schemes are replacing them with pure DC.

Is there anything that can be done which might stem or even go some way towards reversing the current appetite for transferring pension risks from employer to employee?

We consider this question in the next section.

---

**Pension schemes for the 21st century**

Some of the respondents to our survey felt that the solution to employees’ inability to handle pension risks was better communication and education. However, as one particular respondent observed to the contrary:

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

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

Career average revalued earnings (CARE) schemes have already been mentioned. For the few employers who have closed their final salary scheme while sticking with defined benefits, CARE has proved to be very popular.

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

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

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

<table>
<thead>
<tr>
<th>Design</th>
<th>Final Salary</th>
<th>Cash Benefit</th>
<th>Money Purchase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk</td>
<td>Employer</td>
<td>Employer</td>
<td>Employee</td>
</tr>
<tr>
<td>Investment</td>
<td>Employer</td>
<td>Employer</td>
<td>Employee</td>
</tr>
<tr>
<td>Longevity</td>
<td>Employer</td>
<td>Employer</td>
<td>Employee</td>
</tr>
<tr>
<td>Earnings Progression</td>
<td>Employer</td>
<td>Employer</td>
<td>Employee</td>
</tr>
</tbody>
</table>

Further, there is considerable logic in this form of risk-sharing with, broadly speaking, the employer carrying the risk pre-retirement, and the employee dealing with it post-retirement (probably, by annuitisation). In addition to some certainty, cash balance also provides members with flexibility in terms of setting up a retirement income which will fit with their particular circumstances.
A more recent development in DB risk sharing is the ‘living benefit structure’, whereby employee contribution rates, retirement ages and/or even benefits are adjusted to reflect changes in longevity.

The design operates like a conventional final salary or CARE arrangement, except that an additional element – the Change in Life Expectancy Factor (or CLEF) – is written into the benefit formula. So, for instance, a typical living benefit formula would be:

\[ \text{Benefit} = 0.9 \times 	ext{Final Pensionable Pay} \times 1.5\% \times \frac{\text{FPS}}{\text{CLEF}} \]

CLEF is the longevity adjustment – the Change in Life Expectancy Factor – which is a ratio like:

\[ \frac{\text{Age} \times \text{life expectancy at the date the member retires}}{\text{Age} \times \text{life expectancy at the date the living benefit structure is introduced}} \]

And it works like this:

On 1 January 2008, a scheme introduces the living benefit structure for future service. A member in service at that time retires 10 years later and his benefit entitlement will be 15% of FPS x CLEF. If life expectancy has increased by 10% between 2008 and 2018, the effect of CLEF is to reduce the amount of pension by 10%.

The groundbreaking aspect of this is that the whole of the benefit attributable to post-2008 service is adjusted in 2016 to reflect increasing longevity in the interim. Once the pension is in payment, there is, of course, no suggestion of further longevity adjustment (so this is written into the benefit formula).

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

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

Without further encouragement, the fact is that future for DB looks bleak. Our survey, therefore, included a ‘wish list’ question; i.e. if respondents could alter any aspects of the current pensions environment, what one or more changes would they make. The results are shown in the following graph.

**If the pension environment were changed...**

[Graph showing preferences for changes in pension environment]

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

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

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

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

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

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

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

As with DB risk sharing, lessons can also be learned from other countries. In Denmark, for instance, the countries largest pension fund, ATP, is seeking Parliamentary approval for a new DC product, which has a level of guaranteed return on contributions at no extra cost but which also generates higher potential investment returns.

With the continuing growth in DC, and the introduction of personal accounts in 2012, further innovation in this market is inevitable. The question is, given everything said in this paper, will it be enough?
Appendix I –
Other results from the survey

The DB to DC trend will mean that many employees will be disappointed with their eventual pension

Employers should take action to help employees manage their pension risks so their pension is more likely to meet their expectations

Company Pension arrangements are important when it comes to attracting and retaining employees

Employers will consider making changes to the eligibility conditions or benefit structure of their pension arrangements to avoid having to make contributions to personal accounts

Appendix II –
Employer only survey

(From employers - mainly managing, finance and human resource directors - on the HSBC Actuaries and Consultants Limited database)

The employer only survey proved to be a very worthwhile exercise.

Comparing the findings of the main survey with those from the employer-only one, respondents agreed that, on the whole, employees do not understand and cannot handle the substantive risks associated with pensions.

Employers will consider making changes to the eligibility conditions or benefit structure of their pension arrangements to avoid having to make contributions to personal accounts

Broadly, respondents from both surveys also agreed on the wider risks.

Company pension arrangements are important when it comes to attracting and retaining employees
Further, a consensus can be identified on the need for employers to take action to help employees manage pension risks and, albeit to a lesser extent, the need for employers to be willing to share some of the risks.

However, important discrepancies arise between the two surveys when employers are asked about specific risks. In the current environment, around 58% do not accept that employers should share employees’ pensions investment risk, and over 60% do not want to share longevity or inflation risks.

And finally, looking to the future again, employer-only views on the impact of personal accounts are shown below. A majority of respondents are concerned that there could be a leveling down of existing provision, but not as many as in the main survey.