PENSIONS POLICY INSTITUTE
PPI

The shift from Defined Benefit to Defined Contribution

PPI Briefing Note Number 2

Introduction
Occupational pension provision in the private sector is declining. There were 10.1 million active[1] occupational pension scheme members in 2000, compared to the high point of 12.2 million in 1967[2]. There has also been a shift in the type of occupational pension schemes with employers closing Defined Benefit (DB) arrangements and replacing them with Defined Contribution (DC) schemes[3].

Why are employers closing DB schemes?
Four factors are increasing the cost of occupational pension provision:

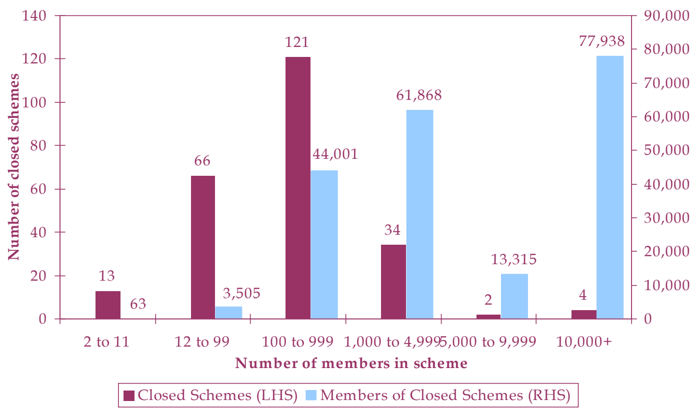
- People are living longer, but not retiring later.
- The long-run investment returns on pension funds are projected to fall in future.
- Pension funds are now less tax advantaged since the changes in Advance Corporation Tax introduced in 1997.
- The value of benefits has increased as regulation has imposed higher minimum standards—such as statutory indexation and the provision of spouses' pensions—which costs more.

In addition, new accounting standards (FRS17) have made pension liabilities more transparent in company accounts, and so made the increasing costs more explicit.

It is therefore not surprising if, after starting DB schemes on the basis of providing a reasonable pension at reasonable cost, **some employers are now finding that the current cost is more than they can afford**. The shift to DC is often part of the solution, as a way of reducing future costs, or sharing them with employees.

How big is the shift to DC?
The full extent of this shift is difficult to measure. Up to three-quarters of all DB schemes have been reported as being closed to new entrants[4].

Chart 1: DB schemes closing to new members in 2002/3



However, **many closures are of relatively small schemes and so only a small proportion of pension scheme members are affected**. There are currently more than 8 million active members of DB schemes[5], while of the 240 closures recorded by the Pension Scheme Registry (PSR) in 2002/3, 200 of them had less than 1,000 members (including active, deferred and pensioner members) (Chart 1)[6]. In total, there were only 200,000 members of all schemes recorded as closing.

But not all scheme closures will be recorded by the PSR—some schemes have changed the rules of their existing schemes rather than closing and opening a new scheme. It is not clear how many schemes have done this, or how big these schemes are.

Many of the largest DB schemes are public service schemes, covering 45% of active occupational pension scheme members (4.5 million)[7]. There is little sign of public service schemes moving away from DB .

PPI Briefing Notes clarify topical issues in pensions policy.

PENSIONS POLICY INSTITUTE

PPI

The shift from Defined Benefit to Defined Contribution

PPI Briefing Note Number 2

Even after a scheme closes, it will take time for the number of members in that scheme to reduce, and for a replacement DC scheme to grow. Generally, only new employees join the new DC arrangement, while those employees who do not change jobs remain within the DB scheme and are not personally affected.

Is the shift from DB to DC a problem?

In theory, DB and DC schemes both work in the same basic way – current earnings are invested to provide a pension income at a future point in time.

But whereas a DC scheme is a collection of individual funds, specific to each employee, a DB scheme pools the funds into one.

The different characteristics associated with DB and DC schemes (Table 1) mean that they are likely to suit different types of individuals.

However, the total amount contributed to build up a pension in future is probably more important in determining how well an individual will do in retirement than the type of arrangement that employers are offering. This means that **the best schemes have high, persistent employer and employee contributions**.

Contributions to DB schemes are more volatile than contributions to DC schemes, with many employers taking contribution holidays, or increasing contributions to make up shortfalls. This makes it difficult to identify and compare long-run contribution levels.

Table 1: Characteristics of DB and DC schemes

	Investment risk	Longevity risk	Employer solvency	Choice	Mobility
Defined Benefit	Employer bears the risk of poor investment performance	Employer bears the risk of increasing longevity	Employee can lose pension rights if the employer becomes insolvent[8]	Some flexibility, but less than in DC	Rewards older workers and those who stay for long periods with the same employer
Defined Contribution	Employee bears the risk of poor investment performance	Employee bears the risk of increasing longevity	Rights in individual funds are independent of the employer*	More flexibility in pension age, spouse provision and indexation	Better suited to those changing jobs frequently

* Unless funds are heavily invested in the employer's stock

Further, in order to keep pace with the rising costs of pension funding (for the reasons outlined on page 1), **contribution rates for all pensions need to increase from the past long-run averages**. This is irrespective of whether they are DB or DC arrangements. Although in recent years there has been some increase in average contributions, contribution levels appear to have stalled at less than 8% of average earnings[9]. This is considerably lower than guideline levels of saving, which suggest that someone beginning to save at age 35 needs to save between 15% and 20% of salary every year until age 65[10].

Perhaps more important than the switch between DB and DC schemes is the **increased perception that all pensions are risky**. If this prevents investment in private pension provision, many individuals could be reliant on state pensions and benefits when they come to retire.

Contact Chris Curry
020 7848 3731 chris@pensionspolicyinstitute.org.uk
www.pensionspolicyinstitute.org.uk

[1] Employees accruing rights as a result of their membership of their employer's pension scheme
[2] Government Actuary's Department (2003) *Occupational Pension Schemes 2000: 11th Survey by the Government Actuary*
[3] See PPI (2003) *The Pensions Primer* for definitions of Defined Benefit and Defined Contribution. A closed scheme can still receive contributions from existing members, and is not the same as a wound-up scheme, where the scheme ceases to exist and the remaining assets are distributed among scheme members.
[4] Association of Consulting Actuaries (2003) *Occupational Pensions 2003 Pension Reform: too little, too late?*
[5] GAD (2003) (see footnote 1)
[6] PPI analysis of data supplied by the Pensions Scheme Registry
[7] GAD (2003) (see footnote 1)
[8] This is likely to change under Government proposals for the Pensions Protection Fund (PPF), contained in Department for Work and Pensions (2003) *Action on Occupational Pensions*
[9] Curry, C and O'Connell, A (2003) *The Pensions Landscape* PPI
[10] Association of Consulting Actuaries