PPI response to the DWP Risk Sharing Consultation

Introduction

The role of the Pensions Policy Institute

1. The Pensions Policy Institute (PPI) promotes the study of pensions and other provision for retirement and old age. The PPI is unique in the study of pensions, as it is independent (no political bias or vested interest); focused and expert in the field; and takes a long-term perspective across all elements of the pension system. The PPI does not make policy recommendations, but exists to contribute facts and analysis to help all commentators and policy decision-makers.

2. In October 2007 the PPI published ***the changing landscape for private sector Defined Benefit pension schemes***. The report assessed trends and their key drivers, together with a range of government and scheme sponsor responses to these drivers, to provide an evidence base on which to consider the future for Defined Benefit (DB) pension schemes in the private sector. This response is based around the findings from this research, supplemented by PPI analysis of recent developments.

3. As the PPI is expert in policy analysis rather than the technical details of running a pension scheme, this response focuses on the questions posed in the early parts of the consultation paper, concerning the theory and principles behind risk-sharing rather than the practical details of implementing a specific risk-sharing regime.

4. This consultation response is submitted on behalf of the PPI, by Niki Cleal, Director of the Pensions Policy Institute. For any follow-up queries please contact niki@pensionspolicyinstitute.org.uk or tel: 020 7848 3744.

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Question 1: Given that scheme members have been protected and measures to combat under-saving are being brought in, should the Government undertake a far-reaching deregulation of the way risks are shared in pension schemes?

5. Recent years has seen a pronounced shift in the type of pension provision available to individuals working in the private sector, with a strong shift away from Defined Benefit (DB) provision towards Defined Contribution (DC) as set out in the consultation document.

6. As a result of this shift, the risks faced by individuals who are members of private pension schemes have been changing, so that more risk (and in particular investment and pre-retirement longevity risk) has been falling onto individuals.

7. At the same time as this shift from DB to DC is occurring, the Government is reforming the pension system to encourage more individuals to save, and in particular low income individuals who may be less able to bear significant risk. From 2012 the Government plans to require employers to auto-enrol all eligible employees into a pension scheme. There appears to be a tension between encouraging individuals to save into pensions, at the same time as they are becoming more risky for the individual.

8. It has also become more expensive for employers to offer DB pensions due to factors such as rises in longevity, historically low inflation and due to legislative and regulatory changes such as requirements for mandatory indexation and the introduction of the Pension Protection Fund (PPF).

9. The Government's policy objective for regulatory and legislative changes such as the introduction of the PPF has been to provide more security for existing members of DB schemes. However, if these changes increase the costs and risks of providing DB schemes for employers they can also make it less likely that future savers will have access to DB schemes and so face different (and potentially greater) risks than the risk of their employer defaulting.

10. Theoretically the introduction of pension schemes that share risks between the individual and employers could mean that less of the longevity and investment risks associated with a pure DC pension scheme are placed onto the individual. The costs and risk for employers could be smaller for risk-sharing schemes than for pure DB schemes. As a

result the introduction of greater risk-sharing in pension schemes could work with the grain of other recent policy change (such as auto-enrolment and the PPF) to both improve the security of retirement saving and encourage more voluntary saving amongst both employees and employers.

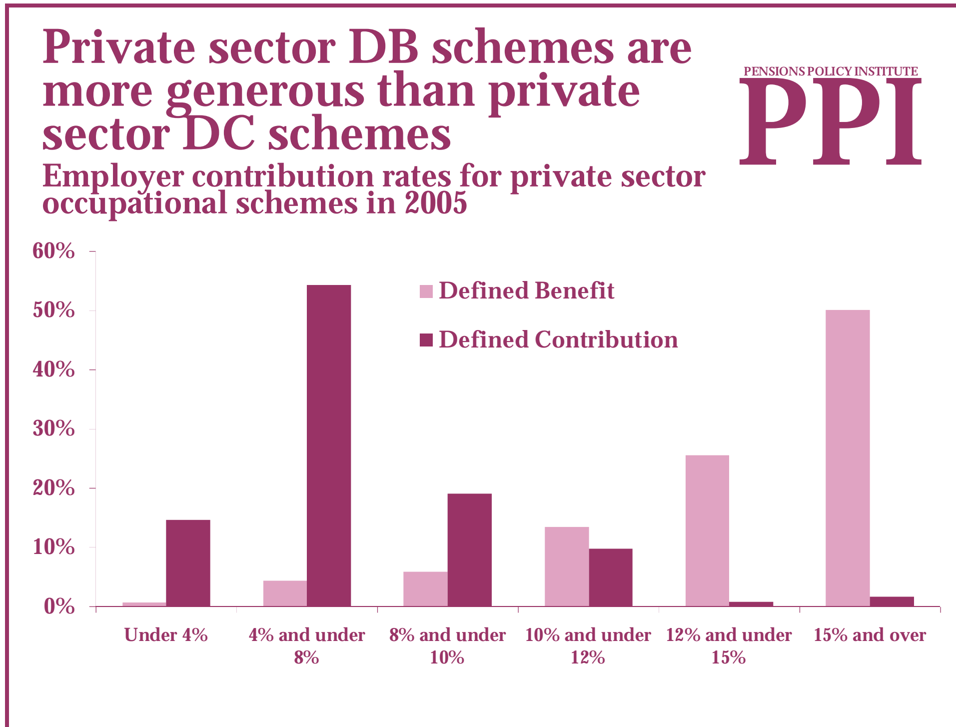
11. However, these potential gains are still largely theoretical. The extent to which these positive effects of risk sharing could be seen will depend on:
    - The extent to which individuals understand and value the benefits of risk sharing, as opposed to a pure DC scheme. Even if the benefits exist, if individuals do not appreciate and value them then risk sharing schemes will do little to encourage saving above pure DC schemes.
    - The extent to which employers wish to offer risk-sharing arrangements. This is obviously linked to the value placed on them by employees – if they are not valued than there is little for an employer to gain by offering one. Even if they are valued, the attractiveness of risk sharing to an employer will depend on the balance of risks they feel comfortable, or want to, take responsibility for.

12. There has been little research in this area. Further research would be extremely helpful to ascertain the likely appetite for introducing risk-sharing pensions among employers and the extent to which employees can understand and place a value on risk-sharing pension schemes.

Question 2: Is there any additional evidence on the impact on pension outcomes of lower contributions into DC schemes when all these complicating factors are taken into account?

13. The consultation document suggests that direct comparisons between DC and DB schemes are difficult for a number of reasons including possible different age profiles and the different approach to contracting-out between DB and DC schemes. While this may be true, the evidence to date suggests that at the same time as the shift from DB to DC pensions provision has occurred, employers have reduced their effective contribution rates to pension schemes. (Chart 1) This has the potential to have a negative impact on the level of retirement income that will be available to future cohorts of pensioners compared to what they could have received from DB pensions.

Chart 1[1]



14. The PPI is just starting a new research program looking at the needs of individuals in retirement, the types of assets that individuals have to fund retirement and how these assets may change over time. The shift from DB to DC pensions in the private pension sector and its potential impact on retirement income will be one of the factors analysed as part of this research program. The research is likely to be published in 2009 and the DWP has a place on the steering group for the research.

[1] ONS (2007 PT) Table 8.3

Questions 3 and 4: Is the DWP characterisation of the allocation of risks in DB and DC schemes correct? Which parties are best placed to bear each risk?

15. The consultation paper covers the main type of risks that exists in pension provision and makes a useful distinction between pre-retirement and post-retirement risks. In general the PPI agrees with the distribution of risks set out in table 3 of the consultation document but we would make the following additional points.

16. The relative importance of the risks may vary between individuals and between employers, so it may not be possible to rank risks in a way that is generally applicable. For example individuals may have different levels of risk adversity, an individual's age may affect their capacity to bear longevity risk and the strength of the employer covenant will vary widely from one employer to another.

17. In the consideration of long-term average longevity risk pre-retirement, it may not always be easy for individuals to bear this risk. The reason given in the consultation document is that it occurs before retirement and individuals therefore have time to change working and saving preferences. While this may be true for those who are a long way from reaching retirement age, this is unlikely to be a possibility for those approaching retirement.

18. In these circumstances it may be difficult for an individual to change savings levels (in particular if saving over the life cycle has been delayed to this point in life when saving may be more affordable), or the types of assets invested in (if using a lifestyle fund for example), or to continue to work if health or labour market conditions are not good.

19. The analysis also overlooks the potential correlation of these risks. For example, investment risk may be heavily correlated with longevity risk. There are two factors that influence the annuity rate that individuals face, the underlying expectations of longevity, and the rate of return on long-dated Government stock, which at the moment are historically low.

20. The example used in the report to illustrate the potential distribution of investment risks makes some simplifications which may mask some of the possible differences between DB and DC provision:
    - As discussed earlier, it is unlikely that the contributions to DC provision will be as high as contributions to DB schemes.

- Investment is likely to be different between DB and DC funds. In a DB scheme there is the opportunity to remain more heavily invested in riskier assets due to the pooled nature of the funds, with no need for individual life-styling. This is one of the potential advantages of a collective DC arrangement over traditional DC schemes.

Question 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?

21. Much of the consultation paper is focused on ways of sharing risks between employees and employers in existing DB schemes, in an effort to mitigate the effects of a future reduction in the number of members of private sector DB schemes. Of increasing importance, however, will be a consideration of whether it is desirable and realistic for employers already operating a DC scheme to introduce risk-sharing schemes.

22. It is also worth noting that many of the public sector pension schemes have already agreed risk-sharing agreements and may provide a possible model for the private sector.

23. In principle, enabling greater diversity of private pension provision by providing a regulatory framework that allows innovative approaches to risk-sharing between employers and employees should be a positive development, if it is implemented in such a way that there is limited risk of it negatively affecting existing private pension provision.

24. In practice, the use of risk-sharing pension schemes in the private sector will depend on the value placed on risk-sharing pension schemes by individuals and the advantages for employers of offering these schemes over traditional DB and DC schemes. Further research is needed to understand individuals' and employers' attitudes in both of these areas.