

Introduction

Over the last 40 years workplace pension provision in the UK has been changing from being predominantly based on Defined Benefit (DB) schemes, where the risks of pension provision are borne by the sponsor, to Defined Contribution (DC) schemes, where the risks are borne by the member.

The Government has published a consultation paper *Reshaping workplace pensions for future generations*¹ which sets out some proposals to implement Defined Ambition (DA) pensions. These types of pensions are intended to provide more certainty for members than a traditional DC scheme and to also ensure less cost volatility for employers who sponsor DB schemes than current DB pension schemes.

This briefing note discusses the possible impact of some of the DA pensions proposals for DB schemes' members. It also assesses the different DA options based on a DC pension structure.

This note does not analyse the impact that the proposals could have on the broader private pension market or on whether employers would be more likely to offer one type of scheme than others. Detailed analysis of all the options on a consistent and comparable basis would be required for this.

The proposals for Defined Benefit schemes

A number of factors such as increased longevity, economic and

labour market changes and changes in legislation and regulation, among others, have increased the costs of providing DB pensions in the UK over the last 40 years.² As a consequence, the number of DB schemes in the private sector closed to new members or to new accruals has increased in recent years. In 2008 around 67% of DB schemes in the private sector were closed to new members or to future accruals. This has increased to around 84% in 2013.³

For DB schemes, the introduction of the single-tier state pension in 2016 will mean that contracting out of the State Second Pension (S2P) will end. The associated loss of the contracted-out rebate from April 2016 (worth 3.4% of employers' National Insurance contributions 2013/14) will mean that sponsors still offering contracted-out DB schemes will either need to restructure their schemes, increase employee contributions, or manage an increase in costs.

Other changes associated with the ending of contracting-out include the removal of the requirement for DB schemes to provide spouse's benefits to meet the reference scheme test.

The consultation paper builds on these developments and sets out a number of DA proposals for DB schemes to make the future provision of DB pensions more flexible. The proposals apply only to future accruals. These include:

- Removing the statutory requirement to index pensions in payment. Sponsors would be free to offer indexation on a conditional basis, which could depend on the scheme funding position in any given year.
- The ability to change the scheme Normal Pension Age (NPA) in line with changes in longevity assumptions.
- The ability to automatically convert benefits to a DC pension when a member leaves the scheme.

Chart 1 shows the impact that the removal of statutory indexation for future accruals could have for a "typical member" of a final salary DB scheme age 45 in 2013. The results show the Effective Employee Benefit Rate (EEBR). The EEBR is calculated by translating the value of the pension benefit offered in the scheme into an equivalent percentage of salary that the scheme member would need to be given to compensate for the loss of the pension scheme. So, put simply, a 15% EEBR means the employee would need to be given a 15% increase in their salary by their employer to compensate for the loss of the pension scheme.

Under the baseline DB scheme with limited indexation for pensions in payment (lesser of RPI and 2.5%), the value of the benefit offered to the member would represent around 16.3% of a member's salary. This would fall to 11.1% of salary if statutory indexation were re-

Defined Ambition in workplace pension schemes

PPI Briefing Note Number 65

Page 2

moved for pensions in payment and CPI revaluation were maintained for deferred benefits.

The two values represent absolute limits assuming the scheme's valuation and funding is carried out in line with the minimum statutory requirements. In practice, if a DB scheme sponsor decided to provide indexation on a conditional basis, the impact on the value of the benefit to a "typical" member, as illustrated in the analysis, will be somewhere in between the two estimated values as benefits could be indexed or increased during the years that the scheme is above the required funding threshold.

Chart 2 shows the impact on the value of the benefit offered to a typical DB scheme member under different Normal Pension Ages. As in Chart 1, under a baseline DB scheme with an NPA of 65, the benefit offered to a typical member age 45 in 2013 would be around 16.3% of salary. This would fall to 15.6% if the NPA were increased to 67. The value of the benefit would fall further to around 14.8% of salary if the NPA were increased to 69. However, increases to NPA would only be made after an increase in longevity projections. So increasing the NPA would only generate cost savings for the sponsor to offset the increased costs of higher life expectancy. If after the changes in NPA members spend the same proportion of their lives in retirement than before the changes, the costs for the employer would remain broadly unchanged.

While this is a highly stylised analysis for one member, a comparison of Charts 1 and 2 suggests that changes to a DB scheme NPA from age 65 to age 69 could have less of an impact on the value of the benefit offered to a scheme member than eliminating the statutory indexation of pensions in payment. Nonetheless, linking the NPA to life expectancy may be attractive to employers with workforces characterised by longer and increasing life expectancy and who are keen to encourage their older employees to keep working beyond 65.

A third option discussed in the paper is to convert accrued benefits in a DB scheme to an equivalent cash value and transfer it to a nominated DC scheme if the member leaves before retirement. The intention of this proposal is to reduce the uncertainty of the costs to employers of funding

deferred members' future benefits.

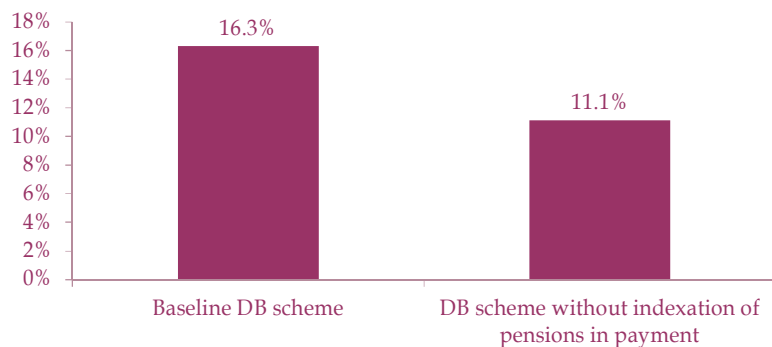
The consultation paper does not stipulate a specific method to convert DB benefits into an equivalent cash value. Instead it suggests two possible options. One option is to calculate benefits on a 'Cash Equivalent Transfer Value' (CETV) basis, as is currently used for member-initiated transfers from a DB scheme to a DC scheme. A second option is to employ a 'Full Buy Out' basis, as is currently used to assess the costs of funding future benefits through an insurer.

The CETV is calculated as the capital sum which, if invested appropriately, is expected to provide the member's benefits as they fall due. By contrast, transfers on a Full Buy Out basis are calculated as the value of the fund needed to buy a deferred annuity at the level of the

Chart 1: impact of removing indexation

PENSIONS POLICY INSTITUTE
PPI

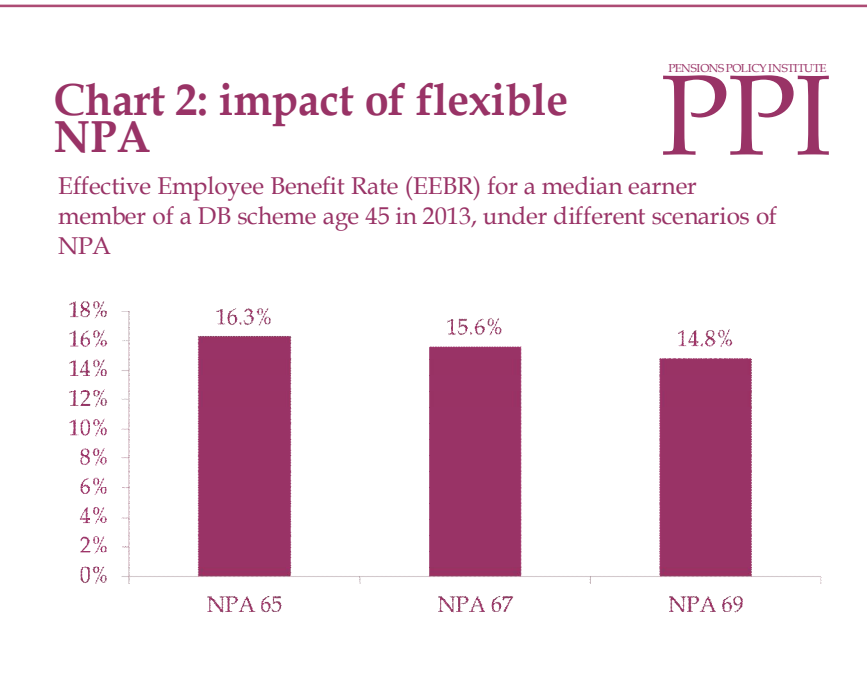
Effective Employee Benefit Rate (EEBR) for a median earner member of a DB scheme age 45 in 2013, under different scenarios



promised pension. Both approaches require a different set of assumptions to be made and the potential difference between the values provided by each approach could be significant. A Full Buyout Basis conversion is more risk averse than a CETV conversion as insurance companies must follow a set of low risk assumptions when pricing annuities. By contrast, conversion on a CETV basis allows for the investment of the fund in a set of riskier assets, albeit with limits, to allow for enough growth in the fund to pay for the equivalent benefits as they become due. As a consequence the value placed on DB benefits on a Full Buyout Basis will tend to be higher than under CETV basis.

The consultation paper also anticipates that under this proposal the sponsor would be required to nominate a default DC fund for transfers when a member leaves employment. This could require the Government to provide some regulations or guidance on what is an appropriate DC fund (e.g. a default fund for a 'qualifying scheme' for the purposes of automatic enrolment) for the member's fund to be fund transferred into when they leave the DB scheme.

All three options could have an impact on the costs of running DB schemes. However, the proposals would apply only to future accruals from the point the new legislation is adopted and once the scheme has made the required changes, which could be as early as 2016. With over 80% of schemes closed to future ac-



cruals or new members, the liabilities associated with pre-2016 accrued rights are likely to dominate employers' funding positions and required contributions to their DB schemes for many years. Therefore, the proposals may have only a limited impact on reducing DB schemes' costs for those employers who are committed to keeping their schemes open.

The Defined Contribution proposals

Employers have moved to providing DC pensions for their members in recent years. In addition, the number of people saving into a DC pension is likely to increase significantly in the upcoming years once automatic enrolment is fully rolled out. This is because with a majority of DB schemes in the private sector now closed to new members

or future accruals, a vast proportion of employers are expected to enrol their employees into a DC scheme. One of the main criticisms of DC schemes is that members face all the investment, inflation and longevity risks, which may lead to a great variation in the retirement incomes of different individuals.

The consultation paper sets out some proposals for DC schemes that seek to provide members with more certainty of their retirement income (Chart 3). The proposals include:

- Money back or capital and investment return guarantees.
- Retirement income insurance.
- Pension Income Builder.
- Collective Defined Contribution schemes.

Money back (MBG) or capital and investment return guarantees (CIRG) ensure that members obtain the same amount that they paid in (money back) or their contributions plus a minimum investment return.

Guarantees may mitigate the investment risk borne by members of a DC scheme. However, the guarantees must be paid for either by the employer or the members. Some empirical analyses have found that the cost of providing capital guarantees can be relatively cheap as they could cost less than 10 basis points of the assets accumulated.⁴ However, this is only if some assumptions relating to minimum years of contributions and a pre-set investment strategy are maintained throughout the accrual period. Relaxing any of these assumptions could increase the estimated cost of guarantees significantly. The guarantees also only relate to the size of the pension fund and not the retirement income that the fund will generate.

The Retirement Income Insurance (RII) model uses a proportion of the member's fund to purchase an income insurance product that insures a minimum level of income, which is expected to grow every year as further insurance is purchased. At retirement the insurance kicks in if the member lives long enough to exhaust their fund.

The Pension Income Builder

(PIB) model is popular in countries such as Denmark and uses part of the contributions to purchase a deferred annuity that guarantees a certain retirement income to each member. For each year of membership, part of each member contribution goes towards a deferred annuity which provides a minimum pension in respect of that year. The rest of the contribution goes to a common pooled fund that is invested in riskier assets and is used to generate growth and pay conditional indexation. In the model illustrated in the consultation, the deferred annuity is not bought from an insurer but is provided from within the fund. Because of the pooling of some of the contributions, this model entails risk sharing among different members.

The Collective Defined Contribution (CDC) model is com-

mon in the Netherlands and it is based on pooling member contributions into a single fund. Employer contributions are fixed and pensions are paid directly from the fund rather than converted into an annuity. Benefits are not guaranteed and in years of underfunding member contributions can be raised and also benefits paid can be cut. As in the PIB, this model also entails risk-sharing among working-age members because of the pooling of contributions into a common fund. In addition, if pensions in payment can be cut, as it is the case in the Netherlands, this model also entails risk-sharing between working-age members and pensioners.

The common feature of all the DC proposals in the DWP consultation is that none of the options place any risk on the employer. Under the different proposed models, the employer would determine their level of contributions into the

Chart 3: the Defined Ambition proposals for DC schemes



Money Back Guarantee (MBG)	Capital and investment return guarantee (CIRG)	Retirement Income Insurance (RII)	Pension Income Builder (PIB)	Collective Defined Contribution (CDC)
<ul style="list-style-type: none"> Guarantee members at retirement the same value of the contributions paid in. 	<ul style="list-style-type: none"> Guarantee members at retirement the same value of the contributions paid. It also guarantees a minimum investment return 	<ul style="list-style-type: none"> Proportion of the member's fund used to purchase a minimum retirement income guarantee. Guarantee kicks in if members exhaust their fund in retirement. 	<ul style="list-style-type: none"> Part of contributions are used to purchase a deferred annuity from the fund. The rest of contributions are invested in a common fund that is used to seek growth and pay conditional indexation. 	<ul style="list-style-type: none"> Fixed employer contributions. All contributions go to a common fund from which pensions are paid. Member contributions can be increased. Pensions in payment can be cut.

scheme but take on no further cost risk.

Chart 4 provides a framework to compare the different models along some dimensions.

In terms of contributions, the different options do not intend to have a direct impact. However, if the options increased confidence in pension saving this could reduce opt-out rates and lead to increasing contributions overall.

Except for CDC, the rest of the options tend to rely on holding more funds in low-risk assets both during the growth phase and in the de-risking phase close to retirement. This may have an impact on the average expected level of retirement income. However, the Pension Income Builder and the Retirement Income Insurance do hold some higher-risk assets during retirement which could offset the impact of holding low-risk assets earlier on.

Most of the models involve a trade-off between the average returns and the upside and downside risk, which is the risk that individuals could have an income in retirement that is higher or lower than expected. Again, the exception is CDC as all contributions are pooled into a common fund from which pensions are paid directly.

The Pension Income Builder and the Retirement Income Insurance models manage downside and upside risk in a

Chart 4: A framework to compare the Defined Ambition proposals for DC schemes



Contributions	Investment Returns	Investment Volatility	Costs and Scale	Pre/At Retirement	During Retirement
Not explicit part of the models, but greater certainty may reduce opt-out and/or encourage higher contributions.	Shift of some or all of the members' fund to lower risk assets pre-retirement. Exception is CDC. PIB, CDC, and RII hold some higher risk assets post-retirement.	Trade-off reducing the upside risks and average returns and reducing the downside risks. Exception is CDC and, to some extent, PIB and RII.	Typically some loading on cost (to pay for a guarantee, or costs of insurance). Where savings are expected typically driven by scale efficiencies.	Focus on guaranteeing some, or all, of the income in the run up to retirement with exception of MBG and CIRG. RII, PIB and CDC do not annuitise at retirement.	Upside risk from PIB to income and indexation. Upside and downside risk from CDC if income allowed to be cut. Upside risk from RII with a floor on downside risk.

more segmented way than the other models. This is because part of the fund is invested in return seeking assets while the rest is used to purchase a retirement insurance product or invested to provide a deferred annuity.

For the Pension Income Builder and CDC in particular, a critical issue is likely to be scale and persistency of contributions. In countries such as Denmark and the Netherlands risk-sharing models are able to deliver good outcomes with reduced volatility and low cost because schemes are organised at an industry or national level and participation in a pension scheme is quasi mandatory.

There is a question on whether enough scale could be achieved in the UK without significant Government or industry inter-

vention. Nonetheless, the introduction of enabling legislation for these DC options could encourage some industry sectors to set up multi-employer DC schemes offering some of these risk-sharing or collective features.

With the exception of the MBG and CIRG, the different models all focus on targeting a retirement income, rather than the pension pot. The CDC, PIB and RII models achieve this in part by not requiring individual annuitisation at retirement.

Finally, the RII and the PIB provide a floor on downside risk during retirement. By contrast, the CDC model has some downside risk if both pension benefits and indexation are allowed to be cut.

Conclusions

The DA options for DB and DC schemes could lead to innovation in pension provision in the UK. However, there are still some significant questions that need to be addressed to ensure DA pensions help to reinvigorate workplace pension provision in the context of automatic enrolment.

For DB schemes with active members, there are timing pressures associated with the abolition of the contracted-out rebates in April 2016. And, for those employers planning to use their DB scheme for automatic enrolment in 2017, with the legislative requirements for a scheme to be a 'qualifying scheme'.

Current legislation stipulates that a qualifying scheme for automatic enrolment must either be contracted out or have benefits equivalent to the level needed for contracting out. With the ending of contracting out and the possible introduction of more flexible DA options for DB schemes that would allow to change the NPA or to provide conditional indexation, the Government will need to clarify what will now be the qualifying requirements for automatic enrolment into DB schemes.

For DC scheme members, the options set out in the consulta-

tion paper could provide more certain retirement outcomes. However, it is not yet clear whether employers will select these schemes or fund choices for their employees or whether members will be willing to pay for the cost of guarantees. More detailed analysis of all the options on a consistent and comparable basis would be required to assess what options would be most suitable or attractive for different employers.

For models such as the Pension Income Builder or CDC some form of Government or industry intervention may be needed to generate the scale to ensure that some of these models can share risks in a sustainable way and provide good outcomes at reasonable costs. In particular, models like CDC will also require strong and transparent governance as decisions will need to be made in future on increasing member contributions or cutting benefits.

Where collective models such as the PIB and CDC are used in other countries, they also rely on quasi mandatory member participation and higher levels of pension contributions than in the UK. For example, the average total contribution rate in the Netherlands⁵ in 2010 was around 16.4% of earnings, whereas the average total contribution rate to occupational

DC schemes in the UK was around 9.4% in 2011.⁶ Higher levels of participation and contribution rates make it easier to models such as the PIB and CDC to take more risk while still delivering good average outcomes for members.

There is also a question on whether the different DA models, once available following the enactment of enabling legislation, could be subject to legislative change by future governments, in the same way that DB schemes have been subject to successive legislative changes over the last 40 years. Given that the main goal of DA pensions is to provide greater certainty for members and control costs for sponsors, further changes to the DA legislation could increase costs for employers. In addition, further changes could increase uncertainty for members and undermine their willingness to save into a pension.

A final important challenge to consider is communications. If employers and members feel that options are too difficult to explain or understand, or that they may lead to unfair outcomes for some groups (e.g. younger members bearing disproportionate risks), then there may be low take up of these options by employers or higher opt-outs from members.

¹ DWP (2013) *Reshaping workplace pensions for future generations*.

² PPI (2012) *The changing landscape of pension schemes in the private sector in the UK*.

³ PPF/TPR (2013) *The Purple Book*.

⁴ Antolin, P et al (2011) "The Role of Guarantees in Defined Contribution Pensions", OECD, p.23

⁵ De Nederlandsche Bank (2010) *Statistical Bulletin March 2010*

⁶ ONS (2013) *Pension Trends*, Chapter 8.

**For more information on this topic, please contact
Dr Leandro Carrera 0207 848 3744**

www.pensionspolicyinstitute.org.uk