

OCCUPATIONAL PENSIONS IN THE PRIVATE SECTOR THE MISSING LINK

“The scale of profits sealed the conspiracy of silence” Simon Schama

INTRODUCTION

The interim assessment report does not assert that commercial interests led directly to the under funding of pension schemes, including those winding up in deficit. But is there any link?

SCHEME DESIGN

There are two main types of scheme design, namely final salary and money purchase. Knowledge of these references will be assumed:-

2003 The Agenda, circulated by the Actuarial Profession, pages 10 and 11

2002 The Edinburgh Debate, British Actuarial Journal number 40, pages 107 to 135

1983 Company Pension Funds: Freedom and Ownership, a report by Stuart Walker

Most large employers adopted final salary schemes long ago, and many other employers have aspired blindly to follow them. The variations within both types are myriad. All designs should be kept under continuous review in the light of actual or expected events, for example the introduction of SERPS in 1978, and of current social trends, such as a widening pay differential. The review purpose is to spot whether any changes are needed. Most changes can be accommodated within the existing type of design. But some changes can occasion a switch from one type of design to the other.

The servicing fee for a complex final salary scheme dwarfs the corresponding fee for a simple money purchase scheme. The incumbent servicing consultant usually gives apparently separate advice on a design review. These “two hats” give rise to the key conflict of interest: this conflict is presumably declared.

In one case, a consultant was asked by an existing final salary scheme client to design a fresh additional voluntary contribution scheme. His assistant drafted for him a money purchase version which without any discussion was destroyed and replaced by a final salary version.

Cross-Subsidies

Unlike money purchase schemes, all final salary schemes involve a number of cross-subsidies. The best known cross-subsidy is from members who leave to members who stay. In 1970, early leavers received no preserved pension at all: presumably this was “pour encourager les autres”. Legislation for their benefit was later introduced in stages: preservation, revaluation and anti-franking. The national interest had required a wider distribution of pensions in payment in order to reduce the overall call on means-tested benefits.

Consultants do not disclose the purpose of cross-subsidies. Are they a justification for the final salary type of design or are they a design effect?

Cross-subsidies mean that there must be winners and losers. Consultants have been known to draw attention to the winners and to keep quiet about the losers. Who cares about the losers?

Sometimes change is initiated wholly by the scheme client. Introduction of the earnings cap, together with the disclosure of pension costs in company accounts, for executive directors and senior staff led to some large schemes switching from final salary to money purchase, either for new entrants only or for all future accrual. This was because these members could no longer manipulate cross-subsidies to their own advantage, for example by substantial pay rises shortly before retirement, and so they were able for the first time to be neutral assessors of the alternative design types.

Winding Up

A scheme client should be aware of three particular properties.

A money purchase scheme is automatically in balance. A final salary scheme may be either in surplus or in deficit.

The priority rule comes into operation when a final salary scheme winds up in deficit. Current pensioners outrank other classes. This represents a crowning cross-subsidy.

A final salary scheme in course of winding up continues to attract service fees. Winding up is a long and complicated process.

Member Interest

Those of us approaching retirement with little or no occupational pension to show for many years of final salary scheme membership are indifferent to the cause: cross-subsidy or deficit or fraud even.

CONCLUSION

There is a key conflict of interest where a consultant advises on both design and service. Commercial interests would drive promotion of the final salary design. And only a final salary type of scheme is exposed to the risk of winding up in deficit.

S M K Walker
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